John Locke FOUNDATION

spotlight

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How to Pay State Employees

Compensation Model Cannot Keep Good State Employees

SUMMARY: **State government needs pay its employees differently if it wants to keep the best of them. The average state employee earns as much as the average employee nationally, but across-the-board pay raises fail to reward employees for performance. Employees who choose to work for the state are more risk averse and may stay despite a lack of productivity. But these employees merely substitute unseen political risk for visible market risk. The General Assembly should consider more pay for performance and portable benefits for state employees.**

If North Carolina state government wants to attract and keep productive and ambitious workers it needs to reform its compensation system. The current system rewards longevity rather than productivity and does not attract those workers who value the ability to advance themselves through greater productivity. Flat-rate pay hikes – whether four percent, five percent or eight percent – reward employment status not performance. This Spotlight looks at the current structure of compensation for state employees, how it differs from the private sector and suggests how it might be reformed to attract more productive workers.

A new requirement that state and local governments report their future health care obligations takes effect next year.[1] It presents the greatest fiscal threat on the horizon for the state. After five years of employment, North Carolina state employees are guaranteed full health coverage after retirement until they qualify for Medicare.[2] State employees have been able to avoid many of the changes in health care and other benefits their private sector peers have faced. The new reporting requirement may force the General Assembly to reconsider how state employees are paid.[3] In the process, taxpayers and effective state employees may gain.

One of the most difficult balancing acts for any government is to provide the services its residents demand without creating excess burden on taxpayers. As the health care example demonstrates, North Carolina's compensation methods do little to achieve that balance.

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Total Compensation

Using the state's employee compensation website, one finds that the average state employee in 2005 with 10.5 years of service and a base salary of $36,189 has benefits equal to another $15,727.[4] Nearly a third of a state employee's compensation comes in the form of benefits. The state is not very different from other employers in the dollar value of compensation. The 30.3 percent of compensation that comes in the form of benefits is only slightly higher than the national average of 29.1 percent for private sector employees (see Figure 1).[5] Two pieces missing from the state compensation numbers, however, are worker's compensation and unemployment insurance – both legally required benefits.

Figure 1: Benefits as Share of Compensation, 2005

	NC State Employees		National Avg. All Sectors		National Avg. Private Industry	
Paid Leave	11.7%	6,094	6.7%	3,540	6.5%	3,220
Legally Required Benefits	5.3%	2,768	8.1%	4,300	8.7%	4,280
Retirement and Savings	4.4%	2,280	4.3%	2,260	3.6%	1,780
Insurance	7.8%	4,042	8.0%	4,260	7.3%	3,620
Longevity Pay	1.0%	543				
Other Benefits			2.6%	1,380	3.0%	1,500
Total Benefit Value	30.3%	15,727	29.7%	15,740	29.1%	14,400
Total Base Pay		36,189		37,180		35,020
Total Compensation		51,916		52,920		49,420

Source: NC Office of State Personnel, US Bureau of Labor Statistics

It is not just the level of benefits that is important, however, but also the type of benefits an employer offers. Stanford University Professor Paul Oyer writes:

> Government and not-for-profit employers are much more likely to provide a package of benefits that might be valued by employees interested in long-term employment relationships. … This is consistent with government and non-profit employees being risk averse and seeking stable employment without long hours.[6]

Oyer categorizes "health insurance, dental insurance, maternity leave, on-the-job training, life insurance, and a retirement plan" as a "tenure package" that appeals to those who want long-term employment. North Carolina state employee benefits fit this pattern, particularly with the addition of longevity pay and extensive paid leave, as shown in Figure 1.

Smaller Raises for Everybody

The General Assembly froze merit pay increases in fiscal year 1982 and has only provided money for merit increases three times since then – in fiscal years 1986, 1989 and 1990. In fiscal year 1998, the General Assembly passed a one-percent performance bonus for state employees. From fiscal year 1996 through fiscal year 2000, the state did provide two-percent "career growth" raises for employees with good performance appraisals.[7] Since then, however, compensation increases have been meager and based on employment status, not performance.

It is not average pay that is the problem, but the narrow distribution of wages that makes high-performing workers leave state government.[8] Poorly performing employees have generally continued to receive pay raises in the one-percent to two-percent range for the past decade. Better performing employees have seen even the modest career growth increases they received in the late 1990s disappear since fiscal year 2000-01.

Figure 2: Compensation Increases under Gov. Easley

Fiscal Year	State Employees	Teachers	CPI
2001-02	1.9%	2.86%	1.8%
2002-03	0.0%	1.84%	2.2%
2003-04	0.0%	1.81%	2.2%
2004-05	2.5%	2.5%	3.0%
2005-06	2.0%	4.2%	3.0%
TOTAL	6.5%	13.9%	12.8%

NOTES:

2001-02: An across-the-board flat rate of $52.08 per month was provided for all employees, equivalent to average 1.9%.

2002-03: Full-time state employees received an additional 10 days vacation.

2003-04: Full-time state employees received an additional 10 days vacation plus a one-time bonus of $550.

