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FROM *THE ANALYSIS OF THE 1994-95 BUDGET BILL*

STATE EMPLOYEE COMPENSATION ISSUES FOR 1994-95

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March 1994

STATE EMPLOYEE COMPENSATION ISSUES FOR 1994-95

What Issues Does the Governor's Budget Present in the Area of State Employee Compensation?

Summary

A major portion of state government expenditures is for compensation of state employees. Expenditures for state employee compensation (excluding higher education employees) will approach $10 billion in 1994-95.

There are three major initiatives in the area of employee compensation in the Governor's Budget for 1994-95:

- *The budget assumes a 10 percent reduction in the number of managers and supervisors in state government.*
- *The budget assumes the institution of a "pay-for-performance" policy for managers in lieu of previously authorized cost-of-living adjustment (COLA) increases.*
- *The budget proposes additional funds for approximately $73 million of the $133 million cost of the employee salary COLA increase scheduled for January 1995. The balance of these costs would be absorbed within the operating budgets of most state departments.*

Each of the above initiatives raises significant issues for the Legislature. In this reprint from the ***Analysis of the 1994-95 Budget Bill****, we discuss these issues and options the Legislature should consider in enacting a Budget for 1994-95.*

Overview of Employee Compensation Issues

A major portion of state government expenditures is for compensation of state employees. The Governor's Budget projects $7.8 billion of salary and wage expenditures for 183,500 authorized positions in 1994-95. These amounts do not include $3.5 billion for 85,000 state higher education positions. Accounting for employee benefits, and again excluding higher education employees, expenditures for state employee compensation will approach $10 billion in the budget year.

There are three major initiatives in the area of employee compensation in the Governor's Budget for 1994-95. These are:

- The budget assumes savings of $150 million ($75 million General Fund) in 1994-95 by reducing the number of managers and supervisors in state government by 10 percent.
- The budget assumes savings over the current and budget years totaling $28 million ($14.5 million General Fund) from institution of a "pay-for-performance" policy in lieu of previously authorized cost-of-living adjustment (COLA) increases.
- The budget proposes to allocate approximately $73 million in additional funds for the $133 million cost of the COLA increase scheduled for January 1, 1995. The balance of these costs would be absorbed by most state departments from their operating budgets.

We discuss the Governor's proposal regarding funding the general salary increase in detail in our analysis of the Augmentation for Employee Compensation (Item 9800). We discuss the reduction of manager and supervisor positions and the pay-for-performance policy below.

Ten Percent Reduction in Manager and Supervisor Positions

We recommend that the DPA and the Department of Finance provide to the fiscal committees the administration's department-by-department implementation plans for reducing manager/supervisor positions well in advance of May Revision letters.

As mentioned above, the budget assumes savings of $150 million ($75 million General Fund) in 1994-95 by reducing the number of managers and supervisors in state government by 10 percent. According to the Department of Personnel Administration (DPA), there are currently about 28,500 supervisors and managers overseeing the work of 140,000 full-time and part-time civil service workers. To accomplish this "downsizing" task, the DPA has imposed a freeze on appointments to management and supervisor positions in civil service, and has asked all state departments to submit plans to reduce manager/supervisor positions by 5, 10, and 15 percent. The plans are to be submitted to the DPA and the Department of Finance by March 1, 1994.

The $150 million savings estimate used in the budget is equivalent to approximately 10.5 months of the average salaries and benefits of existing manager/supervisor positions, applied to 10 percent of those positions. This is an optimistic savings projection. The sheer number of managers and supervisors involved in this proposal, combined with the elaborate nature of the civil service process, means that the 10 percent reduction may not be completed before September (as assumed by the budget totals). Moreover, many of those "demoted" to nonmanager/supervisory positions may be entitled under civil service laws to be paid at or very near their current salary levels, in which case assumed salary savings would be overstated. Finally, the initiative's success will depend to a great extent on receiving support, rather than resistance, from the departments and agencies that actually will be called upon to implement the reductions in their own organizations.

