

JOINT BUDGET COMMITTEE



STAFF BUDGET BRIEFING FY 2018-19

STATEWIDE COMPENSATION AND PERA

JBC WORKING DOCUMENT - SUBJECT TO CHANGE
STAFF RECOMMENDATION DOES NOT REPRESENT COMMITTEE DECISION

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STATEWIDE COMPENSATION

STATEWIDE COMPENSATION OVERVIEW

The General Assembly typically establishes common policies to budget for compensation consistently across all departments. The compensation common policies address three issues:

1. Establish a standard method for calculating base continuation personal services;
2. Determine the amounts for salary and benefit increases; and
3. Set assumptions for determining the cost of compensation for new FTE.

In the budget, statewide or total compensation refers to employee salary and benefit costs, specific to the employees in each department. Compensation common policies are funded through a group of centrally appropriated line items generally found in a department's Executive Director's Office (EDO). The annual budget request for total compensation is driven by employee salaries, benefit elections, requested policy changes, and statutory contributions for amortization payments to improve PERA's funded status. The centrally appropriated line items that make up the total compensation common policies include:

- Salary Survey;
- Merit Pay;
- Shift Differential;
- Short-term Disability (STD);
- Health, Life, and Dental (HLD);
- Amortization Equalization Disbursement (AED); and
- Supplemental Amortization Equalization Disbursement (SAED).

Compensation line items are known as POTS, although the term is not an acronym. Final, budgeted POTS appropriations are generated through the total compensation templates calculated on the prior July's actual payroll data plus known and anticipated staffing adjustments, and as based on Committee funding decisions for each compensation policy. However, because POTS are centrally appropriated, allocations from these line items are distributed to department divisions and programs as determined by the EDO. This approach simplifies the appropriations process and provides flexibility to departments to make adjustments as necessary to accommodate actual POTS needs across a department. However, JBC staff are unable to determine through current budget schedules whether POTS appropriations are distributed and spent at the division and program level as guided by the total compensation templates.

PREVAILING COMPENSATION

Pursuant to Section 24-50-104, C.R.S.:

It is the policy of the state to provide prevailing total compensation to officers and employees in the state personnel system to ensure the recruitment, motivation, and retention of a qualified and competent work force.

A statutory policy statement is not binding, but it provides direction about the General Assembly's intent that helps guide the budget setting process. Even with a clear goal, though, it can be difficult

to determine the funding necessary to provide prevailing compensation. There are a wide range of compensation practices in the market and many state jobs are either uncommon or not found outside of government.

ANNUAL COMPENSATION REPORT

To assist in the process, the Department of Personnel produces an annual total compensation report by September 15th, to compare the State's compensation to prevailing market rates. The General Assembly is not required to follow the recommendations of the report, but the report expresses the professional opinion of the Department regarding how compensation should be adjusted annually. Following issuance of the report, the Department of Personnel works with the Office of State Planning and Budgeting (OSPB) to build the total compensation request for the following year, and directs executive agencies to apply consistent policies in their budget requests.

THE STATE PERSONNEL SYSTEM ACT AND DIVISION OF AUTHORITY

Article 50 of Title 24, C.R.S., sets forth the State Personnel System Act. Section 24-50-101, C.R.S., sets forth two broad areas of authority and responsibility for the administration of the state personnel system (emphasis added):

(3)(c) It is the duty of the state personnel director to establish the general criteria for adherence to the merit principles and for fair treatment of individuals within the state personnel system. It is the responsibility of the state personnel director to provide leadership in the areas of policy and operation of the state personnel system...

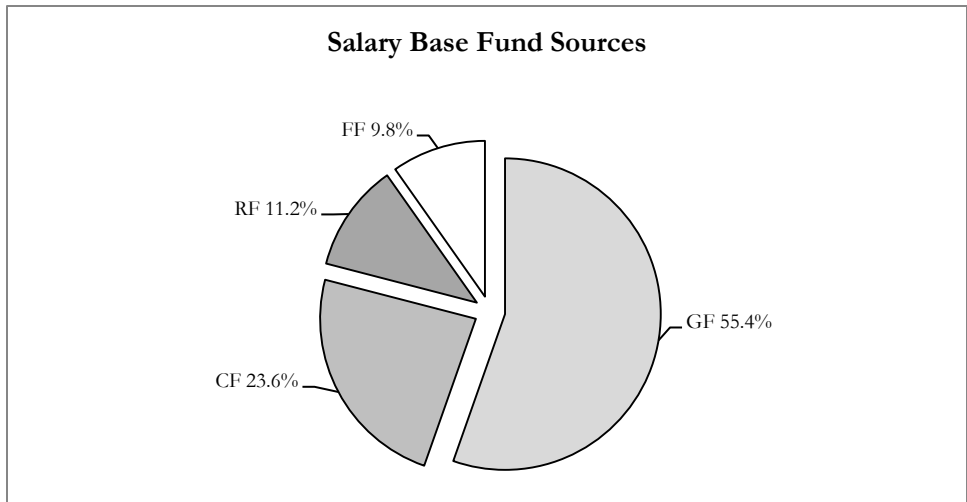
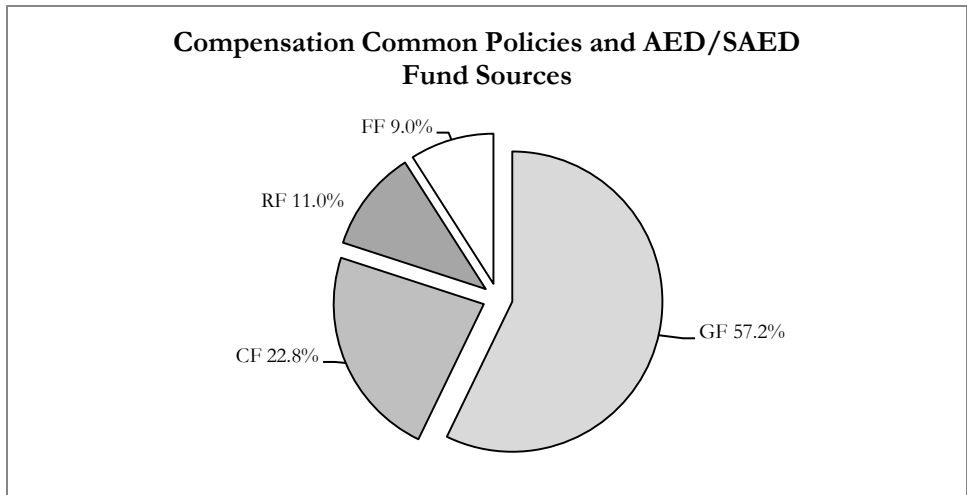
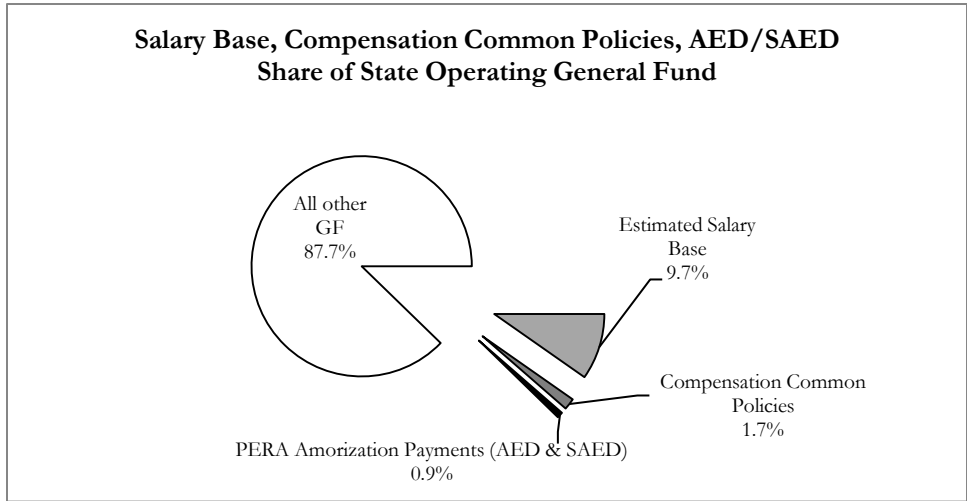
(3)(d) The heads of principal departments and presidents of colleges and universities shall be responsible and accountable for the actual operation and management of the state personnel system for their respective departments, colleges, or universities.

