TOTAL REWARDS
PREPARING TO PAY THE NEXT GENERATION OF STATE GOVERNMENT WORKERS

OPENING STATEMENT/POSITION

While general compensation trends in the marketplace continue to evolve and impact all types of organizations, state governments may be affected most of all. This is true for several reasons: 1) both public-and private-sector organizations are facing the retirement of a significant number of their workforce over the next few years and will likely have to hire both "first job" millennials and mid-career people from other sectors to fill the gaps; 2) just like the private sector, government employees are having to do more with less, meaning that the skill set and performance expectations for the jobs will need to be enhanced ; and 3) total compensation (salary + benefits) for state government employees is not as competitive with the rest of the marketplace as some would have you believe.

For state governments to be able to attract and retain their next generation workforces, they will have to go to market with a total compensation value proposition that includes tangible and intangible rewards. Performance-based rewards may also have to be considered, changing the culture and employment expectation of many public organizations and allowing them to recruit new generation employees who may only stay for several years before moving on but have critical skill sets needed to deliver on the promise of doing more with less and doing it in a customer-centric fashion. States will also have to focus on the "mix" of compensation more — the value of each compensation component, such as base salary, benefits, retirement, perquisites, etc. — rather than just relying on a strong benefits and/or pension to get people in the door and keep them.

That said, public-sector employers and staff are wary of changes to reward programs. They fear the potential cost and pain; some can't see the need. Yet, there are significant gains available if the process is handled in the right way. And, the pressure for change is building.

In some ways, this is a quiet time for public-sector pay. There has been somewhat of a policy lull as cost pressures have limited or stopped pay increases; and proposals for pension reforms have drawn attention away from salaries to benefits.

Yet, this could also be an artificial calm before a greater storm. Public-sector organizations will need to draw greater value for money from their pay systems as financial cuts are implemented — which could mean reducing costs, increasing flexibility, improving the impact pay has on motivation and performance, or all these things together.

Employees have been faced with frozen pay and reducing standards of living and changes to retirement ages, pension contributions and values. The employment "deal" is being changed before their eyes. Satisfaction and acceptance of "the deal" has also changed radically. Ultimately, governing boards are elected and subject to the pressures of their constituents — including both the public and unions. This combination of employer and staff pressures could and should lead to a change in how compensation is viewed and delivered.

BACKGROUND

The news media, politicians and public opinion is often drawn on political lines, with conservative editorial pages often taking the side of Legislatures/Governors and the more liberal media taking the side of public-sector employees and their unions. As long as economic times are a challenge, unemployment remains high and state, city and county budgets are "in the red," these stories will continue to stay in the news cycle.

There is significant debate on the definition of what is fair and appropriate compensation for public-sector employees. The guidance typically provided in the private sector by revenue isn't present in the public sector; however, there are other measures of value that can be used — for example, meeting project goals, customer satisfaction measured by surveys, and internal efficiency targets.

Budgets are tight or decreasing, while citizens' expectations of services and the more efficient use of taxpayer dollars is rising. Pay delivery will be the key going forward, not pay structures that emphasize annual step increases or reward time in grade. Given the slow or seemingly nonexistent movement (adjustment) of pay structures and the tightness and difficulty with budgets to help with the retention of employees, state governments are looking for better and more flexible ways to allocate salary budgets — especially to those employees who deserve it most, either by performing at higher levels, bringing critical skill and behavioral sets to the table, and/or demonstrating high customer competencies. Also, the "mix" of cash and benefits is getting addressed more often now than ever before. While keeping the total reward expenditure the same, it is becoming more prevalent that the allocation between cash and benefits is changing. Indeed, a defined benefit pension plan is of little value with a more highly portable, mobile workforce.

When recruiting employees at any level, state governments and other public-sector employers have typically drawn on the possibilities for better work-life balance and flexible working schedules to offset lower pay compared to the private sector. This is a mistake in current times. What attracts both Generation Y candidates and longer-tenured private-sector candidates is the possibility for challenge provided by the scale and complexity of the work, combined with the prospect of making a real and personal impact on more than just the bottom line. States will have to decide whether they are going to continue to try and "buy and hold" employees for the long term or "hire and train" employees with the understanding that many new employees will only stay for several years at most.

Rather than positioning a job as in the public sector, state governments may be more successful recruiting candidates at all levels by taking a page from the private sector and marketing and branding it, for example, as a role working in one of the largest financial services organizations on one of the biggest transformation projects of its kind. There is also, of course, a minimum in terms of salary for these candidates, and they particularly value the opportunity to earn performance related pay although there have to be clear objectives with measurable metrics for this to work most effectively.