As a general concept, we believe reducing layers of management in California state government has merit. In actual implementation, however, legitimate concerns could arise regarding the pace and manner in which the reductions proceed, and consequent fiscal and program impacts. Given these potential concerns, we believe the Legislature should review the administration's department-by-department implementation plan. This information should be available for the Legislature's review well before the May Revision submittals, given the March 1 due date for departmental proposals to the DPA and the Department of Finance. Accordingly, we recommend that the DPA and the Department of Finance provide to the fiscal committees the implementation plans for reducing manager/supervisor positions well in advance of May Revision letters.

Pay-for-Performance Policy for Managers

We recommend that the DPA and the Department of Finance, prior to budget hearings, address concerns about the pay-for-performance policy for state managers. These concerns include (1) possible infringe-

ment on the Legislature's appropriation authority, (2) issues of basic fairness toward managers in state service, and (3) issues raised in a related lawsuit against the state.

On December 8, 1993, the Governor announced a new compensation policy for the approximately 4,000 managers in state government. On December 10, the DPA issued the following directives in order to implement the Governor's policy:

- A previously authorized COLA increase of 5 percent, due on January 1, 1994, was cancelled for all exempt and civil service *managers*. A second salary increase (of 3 to 5 percent depending on inflation), scheduled for January 1, 1995, also was cancelled.
- *Civil service* managers would be eligible to receive salary increases of *up to* 5 percent, at the discretion of their appointing power, provided that the appointing power certifies that the manager is performing successfully. (The budget further requires that departments fund any pay increases out of existing resources.)
- Department directors have the discretion *not* to authorize any pay increases for managerial employees during the current year.
- Exempt managers (appointed non-civil-service positions) will not receive any pay increase and most will continue until further notice on the "personal leave program," which reduces monthly pay by almost 5 percent in exchange for leave credits (similar to vacation credits) of one day per month.
- All salary increases for managers *after* January 1, 1994, will be subject to annual performance reviews, on the basis of which increases may be withdrawn or reduced.
- Performance pay decisions will be subject to appeal only on the basis of "political affiliation" issues or legally prohibited discrimination.

Finally, the DPA memorandum states that the department will develop a similar program for supervisors for implementation by January 1, 1995, and that it will pursue performance-based pay for rank and file employees in future collective bargaining.

As the DPA memorandum acknowledges, the pay-for-performance policy is a significant departure from the state's traditional approach to managerial pay. In our view, *the concept of reforming the state's process for granting merit pay increases has merit and deserves serious consideration.* We have the following concerns, however, with the specific actions taken by the administration.

The Actions Infringe on the Legislature's Appropriation Authority. The Legislature appropriated funds under Item 9800 of the 1993 Budget Act with the clear understanding that the purpose was for general salary increases for all state employees, including managers. Changing to a performance-based criteria for the increase for managers may be within the legal prerogatives of the DPA. In our view, however, the administration's budgetary actions infringe on the Legislature's appropriation authority in the following two respects:

- The 1993 Budget Act includes provisions stating that the funds appropriated for augmentation of employee compensation are to be allocated by the Department of Finance ". . . in such amounts as will make sufficient money available for each state officer or employee in the state service . . . to receive any such increases provided on or after July 1, 1993, by the Department of Personnel Administration . . .". The Governor, however, intends not to spend the funds appropriated for manager pay increases and instead to require departments to absorb pay-for-performance increases within existing resources.
- By requiring departments to absorb the costs of the current-year pay-for-performance program within existing resources, the budget redirects funds appropriated by the Legislature for a variety of programs to a new, and unrelated, pay program never authorized by the Legislature.