STATE PERSONNEL SYSTEM (CLASSIFIED SYSTEM)

To ensure a state workforce based on merit and fitness, and to protect against cronyism and discrimination, the Colorado Constitution establishes a State Personnel System, commonly referred to in budgeting parlance as the classified system, after the job classes used to determine appropriate pay ranges for employees. The Department of Personnel manages the personnel system, with policy direction from the State Personnel Board. Objective criteria must be used to fill positions in the personnel system and employees hold their positions during efficient service or until reaching retirement age. Of significance from a budgeting perspective, there must be standardization in the personnel system of the way people with like duties are treated with regard to grading performance and determining compensation.

The Constitution specifically exempts some positions from the classified system, allowing potentially different pay ranges, benefits, and hiring and termination procedures. Exempt positions include education faculty and certain education administrators, the judicial branch, the legislative branch other than the State Auditor's Office, assistant attorneys general, certain employees of the Governor's office, the heads of departments, and most boards and commissions. Except at higher education institutions, exempt employees use the same insurance and retirement benefits as employees of the classified system. While the judicial branch is exempt from the state personnel system, the courts have developed their own version of a classified system for employees who are not judges, which largely mirrors the state personnel system with regard to salaries and hiring and termination procedures. For judges, salaries are set in statute.

COMPENSATION POLICIES: GRAPHIC OVERVIEW



All charts are based on the FY 2017-18 appropriation.

GENERAL FACTORS DRIVING THE BUDGET

NUMBER OF STATE EMPLOYEES

Statewide expenditures for compensation are driven by the number of employees, the percentage of employees who choose to participate in optional benefit plans, and contracts with the benefit providers. The following table shows the number of FTE appropriated statewide, excluding employees in the Department of Higher Education.

State Employees ¹ - FTE Reflected in Appropriations										
	FY08-09	FY09-10	FY10-11	FY11-12	FY12-13	FY13-14	FY14-15	FY15-16	FY16-17	FY17-18
Total FTE	31,142.5	31,070.5	31,466.9	30,657.3	30,559.8	30,787.2	31,480.9	31,878.2	32,174.8	32,412.7
Percent Change		(0.2%)	1.3%	(2.6%)	(0.3%)	0.7%	2.3%	1.3%	0.9%	0.7%
Average annual FTE percentage change										0.45%
10-year Colorado population average annual growth - 2007-2016 ²										1.55%
¹ Excludes Department of Higher Education										
² Data from the State Demography Office										

As reflected in the table, FTE growth has averaged less than one-third of the growth in population.

SALARY BASE

Tied to the number of state employees, while incorporating salary "base-building" increases from across-the-board increases, other salary survey adjustments, and merit pay, changes in the salary base reflect the actual increase in salary compensation over time. The following table outlines a seven-year history of the estimated salary base included in department compensation templates.

Statewide Salary Base 7-year Estimated Appropriations History (in millions)							
	FY12-13	FY13-14	FY14-15	FY15-16	FY16-17	FY17-18	FY18-19
Salary Base	\$1,600.8	\$1,600.9	\$1,690.9	\$1,757.2	\$1,836.3	\$1,864.1	\$1,964.2
Change		0.1	90.0	66.3	79.1	27.8	100.1
Percentage Change		0.0%	5.6%	3.9%	4.5%	1.5%	5.5%
Average annual percentage change							3.5%
6-year total percentage change							22.7%

Annual changes in the salary base reflect increases provided in the prior fiscal year; the 0.0 percent change in the salary base in FY 2013-14 reflects no increases provided in FY 2012-13. Overall, the salary base has increased an average of 3.5 percent per year. As reflected in the previous table, a 0.5 percent increase in FTE suggests that base salary compensation has increased approximately 3.0 percent per year on average. The following table outlines a seven-year General Fund share history of salary base plus compensation policies relative to total operating General Fund.

Salary Base and Compensation Common Policies Share of operating General Fund 7-year Appropriations History (in millions)							
	FY11-12	FY12-13	FY13-14	FY14-15	FY15-16	FY16-17	FY17-18
Total Operating General Fund	\$7,059.3	\$7,596.0	\$8,378.5	\$9,020.2	\$9,491.1	\$9,954.6	\$10,619.8
Salary Base	869.2	828.7	828.8	912.8	953.0	1,020.8	1,032.5
Compensation Common Policies	<u>137.6</u>	<u>147.4</u>	<u>195.4</u>	<u>220.0</u>	<u>234.0</u>	<u>227.3</u>	<u>270.6</u>
Total Salary Base and Compensation Policies	\$1,006.8	\$976.1	\$1,024.2	\$1,132.8	\$1,187.0	\$1,248.1	\$1,303.1
Percent of Operating General Fund	14.3%	12.9%	12.2%	12.6%	12.5%	12.5%	12.3%

As reflected in the table, in FY 2017-18 total salary base and compensation policies represented 12.3 percent of all General Fund in the operating budget; this represents a reduction of 2.0 percent since FY 2011-12 and aligns with the trend showing a general decline in the percentage over this period.

COST OF HEALTH INSURANCE

Health insurance is traditionally the compensation component with the greatest increases. The following table outlines the 10-year history of appropriations for Health, Life, and Dental.

Health, Life, and Dental 10-year Appropriations History (in millions)										
	FY08-09	FY09-10	FY10-11	FY11-12	FY12-13	FY13-14	FY14-15	FY15-16	FY16-17	FY17-18
HLD Total Appropriations	\$123.4	\$145.4	\$142.6	\$158.1	\$170.2	\$176.8	\$184.5	\$217.3	\$217.6	\$237.8
Change		22.0	(2.8)	15.5	12.1	6.6	7.7	32.8	0.3	20.2
Percentage Change		17.8%	(1.9%)	10.9%	7.7%	3.9%	4.4%	17.8%	0.1%	9.3%
								Average annual percentage change		7.8%
								9-year total percentage change		92.7%

AMORTIZATION PAYMENTS TO IMPROVE PERA'S FUNDED STATUS

Actuarial analysis of the Public Employee's Retirement Association (PERA) led the legislature to pass bills increasing contributions to the pension plan above the base employer and employee contribution rates. These additional contributions are called the Amortization Equalization Disbursement (AED) and Supplemental Amortization Equalization Disbursement (SAED).