2004-05: State employees received the greater of one thousand dollars ($1,000) or two and one-half percent (2.5%).

2005-06: State employees received the greater of eight hundred and fifty dollars ($850) or two percent (2%).

2005-06: Includes November 2005 pay increase for teachers.

SOURCE: Office of State Personnel, Dept. of Public Instruction

Since Gov. Mike Easley took office in 2001, the average state employee salary has increased 6.5 percent including a flat-rate increase of $624.96 in FY2001-02. Teachers' salaries have risen 13.9 percent. In the FY2005-06 budget, which gave teachers two raises totaling 4.2 percent, state employees could only muster a 2 percent raise with a guarantee of $850 for their lowest-paid colleagues.[9] A late attempt to raise that minimum to $1,000 failed on the House floor. The General Assembly, taking the European approach, instead offered five days of bonus leave for those on staff by September 1, 2005.[10] This is consistent with the model of government employee compensation described by Oyer.

Figure 3: Turnover Rate FY2001-02 through FY2003-04

	2001-02	2002-03	2003-04	2004-05	3-yr Average
NORTH CAROLINA					
Voluntary	9.4%	8.4%	8.6%		8.8%
Total*	13.9%	12.8%	12.6%		13.1%
STATE AND LOCAL GOVERNMENT					
Voluntary	7.4%	7.0%	6.9%	7.6%	7.1%
Total*	14.5%	14.7%	14.7%	15.2%	14.6%
PRIVATE INDUSTRY					
Voluntary	24.2%	22.4%	22.3%	25.2%	23.0%
Total*	44.5%	42.0%	42.6%	45.4%	43.0%

*Includes voluntary, retirement, layoff

Source: NC Office of State Personnel, US Bureau of Labor Statistics

Paying for Performers

The combination of across-the-board salary increases, defined-benefit pensions, and traditional health insurance attracts workers who are more interested in a stable paycheck and benefits than in potentially higher rewards now or in the future, though with commensurately higher risk. These tend to be the most motivated and productive workers. Oyer summarizes: "It appears people sort to [employers] based on their demand for benefits."[11] North Carolina gets the kind of workers that its compensation package would be predicted to attract.

Despite complaints about losing workers to the private sector, the Office of State Personnel's Compensation Report shows that total turnover in state government from fiscal year 2001-02 through fiscal year 2003-04 was less than voluntary turnover in private industry (see Figure 3).[12] While it may be true that the state is not able to retain its best employees, it is clear that the state is able to keep employees as a whole. But these are not the most ambitious and productive workers, who tend to use state jobs as a stepping-stone for private sector jobs that have the prospect for greater pecuniary rewards.

This example makes clear the need to change the way state government rewards employees if it is to meet the increasing demand for government services. One example of a results-focused approach is the payment of bonuses for lottery staff who worked to make games available before March 31. The Office of State Personnel has recommended rewarding all employees for "performance and competencies."[13]

Risky Promises

The advantages of government employment are greatest in poor economic times. State employees are less likely to be laid off. Flat wages are better than a complete loss of work and wages, as can happen with layoffs in the private sector regardless how well the individual employee or her division performs. As large companies, such as United Airlines, have transferred their pension liabilities to the Pension Benefit Guaranty Corporation, others, such as General Motors, have reduced health benefits to their employees. Others have converted their benefits to defined contribution plans such as 401(k) retirement programs or health savings accounts. In addition to helping the corporation save money, such moves increase the portability of retirement and health benefits for employees and make the employee less dependent on the future performance of the company. Both features remove risk and strengthen the financial position of employees.

The current rebounding economy may lead to more state employees moving back to the private sector and the potential for higher pay. State government simply cannot compete with the salaries available for high performing individuals as long as it attempts to carry out tasks it should not and fails to differentiate individuals based on performance instead of seniority. The traditional benefits package is becoming more expensive for both the state and its employees, but leaves employees at the mercy of legislators to fully fund their raises, pensions and health care. Given the General Assembly's proven inability to provide promised funds for merit pay, and the likely shortfall in health care financing for retirees under new reporting rules, state employees are wise to consider alternatives.

Positive Steps

The State Health Plan has begun to offer a PPO for state employees. Under its new director, the Health Plan has become more professional. It has even begun consideration of a Health Savings Account option for state employees. The organization can provide lessons for the rest of state government, and the new plans can ease some of the burden of providing insurance for state employees while shifting some of the risk to them from taxpayers.

Career banding, for all its problems, is one way that some state agencies have begun to address inequitable salaries. Part of the process involves comparing salaries with other departments and with the private sector to determine market rates for different jobs.

Overall, however, current compensation practices in state government do little to encourage innovation and customer service. The best state employees should be rewarded with compensation that acknowledges their abilities and efforts. Filling seats in government is less important than getting the right person in the right seat. North Carolina does not need to take the Jack Welch approach of eliminating the bottom 10 percent each year, but for the sake of state employees, government service recipients and taxpayers, the General Assembly needs to find a way to reward the state's best performers.

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Notes

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13. *Ibid.*, p. 2.