The Actions Confuse the Purposes of a General Salary Increase Related to Inflation and a Merit Increase. There are two basic types of pay increase—one intended to compensate for inflation and one intended to reward meritorious performance. The 5 percent salary increase negotiated by the DPA for represented employees and previously authorized for nonrepresented employees (including managers) was specifically for a COLA to compensate employees for inflation. In fact, the salary increase effective January 1, 1995 is set at 3 percent to 5 percent, dependent on a cost-of-living index. Since inflation equally affects all, across-the-board COLAS make sense. Whether or not a COLA should be granted to state employees under current fiscal circumstances is a valid issue. Objections to a COLA because of its across-the-board nature, however, misread its purpose.

The state's practice for giving "merit" salary increases is another matter. Under state law, there is a completely separate process for the granting of "merit" pay increases to state employees. In theory, this process recognizes meritorious work and provides for appropriate salary adjustments. In practice, however, the merit pay increase process has become virtually an across-the-board entitlement program. This has effectively defeated the purpose of a "merit" process. A true pay-for-performance policy *and practice* are needed. To accomplish a true reform in this area will require the involvement of the Legislature and the administration to recast the laws, regulations, and practices surrounding merit pay. The administration's action, unfortunately, confuses two types of pay increase that have entirely different purposes. It also provides no basis for assuming that there will be improvements in the current merit pay practice. For instance, if most agencies grant performance pay to virtually all eligible managers, there will have been no fundamental change. In fact, this is what has happened on the first round of the pay-for-performance programs. Based on information from the State Controller's Office, the vast majority of departments granted the maximum 5 percent increase to virtually all eligible managers.

The Action Raises Issues of Basic Fairness. Given that the purpose of the general salary increase was to adjust employees salaries for inflation, it is unfair to deny it to managers and grant it to everyone else. Another potential issue of fairness arises from the budget's requirement that departments absorb pay-for-performance raises granted to managers within existing resources. There are undeniably sharp differences among departments in their capacities to absorb additional costs. Inevitably, there will be cases of excellent managers in "poor" departments going unrewarded while mediocre managers in "rich" departments receive increases.

The Policy Does Not Adequately Reward Excellence. The action converts a 5 percent COLA increase for all managers into a 5 percent increase for (presumably) only the best managers, while leaving in place a 5 percent COLA increase for other employees. We think this sends the wrong message to those managers who are doing the best work for the state. A policy designed to reward and encourage excellence should at least provide salary increases greater than those given to other employees regardless of their performance. It also should guard against the possibility of supervised employees making more than their manager.

We recommend that the DPA and the Department of Finance address all of the above concerns prior to budget hearings.

We would also note that on January 14, 1994, Senator Alfred E. Alquist, the California State Managers and Supervisors Association, and the California Association of Highway Patrolmen filed suit against the DPA to overturn the pay-for-performance actions. The suit makes two basic claims:

- That the administration violated the constitutional separation of powers by diverting funds appropriated by the Legislature.
- That the imposition of the pay-for-performance program violates existing statutes regarding a manager bonus program, merit salary increases, and salary ranges.

The Superior Court in Sacramento has ordered the DPA to show cause why the pay-for-performance program should continue in lieu of a general salary increase for managers. At the time this *Analysis* was prepared the case was scheduled to be heard April 1, 1994.

AUGMENTATION FOR EMPLOYEE COMPENSATION (9800)

The budget does not provide the amounts needed to fully fund employee pay increases in 1994-95. In addition, our review identifies other problems with the administration's approach to employee pay increases in the current year and budget year.

Background. Under approved memoranda of understanding (MOU's) for the three years 1992-93 through 1994-95, represented state employees:

- Received a 5 percent pay increase on January 1, 1994.
- Are scheduled to receive a 3 to 5 percent increase (depending on inflation) on January 1, 1995.

In July 1992 the Department of Personnel Administration (DPA) approved identical increases for nonrepresented employees.