Pursuant to Section 24-51-411, C.R.S., the State contributes additional funds to assist in the amortization of PERA's unfunded liability. During the 2005 legislative session the General Assembly created a separate line item to provide funding for this commitment. By statute the AED rate increased 0.4 percent each calendar year until reaching the maximum contribution rate of 5.0 percent for calendar year 2017; except for judges where the state contribution remained constant at 2.2 percent until H.B. 17-1265 (*PERA Judicial Division Total Employer Contribution*) enacted increases to 3.4, 3.8, 4.2, 4.6 and 5.0 percent in each succeeding year beginning in calendar year 2019.

Similar to the AED line item, the SAED line item increases contributions to PERA to amortize the unfunded liability. By statute the SAED rate increased 0.5 percent each calendar year until reaching the maximum contribution rate of 5.0 percent for calendar year 2017; except for judges where the state contribution remained constant at 1.5 percent until H.B. 17-1265. As with AED, H.B. 17-1265 also enacted increases in SAED for judges to 3.4, 3.8, 4.2, 4.6, and 5.0 percent in each succeeding year beginning in calendar year 2019.

Both the AED and SAED are paid by the employer. Although the SAED payment is made by the State, statute specifies that funding is to come from money that would have otherwise gone to state employees as part of salary increases, pursuant to Section 24-51-411 (10), C.R.S., and if paid as salary increases would appear in the salary base. While the State's contribution to PERA is often cited as 20 percent, including the 10.15 percent standard employer contribution plus 5 percent each for AED and SAED, it is also reasonable to cite contribution figures of 15 percent from the State and 13 percent from the employee, including the 8 percent employee contribution plus the 5 percent of base salary foregone as SAED.

Normal cost is the actuarially calculated annual cost for providing retirement benefits that are earned in the year by an employee. The normal cost for all state employees in 2016 was actuarially calculated

at 11.01 percent. After the 8 percent employee contribution, only 3 percent of the state contribution is paying for the cost of current employees retirement cost in PERA. The June 2015 PERA cost and effectiveness comparison study identified that employees hired after January 1, 2011, experience a normal cost of 8.82 percent based on the reduced benefits enacted in S.B. 10-001. After the 8 percent employee contribution, only 0.82 percent of the statutory 10.15 percent state contribution is provided for PERA benefits for employees hired on or after 2011. The rest of the state contribution (except for 1.02 percent paid for the Health Care Trust Fund and 1.0 percent credited to the Annual Increase Reserve or AIR for funding future cost of living adjustments) goes to pay the unfunded liability along with the AED and SAED payments.

Or, considered another way, including the SAED which would otherwise be employee salary, current employees could be considered to be contributing 13 percent of salary to cover their retirement benefit cost of 11 percent – or just under 9 percent for employees hired on or after 2011. Current employees are paying the additional 2 to 4 percent to the unfunded liability, along with the State's entire contribution of 15 percent.

AED and SAED are calculated on revised base salary, which includes base salary, salary survey, merit pay, and shift differential. AED and SAED are commonly considered to be part of the total compensation package because payment amounts are calculated on total salary. However, these payments are primarily intended to be amortization payments for PERA's unfunded liabilities and not state employee compensation. As created in statute and by federal pension fund rules, AED and SAED contributions are structured as employee compensation and in the case of SAED represent salary increases foregone by employees. While AED and SAED represent a cost to the State and are paid by state agencies on total payroll, they are neither technically nor in practice paid to state employees as compensation. Therefore it is reasonable to exclude AED and SAED when estimating the increase in total compensation funding to be paid to state employees.

The following tables outline the 8-year history of AED and SAED appropriations.

Amortization Equalization Disbursement (AED) 8-year Appropriations History (in millions)								
	FY10-11	FY11-12	FY12-13	FY13-14	FY14-15	FY15-16	FY16-17	FY17-18
AED Total Appropriations	\$33.3	\$40.3	\$44.6	\$52.5	\$62.1	\$70.1	\$78.3	\$84.8
Change		7.0	4.3	7.9	9.6	8.0	8.2	6.5
Percentage Change		21.0%	10.7%	17.7%	18.3%	12.9%	11.7%	8.3%
					Average annual percentage change			14.4%
					7-year total percentage change			154.7%

Supplemental Amortization Equalization Disbursement (SAED) 8-year Appropriations History (in millions)								
	FY10-11	FY11-12	FY12-13	FY13-14	FY14-15	FY15-16	FY16-17	FY17-18
SAED Total Appropriations	\$23.2	\$32.8	\$38.0	\$47.1	\$58.0	\$67.3	\$77.0	\$84.4
Change		9.6	5.2	9.1	10.9	9.3	9.7	7.4
Percentage Change		41.4%	15.9%	23.9%	23.1%	16.0%	14.4%	9.6%
					Average annual percentage change			20.6%
					7-year total percentage change			263.8%

SUMMARY: FY 2017-18 APPROPRIATION & FY 2018-19 REQUEST

SALARY BASE, COMPENSATION COMMON POLICIES, AND PERA PAYROLL COMPONENTS					
	TOTAL FUNDS	GENERAL FUND	CASH FUNDS	REAPPROPRIATED FUNDS	FEDERAL FUNDS
FY 2017-18 Appropriation					
Base Salary Estimate	\$1,666,739,716	\$923,013,894	\$393,733,707	\$186,819,001	\$163,173,115
PERA	173,171,872	96,129,487	41,322,536	19,085,756	16,634,093
Medicare (FICA)	24,167,725	13,383,700	5,709,139	2,708,874	2,366,012
Shift Differential	14,562,299	11,354,074	612,530	2,539,327	56,368
Salary Survey	34,610,782	18,335,747	9,263,793	3,800,073	3,211,168
Merit Pay	13,936,629	8,014,451	3,053,180	1,539,295	1,329,703
Health, Life, Dental	238,188,184	139,574,100	52,866,903	25,017,629	20,729,552
Short-term Disability	3,082,103	1,677,953	735,205	360,166	308,779
AED	84,568,009	46,424,560	20,115,241	9,664,263	8,363,945
SAED	84,161,978	46,020,716	20,113,054	9,664,263	8,363,945
TOTAL	\$2,337,189,297	\$1,303,928,683	\$547,525,289	\$261,198,646	\$224,536,680
FY 2018-19 Request					
Base Salary Estimate	\$1,754,667,548	\$962,225,256	\$425,461,473	\$193,384,011	\$173,596,808
PERA	184,113,600	102,030,030	44,606,578	19,794,183	17,682,809
Medicare (FICA)	25,442,675	13,952,266	6,169,189	2,804,067	2,517,153
Shift Differential	15,843,834	11,983,905	800,399	2,081,236	978,294
Salary Survey	59,670,368	33,183,213	14,166,687	6,500,090	5,820,378
Merit Pay	0	0	0	0	0
Health, Life, Dental	261,319,463	149,636,817	60,736,546	26,549,539	24,396,561
Short-term Disability	2,928,068	1,573,923	720,945	335,181	298,019
AED	89,787,143	48,828,430	21,920,944	10,053,414	8,984,355
SAED	89,578,799	48,621,349	21,919,681	10,053,414	8,984,355
TOTAL	\$2,483,351,497	\$1,372,035,188	\$596,502,442	\$271,555,135	\$243,258,732
Increase/(Decrease)	\$146,162,200	\$68,106,505	\$48,977,154	\$10,356,489	\$18,722,052
Percent Change	6.3%	5.2%	8.9%	4.0%	8.3%

THE FY 2018-19 TOTAL COMPENSATION REQUEST

The FY 2018-19 request is estimated at \$2.48 billion total funds, an increase of \$146.2 million over the prior year appropriation, which represents a 6.3 percent increase in total compensation-related appropriations. The FY 2018-19 total compensation request includes the following elements:

SALARY SURVEY: The Salary Survey request includes:

- A 3.0 percent across-the-board or ATB salary increase for all occupational groups;
- A 3.0 percent increase for all State Patrol Trooper classes; and
- A 2.0 percent salary range adjustment for all occupational groups.