It should be remembered that pay programs alone do not lead change efforts, they only support and reinforce them. Change will always be led by leadership of the organization, the vision they promote, and the perceived opportunity to make a difference in the organization. The key employment proposition will not be pay, but impact.

PUBLIC-SECTOR COMPENSATION: PERCEPTION VS. REALITY

All too often public sector organizations follow the mantra that as long as benefits are strong, then salary does not need to be competitive. Indeed, employees in the public and private sectors have been/are compensated differently over the course of a career. Following is a look at some assumptions for a career earnings comparison focusing on base salary and the retirement benefit:

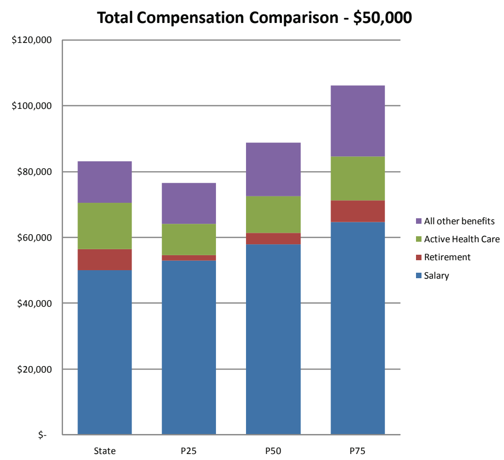
Assumption:	Private Sector	Public Sector
Age at Hire	25	25
Salary at Hire	$40,000	$36,000
Annual Salary Increase	4.00%	3.00%
DB Formula	1.50%	2.00%
Rate of Return (DC)	7.50%	7.50%
Employer Contr. (DC)	4.00%	0.00%
EE Contr. (DC)	6.00%	3.00%

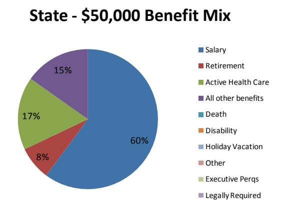
As shown, the public sector employee shown in the table above will earn less salary than a private sector employee over the course of a career. The result — shown below — is lower retirement income, despite the above median pension benefit formula.

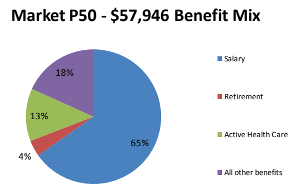
Result:	Private Sector	Public Sector
Retirement Age	65	65
Years in Retirement	20	20
Career Earnings	$3,993,061	$2,831,879
Pension Annuity	$76,734	$68,864
Pension Total Benefit	$1,534,678	$1,377,281
Defined Contribution Annuity (ER Contributions Only)	$50,653	-
Defined Contribution Total Benefit (ER Only)	$1,013,063	-
Defined Contribution Annuity (ER + EE Contributions)	$126,633	$29,608
Defined Contribution Total Benefit (ER + EE)	$2,532,569	$59,160
Grand Total - Career Earnings Plus Retirement DB Only for Private and Public Sector	$5,527,740	$4,209,160
Grand Total - Career Earnings Plus Retirement Private Sector - DC Only, Public Sector - DB + DC	$6,525,720	$4,801,320

Relying on the strength of the retirement benefits package — perceived or actual — may not be enough.

The chart below shows the total compensation picture for a $50,000/year salary employee at a State that has a strong benefits program (including retirement, healthcare, etc.), but pays salaries at P25 of the private sector market.







Consider here the healthcare benefit: employee contributions toward the cost of coverage are the sole basis for determining value, when in reality healthcare costs occur at two events, not just one:

1. At the pay check (contribution to premium)
   – Employee coverage only
   – Employee and family

2. At the point of service (co-pay, out-of-pockets, deductibles, maximums, etc.)

Both of these events need to be considered when determining the overall level of competitiveness. The Affordable Care Act will not only impact these Cadillac plans, but may also impact an organization's approach to healthcare in the future.

The discussion above shows that some or all of the following elements are often missing in the debate about public-sector compensation:

1. It is not done within the context of total remuneration (salary AND benefits)

2. It is not done within the context of a clearly defined labor market (which segments are our attraction and retention targets)

3. There is a lack of understanding that "one size does not fit all" (employees are expecting a different "mix" of packages depending on their demographic)

4. It is not done within the context of a sound and defensible compensation philosophy (against which markets do we compare and at what levels in that market are we positioned)

The balance of this brief puts these challenges in context with some suggestions for action.

EXAMPLES OF WHERE WE MIGHT SEE THIS ACTION TODAY:

State of Utah

Issues: What is the best appropriate salary/benefit mix that balances fiscal responsibility with market competitiveness? Where Utah is not competitive with the market, what immediate and long-term options should it consider in reorganizing its total compensation mix?

Findings: The State's **total compensation** program is market competitive when compared to both the private sector and a regional peer group of states (their defined comparator market).