The purpose of Item 9800 is to provide the funds needed for the pay increase that becomes effective January 1, 1995. When the pay increase takes effect, the Department of Finance allocates funds from this item to the various departments. (The full-year effect of the January 1994 increase is already built into each department's budget for 1994-95 rather than included in this item.)

We have identified three major issues with the budget's approach to funding the pay raises in 1994-95. We discuss these issues below.

The Budget Overstates the Likely Rate of Pay Increase

According to the Governor's Budget, the MOU's authorize a January 1995 pay increase (cost-of-living adjustment (COLA)) of between *3.5 percent* and 5 percent, depending on inflation. The budgeted amounts are based on an assumption that the pay increase will be at the minimum—3.5 percent. However, the MOU's actually authorize a minimum increase of *3 percent.* Considering the inflation index that the MOU's specify for the purpose of calculating the increase, and the time period over which inflation is to be measured (first quarter 1993 to first quarter 1994), it is almost certain that the 3 percent minimum increase will govern.

As a result, the budget overstates the likely cost of the January 1995 increase. The budget assumes that the 1994-95 cost of the pay (and related benefits) increase for all state employees will be approximately $158 million. Using instead the 3 percent inflation factor, the 1994-95 costs will be approximately $133 million. (In our estimate we also assume a lower factor for those benefit costs that are tied to salary/wage increase than assumed by the administration.)

The Budget Forces Most, But Not All, Departments to Absorb the Pay Increase

Although projecting total costs for the 1995 pay increase of $158 million on the basis of a 3.5 percent raise, the budget includes only $72.7 million ($50.9 million General Fund) to fund the increase under Item 9800.

Departments do not have discretion to deny the pay increase to represented employees, except for managerial staff (another issue discussed below). Therefore, the fact that the budget does not fully fund the costs of the raises means that most departments must absorb the unfunded portion within existing resources. Under the administration's approach not all departments and programs are to be treated alike. The budget states that Item 9800 funds will be allocated only for pay increases for employees who ". . . provide direct public safety, 24-hour care services or are major revenue producers."

According to Department of Finance staff, funds will be allocated to only 14 departments, to the extent that they have employees meeting this definition. Figure 1 lists these departments and the estimated amounts that would be allocated.

Approximately $21.3 million of the total amount not provided for the January 1995 pay increase is related to pay increases for managers, a special case under the administration's proposal that we discuss below.

The Budget Deletes Funds for Pay Increases for Managers

On December 8, 1993, the Governor announced a new compensation policy for the approximately 4,000 managers in state government. On

Figure 1

Augmentation for Employee Compensation Programs To Receive Funds for January 1995 Increase

(Dollars in Thousands)

Department/Program	General Fund	Other Funds	Total
Public Safety:			
Corrections	$35,614	$538	$36,152
Forestry and Fire Protection	3,135	1,229	4,364
Youth Authority	1,550	3	1,553
Highway Patrol	—	7,039	7,039
State Police	—	314	314
Alcoholic Beverage Control	—	152	152
24-Hour Care:			
Developmental Services	3,879	3,461	7,340
Mental Health	1,637	2,419	4,056
Veterans' Home	350	221	571
Special Schools	643	44	687
Revenue Producers:			
Board of Equalization	1,477	864	2,341
Franchise Tax Board	2,258	107	2,365
Employment Development	196	5,448	5,644
Conservation	112	—	112
Totals	**$50,851**	**$21,839**	**$72,690**

December 10, the DPA issued directives to implement the policy. Among the actions taken, the DPA cancelled the previously authorized COLA for managers scheduled for January 1994 and January 1995. In place of the COLA, *civil service* managers are eligible to receive salary increases of up to 5 percent, provided their department certifies that the manager is performing successfully. (Managers exempt from civil service will not be eligible for either a COLA or a pay-for-performance increase.)