The Governor's request for Salary Survey totals \$59.6 million total funds, including \$33.1 million General Fund. JBC staff identifies a total salary survey request from all department compensation templates of \$59.7 million total funds, including \$33.2 million General Fund.

MERIT PAY: A Merit Pay increase is not requested.

SHIFT DIFFERENTIAL: Shift differential is requested at 100 percent of prior year actual expenditures. In FY 2018-19 shift differential increases by \$1.3 million total funds, including \$0.6 million General Fund; an 8.8 percent increase in total funds and a 5.5 percent increase in General Fund.

AED: Amortization Equalization Disbursement is set at a statutory rate of 5.0 percent in 2017 and future years, except for judges set at 2.2 percent for 2018 and 3.4 percent in 2019. The AED increase is estimated to be \$5.2 million total funds, including \$2.4 million General Fund; a 6.2 percent increase in total funds and a 5.2 percent increase in General Fund.

SAED: Supplemental Amortization Equalization Disbursement is set at a statutory rate of 5.0 percent in 2017 and future years, except for judges set at 1.5 percent for 2018 and 3.4 percent in 2019. The SAED increase is estimated to be \$5.4 million total funds, including \$2.6 million General Fund; a 6.4 percent increase in total funds and a 5.7 percent increase in General Fund.

STD: Short Term Disability is requested at 0.17 percent of revised base salaries; a reduction from 0.19 percent in the prior fiscal year. The STD adjustment is estimated to decrease by \$154,000 total funds, including \$104,000 General Fund; a 5.0 percent decrease in total funds and a 6.2 percent decrease in General Fund.

HLD: Request amounts submitted for Health, Life, and Dental are based on employee health and dental elections as of July of the current year. Final adjustments may be included in a budget amendment based on actuarial recommendations received in December. The base adjustment request reflects an increase of \$23.1 million total funds, including \$10.1 million General Fund; a 9.7 percent increase in total funds and a 7.2 percent increase in General Fund.

COMPENSATION TABLES

The following table reflects state employee compensation – salary base plus discretionary components.

STATE EMPLOYEE COMPENSATION					
	TOTAL FUNDS	GENERAL FUND	CASH FUNDS	REAPPROPRIATED FUNDS	FEDERAL FUNDS
FY 2017-18 Appropriation					
Salary, PERA, and Medicare	\$1,864,079,314	\$1,032,527,081	\$440,765,382	\$208,613,631	\$182,173,220
Shift Differential	14,562,299	11,354,074	612,530	2,539,327	56,368
Salary Survey	34,610,782	18,335,747	9,263,793	3,800,073	3,211,168
Merit Pay	13,936,629	8,014,451	3,053,180	1,539,295	1,329,703
Health, Life, Dental	238,188,184	139,574,100	52,866,903	25,017,629	20,729,552
Short-term Disability	3,082,103	1,677,953	735,205	360,166	308,779
TOTAL	\$2,168,459,310	\$1,211,483,407	\$507,296,994	\$241,870,120	\$207,808,790
FY 2018-19 Request					
Salary, PERA, and Medicare	\$1,964,223,823	\$1,078,207,552	\$476,237,240	\$215,982,261	\$193,796,770
Shift Differential	15,843,834	11,983,905	800,399	2,081,236	978,294
Salary Survey	59,670,368	33,183,213	14,166,687	6,500,090	5,820,378
Merit Pay	0	0	0	0	0
Health, Life, Dental	261,319,463	149,636,817	60,736,546	26,549,539	24,396,561
Short-term Disability	2,928,068	1,573,923	720,945	335,181	298,019
TOTAL	\$2,303,985,555	\$1,274,585,409	\$552,661,817	\$251,448,307	\$225,290,022
Increase/(Decrease)	\$135,526,245	\$63,102,002	\$45,364,823	\$9,578,187	\$17,481,232
Percent Change	6.2%	5.2%	8.9%	4.0%	8.4%

Total state employee compensation is estimated at \$2.30 billion total funds including \$1.27 billion General Fund; an increase of \$135.5 million total funds or 6.2 percent and an increase of \$63.1 million General Fund or 5.2 percent.

The following table outlines the estimated salary base.

ESTIMATED SALARY BASE - BASE SALARY PLUS PERA AND FICA					
	TOTAL FUNDS	GENERAL FUND	CASH FUNDS	REAPPROPRIATED FUNDS	FEDERAL FUNDS
FY 2017-18 Appropriation					
Base Salary	1,666,739,716	923,013,894	393,733,707	186,819,001	163,173,115
PERA	173,171,872	96,129,487	41,322,536	19,085,756	16,634,093
Medicare (FICA)	24,167,725	13,383,700	5,709,139	2,708,874	2,366,012
Salary Base	1,864,079,314	1,032,527,081	440,765,382	208,613,631	182,173,220
FY 2018-19 Request					
Base Salary	1,754,667,548	962,225,256	425,461,473	193,384,011	173,596,808
PERA	184,113,600	102,030,030	44,606,578	19,794,183	17,682,809
Medicare (FICA)	25,442,675	13,952,266	6,169,189	2,804,067	2,517,153
Salary Base	\$1,964,223,823	\$1,078,207,552	\$476,237,240	\$215,982,261	193,796,770
Increase/(Decrease)	\$100,144,509	\$45,680,470	\$35,471,858	\$7,368,630	\$11,623,550
Percent Change	5.4%	4.4%	8.0%	3.5%	6.4%

The estimated salary base includes adjustments approved in prior year policy decisions related to salary and staffing increases. Salary base is estimated at \$1.96 billion total funds including \$1.08 billion General Fund; an increase of \$100.1 million total funds or 5.4 percent and an increase of \$45.7 million General Fund or 4.4 percent. The increase in salary base represents 73.9 percent of the total compensation increase.

The following table outlines discretionary compensation components included in the request.