- **Cash compensation** lags the market by an average of 10 percent.
- **Benefits** are at or above the median of both markets for all employees, driven by strong retirement and health care programs.
- **Total compensation** is at or below the median of the market, *as the higher benefits program value does not fully offset the low cash compensation.*

Actions: To balance out the mix of total compensation while trying to remain competitive overall, Utah has introduced a new retirement program that provides a competitive benefit while also addressing long-term costs; increased employee cost sharing in the healthcare program; and provided salary adjustments on a more proactive basis.

State of Tennessee

Issues: How does the State transform its culture from a service-based system to a performance-based system, thereby improving its ability to recruit, retain and reward top talent in State government? Key challenges included creating fiscally viable and market competitive alternatives to the current retirement, retiree health care, sick leave and longevity pay programs.

Findings: The State's **total compensation** program approximates the market median when compared to the Tennessee employer market, which provides the opportunity to recalibrate the mix of pay to be better aligned with high performing organizations.

Actions: Tennessee has developed a three-year plan for transforming its compensation program. Changes include introducing pay for performance, pension reform, enhanced life and disability benefits, and conducting annual reviews of the compensation structure.

ADDRESSING THE CHALLENGES, FINDING SUCCESS

The following are trends in the marketplace, some of them not so new:

REWARD STRATEGY

1. More consistent reward strategies and designs within organizations/enterprises – may be deviations, but will be more thoughtful and support centralized and/or consistent administration
2. Performance measures balanced between short-term and long-term and between quantitative and qualitative
3. More focus on the total investment made in an employee – the various combined elements of reward – rather than each individual compensation element, including soft costs like training and development
4. The perspective around compensation is changing from one of "cost" (an expense that must be minimized) to one of "investment" (that creates future value). Just changing this vocabulary can help to shift the culture and focus the organization on sustainable programs.

REWARD DESIGN

1. Shifting emphasis from managing base pay to managing total compensation
2. Renewed focus on leveraging total rewards, particularly career development, design of meaningful work, improving work climate and non-financial recognition. For example, consider creating a recognition program with just 1% of the salary budget instead of spreading around a 3% general salary increase. Regular recognition by way of in-kind rewards (modestly denominated gift cards, an extra day off, a training program) can increase employee engagement, encouraging the incremental effort that lifts organization performance. Predictably, there will be skeptics criticizing this use of "public money." A cost-benefit analysis can be used to change their opinion.
3. Introducing flexibility and choice in benefit programs so employees are able to choose the right level of benefits based on their needs. For example, offering a range of health care programs from both a cost and coverage perspective.
4. Accounting for both the management and employee perspective in the development and design of reward programs.

REWARD IMPLEMENTATION

1. More focus on reward program implementation and communication rather than reward program design. The best-designed program poorly implemented has less impact than a program that delivers on fairly defined results.
2. More performance-based differentiation of pay than treating all employees the same. This can even be tailored to specific job families or specific jobs based on specific needs. The key is to be and stay flexible, just like the new generation of employees.
3. Line manager-led program implementation and involvement versus solely Human Resources-led initiatives.
4. Sustained and consistent senior leader messaging rather than ad-hoc reward communications about pay. This can be bolstered by regular communication on the value of the reward package through Total Compensation Statements.

None of these changes can occur overnight – in some cases, it will require modifications to state legislation – so expect at least three-five years to build the case, make the change, and implement. It is also imperative that the Governor and the Legislature support any change to make it happen. This can be challenging in itself as administrations and elected officials often change every few years.

IMPLICATIONS FOR PUBLIC POLICY OR THE PUBLIC SECTOR

Public-sector organizations tend to have a relatively large number of narrow grades or job levels linked to incremental ranges. In many systems, these ranges are drawn from a top-to-bottom pay spine, and progression through the increments is in most places automatic – a reward for experience. For many people, the value offer has only three ingredients: base pay, pension and holidays. There are plenty of examples of recognition schemes, but little use of either variable pay or other benefits. The fulcrum of all the pressures around pay is that the offering has to be different and benefits may have to be more portable so states can get the talent they need for the time they need it.

This is very different from the private sector — which, after all, accounts for a much higher percentage of employment in the economy. Commercial organizations tend to operate with fewer, broader levels of work and pay, and flexibility is more important than entitlement to progress. There is widespread and increasing use of variable pay, particularly among the most successful organizations. Some of the distinctions probably relate to the composition of the workforce and the need to emphasize professional experience and expertise, but it is also about history and predominant culture.

Many states are already moving, or having discussions about moving, in the direction outlined in this brief – sometimes on their own volition as they see the writing on the wall; others being forced to make the change. Either way, this train is leaving the station and states will need to decide soon how they can best adapt to the new landscape.

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