If departments grant pay-for-performance increases to managers, they must do so within existing resources. Accordingly, the budget indicates that the administration will not spend the $7 million ($3.5 million General Fund) appropriated under Item 9800 of the 1993 Budget Act and earmarked for managerial pay increases. As discussed in our overview of employee compensation issues in the Crosscutting Issues section of this chapter, we believe the reversion of funds, combined with the granting of pay increases from existing departmental appropriations, is inconsistent with the provisions of Item 9800 of the 1993 Budget Act.

In 1994-95, the budget assumes savings of $21.3 million ($11 million General Fund) from cancellation of the COLA for managers and the requirement that most departments absorb pay-for-performance increases within existing resources.

Options for the Legislature Regarding Employee Pay Increases

The Legislature has four basic options in approaching employee COLA pay increases in 1994-95: (1) approve as budgeted, (2) fully fund the pay increases, (3) require all departments to absorb the pay increases, and (4) cancel or reduce the size of the pay increase. Given the state's current fiscal situation, and the consequent pressures on the provision of program services to the public, we believe the last of these options is the most appropriate.

The Legislature has four basic options in approaching COLA pay increases in 1994-95. We discuss each option below.

Approve as Budgeted. We believe the approach taken in the budget is flawed in several respects, as follows:

- *Fairness.* Denying a COLA to managers and granting it to all other state employees raises an issue of basic fairness. Also, it is inevitable under the budget approach that excellent managers in "poor" departments will not receive pay-for-performance increases while mediocre managers in "rich" departments will.
- *Hidden Program Impacts.* All but 14 departments must absorb the COLA for nonmanagerial employees within existing resources. In addition, all departments must absorb pay increases that may be granted to managers. We estimate that the amount that would have to be absorbed across state government would range from $52 million to $56 million, depending on the extent to which manager pay raises are granted. Given all the other costs that departments have had to absorb in recent years, this additional requirement is bound to have impacts on the delivery of program services to the public.

If the Legislature wishes to proceed with the funding approach proposed in the budget, we would recommend that the Legislature reduce Item 9800 by a total of $9.6 million ($7 million General Fund) to account for the likely 3 percent pay increase (rather than the 3.5 percent rate assumed in the budget) and a lower factor for benefits.

Fully Fund Employee Pay Increases. This approach would require augmenting the budget. In the present fiscal context, this would mean making reductions elsewhere. We estimate that an additional

$73 million ($24 million General Fund) would be needed to fully fund employee pay increases, including $16.8 million ($8.6 million General Fund) for restoration of COLA increases for managers.

Require All Departments to Absorb Pay Increases. This approach would reduce net expenditures compared to the budget by $58.7 million ($43.9 million General Fund), and would create unknown program impacts. On the other hand, the administration has provided no evidence that the 14 departments that would receive additional funding in the budget for employee compensation are less able than other state departments to find economies in their operations.

Not Grant the Pay Increase Scheduled for January 1995. This approach would (1) save the state $58.7 million ($43.9 million General Fund) and (2) eliminate the need for up to an additional $56 million of hidden program reductions statewide (by relieving departments of the obligation of funding pay increases with existing resources).

Each of the seven bills enacted to ratify the 21 negotiated MOUs with represented employees includes a section specifying that any MOU provision which is scheduled to take effect on or after July 1, 1993, and which requires the expenditure of funds, shall not take effect unless funds for these provisions are specifically appropriated by the Legislature. Each measure further states that in the event funds for any of these provisions are not appropriated, the state and the affected employee organizations shall renegotiate the affected provisions.

As a result, the pay increase scheduled for January 1995 is conditioned on the Legislature appropriating the funds requested under Item 9800. Thus, the Legislature has the option of saving $58.7 million ($43.9 million General Fund) by not approving the pay increase. Alternatively, the Legislature could save lesser amounts by providing for a smaller pay increase.

Given the state's current fiscal situation, and the consequent pressures on the provision of program services to the public, we believe the option of not granting the COLA is the most appropriate of the options available to the Legislature.

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