DISCRETIONARY COMPENSATION COMPONENTS					
	TOTAL FUNDS	GENERAL FUND	CASH FUNDS	REAPPROPRIATED FUNDS	FEDERAL FUNDS
FY 2017-18 Appropriation					
Shift Differential	14,562,299	11,354,074	612,530	2,539,327	56,368
Salary Survey	34,610,782	18,335,747	9,263,793	3,800,073	3,211,168
Merit Pay	13,936,629	8,014,451	3,053,180	1,539,295	1,329,703
Health, Life, Dental	238,188,184	139,574,100	52,866,903	25,017,629	20,729,552
Short-term Disability	3,082,103	1,677,953	735,205	360,166	308,779
TOTAL	\$304,379,997	\$178,956,325	\$66,531,612	\$33,256,489	\$25,635,570
FY 2018-19 Request					
Shift Differential	15,843,834	11,983,905	800,399	2,081,236	978,294
Salary Survey	59,670,368	33,183,213	14,166,687	6,500,090	5,820,378
Merit Pay	0	0	0	0	0
Health, Life, Dental	261,319,463	149,636,817	60,736,546	26,549,539	24,396,561
Short-term Disability	2,928,068	1,573,923	720,945	335,181	298,019

DISCRETIONARY COMPENSATION COMPONENTS					
	TOTAL FUNDS	GENERAL FUND	CASH FUNDS	REAPPROPRIATED FUNDS	FEDERAL FUNDS
TOTAL	\$339,761,732	\$196,377,857	\$76,424,577	\$35,466,046	\$31,493,252
Increase/(Decrease)	\$35,381,735	\$17,421,532	\$9,892,965	\$2,209,557	\$5,857,682
Percent Change	11.6%	9.7%	14.9%	6.6%	22.8%
Discretionary Compensation Components Increase on FY17-18 Total Compensation	1.6%	1.4%	2.0%	0.9%	2.8%

Discretionary compensation components total \$339.8 million including \$196.4 million General Fund. These amounts reflect an increase of \$35.4 million total funds or 11.6 percent and an increase of \$17.4 million General Fund or 9.7 percent over discretionary component appropriations in the prior fiscal year. The increases also represent a 1.6 percent total funds increase and 1.4 percent General Fund increase on FY 2017-18 total compensation. The \$35.4 million total funds increase represents 26.1 percent of the total compensation increase. Of the \$35.4 million total funds increase, salary survey represents \$11.1 million and health, life, and dental represents \$23.1 million. The other components make up the additional \$1.2 million increase.

The following table outlines PERA amortization payments, which are formula-derived amounts set in statute. As discussed in the General Factors section, while AED and SAED are calculated on state employee salary, they are not current state employee benefits as they do not increase benefits for state employees but instead function as state payments to improve PERA's funded status.

PERA AMORTIZATION PAYMENTS					
	TOTAL FUNDS	GENERAL FUND	CASH FUNDS	REAPPROPRIATED FUNDS	FEDERAL FUNDS
FY 2017-18 Appropriation					
AED	\$84,568,009	\$46,424,560	\$20,115,241	\$9,664,263	\$8,363,945
SAED	84,161,978	46,020,716	20,113,054	9,664,263	8,363,945
TOTAL	\$168,729,987	\$92,445,276	\$40,228,295	\$19,328,526	\$16,727,890
FY 2018-19 Request					
AED	\$89,787,143	\$48,828,430	\$21,920,944	\$10,053,414	\$8,984,355
SAED	89,578,799	48,621,349	21,919,681	10,053,414	8,984,355
TOTAL	\$179,365,942	\$97,449,779	\$43,840,625	\$20,106,828	\$17,968,710
Increase/(Decrease)	\$10,635,955	\$5,004,503	\$3,612,330	\$778,302	\$1,240,820
Percent Change	6.3%	5.4%	9.0%	4.0%	7.4%

Amortization payments to improve PERA's funded status are estimated at \$179.4 million total funds including \$97.5 million General Fund, an increase of \$10.6 million total funds or 6.3 percent and an increase of \$5.0 million General Fund or 5.4 percent.

TOTAL COMPENSATION BY AGENCY

The following tables outline the FY 2018-19 total compensation and PERA amortization payments request and percentage change by agency.

FY 2018-19 Total Compensation and PERA Amortization Payments by Agency

	TOTAL FUNDS	GENERAL FUND	CASH FUNDS	REAPPROPRIATED FUNDS	FEDERAL FUNDS
FY 2018-19 Request					
Agriculture	\$23,408,769	\$7,502,283	\$15,906,486	\$0	\$0
Corrections	464,831,247	451,524,633	13,306,615	0	0
Education	60,819,703	21,573,031	8,764,550	6,513,028	23,969,094
Governor	119,337,159	10,929,298	4,536,412	101,584,302	2,287,147
Health Care Policy and Financing	49,736,690	18,647,956	2,813,719	1,240,268	27,034,748
Higher Education - Admin & HistCO	16,961,797	483,573	8,894,073	3,310,267	4,273,884
Human Services	371,701,227	238,962,060	25,551,398	58,282,435	48,905,335
Judicial	433,540,030	406,649,505	26,890,525	0	0
Labor and Employment	111,023,038	5,702,621	46,203,670	810,520	58,306,228
Law	56,192,948	15,707,001	6,614,773	32,382,156	1,489,018
Legislature	35,333,182	35,333,182	0	0	0
Local affairs	17,012,499	3,414,282	2,127,659	7,615,093	3,855,465
Military and Veterans Affairs	11,431,942	4,231,325	177,822	0	7,022,795
Natural Resources	151,307,092	24,428,248	118,494,061	4,660,186	3,724,596
Personnel	36,330,060	13,375,352	2,580,446	20,374,263	0
Public Health and Environment	139,821,916	19,552,629	47,811,159	16,489,851	55,968,277
Public Safety	192,412,241	44,809,429	126,895,714	15,039,770	5,667,328
Regulatory Agencies	52,619,490	1,845,847	46,903,044	3,115,779	754,819
Revenue	109,427,378	45,642,166	63,647,994	137,218	0
State	13,152,040	0	13,152,040	0	0
Transportation	14,075,898	0	14,075,898	0	0
Treasury	2,875,151	1,720,767	1,154,384	0	0
TOTAL	\$2,483,351,497	\$1,372,035,188	\$596,502,442	\$271,555,135	\$243,258,732

FY 2018-19 Percent Change in Total Compensation and PERA Amortization Payments by Agency

	TOTAL FUNDS	GENERAL FUND	CASH FUNDS	REAPPROPRIATED FUNDS	FEDERAL FUNDS
FY 2018-19 Request					
Agriculture	6.8%	16.3%	4.2%	n/a	(100.0%)
Corrections	(0.1%)	(0.3%)	5.5%	n/a	n/a
Education	(0.0%)	(1.7%)	7.8%	0.2%	(1.3%)
Governor	5.7%	34.3%	(10.6%)	3.2%	85.3%
Health Care Policy and Financing	15.7%	17.1%	(21.8%)	20.6%	20.6%
Higher Education - Admin & HistCO	1.9%	14.4%	(4.9%)	1.3%	18.6%
Human Services	20.0%	13.7%	176.8%	0.7%	50.4%
Judicial	5.8%	5.7%	7.1%	n/a	n/a
Labor and Employment	4.4%	(5.8%)	21.4%	3.7%	(5.1%)
Law	2.6%	9.3%	2.0%	(0.9%)	22.3%
Legislature	3.8%	3.8%	n/a	n/a	n/a
Local affairs	3.2%	(4.5%)	(2.7%)	5.1%	10.6%
Military and Veterans Affairs	(0.5%)	5.4%	68.6%	n/a	(4.8%)
Natural Resources	3.7%	1.3%	4.1%	17.8%	(6.7%)
Personnel	6.6%	12.9%	11.9%	2.3%	n/a
Public Health and Environment	4.6%	21.4%	3.1%	10.6%	(0.5%)
Public Safety	8.4%	7.9%	7.0%	36.7%	(9.8%)
Regulatory Agencies	5.5%	(0.9%)	4.5%	6.7%	254.7%
Revenue	4.9%	3.1%	6.2%	3.4%	n/a
State	16.8%	n/a	16.8%	n/a	n/a
Transportation	(2.6%)	n/a	1.0%	(100.0%)	n/a
Treasury	3.0%	0.7%	6.5%	n/a	n/a
TOTAL	6.3%	5.2%	8.9%	4.0%	8.3%

BASE SALARY BY AGENCY

Base salary is the largest element in total compensation and drives the calculations for other elements. The following table outlines the percentage change in base salary estimate by agency.

Percentage Change in Base Salary Estimate by Agency					
	TOTAL FUNDS	GENERAL FUND	CASH FUNDS	REAPPROPRIATED FUNDS	FEDERAL FUNDS
FY 2018-19 Request					
Agriculture	5.6%	15.2%	2.9%	n/a	(100.0%)
Corrections	(1.0%)	(1.1%)	4.5%	n/a	n/a
Education	(1.0%)	(2.7%)	6.4%	(0.5%)	(2.3%)
Governor	5.0%	30.0%	(11.2%)	2.6%	91.2%
Health Care Policy and Financing	14.2%	15.6%	(23.0%)	19.1%	18.9%
Higher Education - Admin & HistCO	(0.4%)	(9.8%)	(7.3%)	1.1%	17.9%
Human Services	18.7%	13.4%	144.3%	0.9%	42.2%
Judicial	4.4%	4.2%	6.4%	n/a	n/a
Labor and Employment	3.5%	(7.0%)	20.5%	1.5%	(6.1%)
Law	1.8%	8.8%	0.5%	(1.7%)	21.5%
Legislature	2.4%	2.4%	n/a	n/a	n/a
Local affairs	2.6%	(5.1%)	(3.9%)	4.3%	11.0%
Military and Veterans Affairs	(0.7%)	4.7%	65.2%	n/a	(4.7%)
Natural Resources	2.7%	0.4%	3.1%	16.5%	(7.5%)
Personnel	6.2%	12.3%	9.9%	1.9%	n/a
Public Health and Environment	3.5%	20.6%	2.0%	8.8%	(1.6%)
Public Safety	8.7%	7.2%	7.6%	37.5%	(10.6%)
Regulatory Agencies	4.7%	(0.8%)	3.7%	5.5%	243.0%
Revenue	4.3%	2.0%	6.0%	8.7%	n/a
State	15.7%	n/a	15.7%	n/a	n/a
Transportation	(3.3%)	n/a	0.2%	(100.0%)	n/a
Treasury	1.9%	(2.0%)	8.3%	n/a	n/a
TOTAL	5.3%	4.2%	8.1%	3.5%	6.4%

As reflected in the table in comparison to the previous table, the percentage change in base salary correlates to a large extent with the percentage change in total compensation. As previously discussed, base salary represents policy decisions made in the prior fiscal year regarding salary and staffing increases. Also as previously discussed, the statewide percentage change in base salary minus the percentage increase in staffing reflects the general average percentage increase in statewide state employee salary. The FTE table in the General Factors section shows that FTE increased by 0.7 percent in FY 2017-18. This suggests that salary base compensation has increased by approximately 4.6 percent in the FY 2018-19 salary base estimate, despite a total average salary base-building increase of 2.5 percent approved in FY 2017-18.

So the actual increase in statewide salary compensation appears to be exceeding base-building salary increases provided annually in the budget. Generally in recent years, the annual compensation report has identified a figure of approximately 3 percent salary growth in the market annually. The salary base history table in the General Factors section identifies a 3 percent average annual increase over the last seven years. Since FY 2013-14, a total of 11.5 percent has been provided in total salary increases, including 3.5, 3.5, 2.0, 0.0, and 2.5 percent. Over that period, FTE increased approximately 6 percent, while salary base increased just over 22 percent. Beyond the 11.5 percent provided in base-building increases, it appears that an additional 4.5 percent in increases have been provided by other means. These likely include ad-hoc budget requests by individual agencies for particular division or programs and occupational groups as well as state patrol trooper increases.

ISSUE 1: TOTAL COMPENSATION REQUEST OVERVIEW AND STATEWIDE COMPENSATION CONCERNS

The FY 2018-19 total compensation request includes a 3.0 percent across-the-board (ATB) increase, no merit pay increase, and a 2.0 percent salary range adjustment for all occupational classes. The Governor's Office of State Planning and Budgeting (OSPB) estimates the ATB increase will total \$59.6 million total funds, including \$33.1 million General Fund. In addition to the statewide compensation request, individual state agencies continue to submit budget requests to increase pay for select occupational classes. The Department of Personnel believes it is the proper response for state agencies to submit individual, ad hoc requests to address turnover and career ladder progression and compensation problems. However, the clustering of state employees at the bottom of the range appears to be consistent across all requests and appears to be a statewide problem.

SUMMARY:

- The FY 2018-19 Annual Compensation Report from the Executive Director of the Department of Personnel and survey report by Gallagher identifies that the State is at 5.5 percent below the prevailing market overall; identifies that individual employee pay is projected to increase by 3.0 percent in the market over the next year and to maintain alignment with the market, the State should consider merit pay adjustments; and recommends that range minimums and maximums for all occupational groups be increased by 2.0 percent equal to the market trend factor.
- The Governor's FY 2018-19 total compensation request includes a 3.0 percent across-the-board (ATB) increase, no merit pay increase, and a 2.0 percent salary range adjustment for all occupational classes.
- OSPB estimates the requested salary increase will total \$59.6 million total funds, including \$33.1 million General Fund.
- This request is the third year in a row without a merit pay request; out of a total of six years since the merit pay system was implemented by the administration.
- The Departments of Human Services, Corrections, and Public Safety have all submitted individual agency requests to increase pay for particular occupational groups or classes, which follows similar requests over the last two budget years.
- The consistent theme in all requests is increased turnover from labor market competition and employee dissatisfaction at the lack of career ladder progression due to a general clustering of employees at the bottom of the salary range and lack of movement to midpoint.

DISCUSSION:

THE TOTAL COMPENSATION REPORT FROM THE STATE PERSONNEL DIRECTOR

The FY 2018-19 Annual Compensation Report from the Executive Director of the Department of Personnel and survey report by Gallagher identifies that the State is at 5.5 percent below the prevailing market overall. Overall, base salary for state employees is 6.3 percent below market, the value of benefits is 0.1 percent above market, and retirement benefits are 9.9 percent above market.

Currently, the state compensation philosophy targets a variance of plus or minus 7.5 percent in base salaries from the market to be competitive; at 5.5 percent below, the state is considered to meet this standard. Individual employee pay is projected to increase by 3.0 percent in the market over the next year and to maintain alignment with the market, the State should consider merit pay adjustments. The letter also recommends that range minimums and maximums for all occupational groups be increased by 2.0 percent equal to the market trend factor.

THE GOVERNOR'S REQUEST FOR STATE EMPLOYEE INCREASES

The salary increase aspects of the Governor's total compensation request include:

- A 3.0 percent across-the-board (ATB) salary survey increase for all state employees, including base building up to the range maximum;
- A 3.0 percent salary increase for all State Patrol Trooper classes, pursuant to Section 24-50-104 (1)(a)(III), C.R.S.; and
- A salary range adjustment of 2.0 percent for all occupational classes.

STAFF OBSERVATIONS ON INCREASE REQUEST

The Governor's request for the third year in a row includes no merit pay. For the second year, it instead includes an across-the-board increase.

The State Personnel Director's cover letter to the Annual Compensation Survey Report from Gallagher states (emphasis added):

*Individual employee pay is projected to increase by 3% in the market. ... **the State should continue to consider offering pay increases through merit; ...***

Staff assumes that the State Personnel Director is the primary administration official charged with providing recommendations to the Governor related to state employee increases. It appears that the State Personnel Director's intent in *continuing to consider* does not actually lead to *proposing*. It is unclear to staff why the State Personnel Director would speak to, about, or encourage merit pay in the Annual Compensation Report while the Governor's budget request continues to rely on across-the-board increases.

The Department of Personnel continues to rely on its reason from last year regarding this policy intent and policy action disconnect, saying, *sometimes an across-the-board increase is just better*. Staff took issue with that general statement last year, provided without evidence or reasoning. In staff's opinion, the Department and OSPB still have not provided data, analysis, or reason to support this policy choice;

staff continues to question the basis for this statement and the efficacy of across-the-board increases over merit pay.

Nevertheless, staff is not recommending that the Committee consider merit pay instead of across-the-board increases as staff recommended in FY 2017-18.

THE FY 2017-18 MERIT PAY AWARD

In FY 2017-18, staff recommended that the Committee replace 2.0 percent of the requested 2.5 percent across-the-board increase with an average merit pay increase of 2.0 percent; but suggested that no less than 2.0 percent should be provided if merit pay were to be used. However, for FY 2017-18, the Committee arrived at a compensation increase compromise that included a 1.75 percent across-the-board increase with an average 0.75 percent merit pay increase.

Staff's recommendation of a "steeper" matrix may have generated an average 0.75 percent merit pay matrix as follows:

JBC Staff Recommended 0.75% Average Merit Pay Matrix					
Performance	Quartile of class range				
Rating	Q1	Q2	Q3	Q4	>Q4
3	1.00%	0.85%	0.75%	0.50%	0.50%
2	0.85%	0.75%	0.50%	0.25%	0.25%
1	0.00%	0.00%	0.00%	0.00%	0.00%

With such a matrix a quartile 1 employee would receive a 2.75 or 2.6 percent total increase, including the 1.75 percent across-the-board increase; as compared to a quartile 4 or 5 employee who would receive a 2.25 or 2.0 percent total increase.

However, pursuant to statute, the Department has full authority to implement merit pay independent of legislative intent. The Department informed staff in June that it intended to apply its traditional, "flat" merit pay matrix, which provides larger increases to superior ratings rather than to the lowest quartile employees. The following table outlines the matrix implemented by the Department.

Department Implemented 0.75% Average Merit Pay Matrix					
Performance	Quartile of class range				
Rating	Q1	Q2	Q3	Q4	>Q4
3	1.15%	1.05%	0.95%	0.85%	0.85%
2	0.75%	0.65%	0.55%	0.35%	0.35%
1	0.00%	0.00%	0.00%	0.00%	0.00%

With this matrix a quartile 1 employee receives a 2.9 or 2.5 percent total increase as compared to a quartile 4 or 5 employee who receives a 2.6 or 2.1 percent total increase. A quartile 1 employee with a superior rating receives a greater increase – 2.9 percent versus 2.75 percent – relative to staff's recommended matrix. However, only 20.9 percent of employees receive a superior rating, while 78.6 percent receive a mid-level rating. At the mid-level rating, a quartile 1 employee receives 2.5 percent with the Department's matrix versus 2.6 percent with staff's matrix. But, at a 0.75 percent average merit pay increase, there is not much difference; and for this reason staff would continue to recommend the use of merit pay only with a minimum 2-percent average award.

While Section 24-50-104 (1)(c)(I), C.R.S., does not specify whether the greater increases should be applied at the highest rating level or at the quartile level first, the statutory list of characteristics of the merit pay system specifies the quartile consideration in subsection (B), while the performance category is cited in subsection (D). However, the Department states that its priority is to reward rating before quartile.

The merit pay policy is this administration's performance-based pay system that it implemented in statute in 2012. The Department states that it is implementing the merit pay matrix and merit pay policy consistently with the intent of its legislation to reward merit above all. However, for the last three years the administration has not requested merit pay. Due to the scheduled change in administration over the next year, staff is not recommending a policy change to the existing merit pay system at this time. However, if the next administration similarly chooses not to use the merit pay system, staff would recommend the repeal of the merit pay system.

THE UNRESOLVED ISSUE OF CLUSTERING AT THE BOTTOM OF THE RANGE

The general "HR" rule-of-thumb is that a competent employee should reach a mid-level of expertise in a position in five years and that the employee should be compensated at a median or midpoint of the salary range at that five-year point in time. This policy rewards performance for the purpose of building a competent and committed workforce, but does not lose sight of the concept of the accumulation of knowledge and experience in a position over time.

Prior years' staff analysis indicates that 55 percent of classified state employees are in the first quartile and generally grouped near the minimum of their salary range; an additional 20 percent are below midpoint. So approximately 75 percent of classified state employees are below midpoint. Previous analysis also indicated that classified state employees are not moving up the salary range over time. Across-the-board increases provide all state employees with an equal increase and are typically made in concert with equivalent salary range adjustments. So while an employee may receive a 2 percent nominal increase in a year, along with a 2 percent salary range adjustment reflecting compensation in the market generally, the employee's real compensation compared to the market, remains at the bottom of the salary range.

To provide increases while also addressing this structural salary range issue, staff recommended the use of the only tool available in the current statewide classified system: merit pay along with the use of a "steeper" matrix which would emphasize greater increases for the lowest quartile employees rather than for the highest ratings. While staff would not identify the current merit pay system as ideal or entirely adequate for this purpose, it was the only tool available. Following the disagreements over staff's merit pay recommendation from last year, staff does not believe it is of value to the Committee, the General Assembly, and the State for staff to continue to insist on the use of this flawed system; a system which even its own founding administration chooses – and even fights – not to use.

INDIVIDUAL STATE AGENCY PROBLEM OR A STATEWIDE CONCERN

It is the opinion of human resources representatives at the Department of Personnel that there is nothing wrong with the current statewide classified system. Their opinion includes the belief that state agencies have all the HR and compensation tools they need to make adjustments internally and through the budget process to better structure compensation on an ad hoc basis to better address employee turnover and career ladder progression. Such adjustments and budget requests include the

several submitted by the Department of Human Services, the Department of Corrections, and the Department of Public Safety over the last two to three budget cycles.

Staff agrees that this may be a reasonable method for addressing problems with distinct occupational classes and groups in particular departments. However, staff is concerned that the primary purpose for the submission of these requests by individual departments is for the exact same reason: employees are stuck at the bottom of the range, and maintaining a competent workforce is becoming a challenge because of employee turnover.

While the Department of Personnel believes these are isolated concerns in specific departments, staff believes this is systemic and statewide. All state employees are experiencing this issue of being stuck at the bottom of the range – with the exception of the managerial and professional classes. Staff is further concerned that individual budget requests to increase pay for particular occupational groups or classes in particular departments will lead to the inconsistent application of compensation policies across the classified system. Staff is concerned that similar occupational groups or classes in other departments will begin to recognize that their positions are not being compensated fairly relative to the same occupational classifications in other departments.

Staff cannot predict or say with assurance that there will be legal issues, increasing turnover rates, or decreasing efficiency or effectiveness at state agencies with large classified workforces. However, staff is aware of multiple, dispersed, and inchoate signs that the statewide compensation system is deteriorating and it is staff's opinion that the Department of Personnel is not similarly recognizing issues and concerns related to the statewide classified system and statewide compensation.

ISSUE 2: PERA LEGISLATIVE RECOMMENDATIONS TO ADDRESS FUNDED STATUS

In 2017 the PERA Board adopted a 7.25 percent assumed rate of return (from 7.5 percent) as well as more conservative mortality assumptions. Due to these changes, most PERA divisions are now designated "orange" in PERA's signal light system, representing "solvent but longer than 50 years to reach 100% funded". In order to restore a 30-year full funding horizon, PERA's Board has adopted recommendations for legislation: to increase contributions from employers and current and future members; more fairly align contributions for future members; reduce cost-of-living adjustments for current retirees and all members; and modify benefits for future members.

SUMMARY:

- PERA's 2016 Comprehensive Annual Financial Report (CAFR) projects the period to achieve full funding for the State Division at 65 years compared to 44 years reported in the 2015 CAFR and 45 years in the 2014 CAFR.
- However, at odds with the figures presented in the 2016 CAFR, PERA's *12/31/2016 Actuarial Valuation Results and 40-year Projections* from Cavanaugh Macdonald Consulting, LLC, issued on June 23, 2017, identifies the full funding period for the State Division at 58 years.
- Additionally, the Judicial Division is now projected at *infinite* or 54 years, the Local Government Division is projected at 42 years or 55 years, the Denver Public Schools (DPS) Division is projected at *infinite* or 56 years, and the School Division is projected at 128 years or 78 years depending on the respective document cited.
- Among other changes, PERA recommends increasing employer contributions by 2 percent and increasing employee contributions by 3 percent for current members and 2 percent for members hired on or after 2020.
- Additionally, PERA recommends reducing the cap on cost-of-living-adjustment or *cola* increases from 2.0 percent to 1.5 percent and eliminating the *cola* adjustment for two years.
- The Governor has recommended a 2 percent increase in employee contributions, effective in 2019, no change to employer contributions, and a reduction in the cap on *cola* increases to 1.25 percent.

DISCUSSION:

PERA'S REQUEST

In 2017 the PERA Board adopted a 7.25 percent assumed rate of return (from 7.5 percent) as well as more conservative mortality assumptions. Due to these changes, most PERA divisions are now designated "orange" in PERA's signal light system. Orange represents "solvent but longer than 50

years to reach 100% funded". The color designations on either side of orange are red, which represents "insolvent beyond 20 years", and yellow, which represents "100% funded within 50 years".

PERA's 2016 Comprehensive Annual Financial Report (CAFR) projects the period to achieve full funding for the State Division at 65 years compared to 44 years reported in the 2015 CAFR and 45 years in the 2014 CAFR. However, at odds with the figures presented in the 2016 CAFR, PERA's *12/31/2016 Actuarial Valuation Results and 40-year Projections* from Cavanaugh Macdonald Consulting, LLC, issued on June 23, 2017, identifies the full funding period for the State Division at 58 years. Additionally, the Judicial Division is now projected at *infinite* or 54 years, the Local Government Division is projected at 42 years or 55 years, the Denver Public Schools (DPS) Division is projected at *infinite* or 56 years, and the School Division is projected at 128 years or 78 years depending on the respective document cited.

The plan adopted in S.B. 10-001 was intended to provide full funding in 30 years, which is represented by the green signal light designation. At the time of S.B. 10-001, PERA's assumed rate of return was 8.0 percent. In order to restore a 30-year full funding horizon, PERA's Board has adopted recommendations for legislation: to increase contributions from employers and current and future members; more fairly align contributions for future members; reduce cost-of-living adjustments for current retirees and all members; and modify benefits for future members. The following components outline the PERA recommendations. *Current members* represent all current, non-retired members beginning employment before January 1, 2020; *2020 members* represent members beginning employment on or after January 1, 2020.

INCREASE CONTRIBUTIONS:

- *All employers:* A 2 percent increase in employer contributions, effective January 1, 2020.
- *Current members:* A 3 percent increase in employee contributions, effective January 1, 2020.
- *2020 members:* A 2 percent increase in employee contributions, effective January 1, 2020.

ALIGNMENT OF CONTRIBUTIONS:

- *Current and 2020 members:* Redefine PERA salary from net pay to gross pay to include Section 125 or "cafeteria plan" deductions, effective January 1, 2020.
- *2020 members:* Change service credit accrual standard for part-time work based on the percentage of full-time employment actually worked, effective January 1, 2020.

MODIFY BENEFITS:

- *Current members non-vested as of January 1, 2020 and 2020 members:* Increase the number of years used in the Highest Average Salary (HAS) calculation from three to five years, except for Judicial Division members which will increase to three years, effective January 1, 2020.
- *2020 members:* Increase eligibility for full service retirement to age 65, or age 55 for State Troopers, effective January 1, 2020.

- *2020 members*: Increase eligibility for reduced service retirement to age 55 with 25 years of service, effective January 1, 2020.
- *Current retirees and all members*: Reduce the Annual Increase "cola" adjustment from a cap of 2.0 percent to a cap of 1.5 percent, effective immediately.
- *Current retirees*: Suspend the Annual Increase for two years, effective immediately.
- *Current and 2020 members*: Increase the Annual Increase waiting period from one to three years, effective immediately.

Additionally, PERA has suggested that contribution rates and the Annual Increase cap might include statutory, automatic adjustments based on reaching funded status thresholds but has not proposed specifics related to this policy component.

THE GOVERNOR'S RESPONSE

In response to PERA's request, the Governor has proposed a 2 percent increase in employee contributions beginning in 2019, an immediate reduction in the Annual Increase to a cap of 1.25 percent, and no change to employer contributions. The Governor also supports automatic adjustments.

JBC STAFF'S OBSERVATIONS, CONCERNS, AND RECOMMENDATIONS

SIGNAL LIGHT DESIGNATION TIMING AND THE CHARACTERIZATION OF CRISIS

The Committee and General Assembly should keep in mind the designation of "crisis" for PERA's funded status as it relates to the signal light change at this time. The signal light has changed from yellow to orange directly due to the change in PERA Board-determined assumptions and only tangentially or symptomatically due to exogenous, current (and therefore anticipated), economic or financial market conditions.

It can be argued that the move to a 7.25 percent assumed rate of return is a reasonable adjustment to actuarial assumptions to better reflect current market conditions. However, an even more conservative move to 6.0 percent would likely project PERA's divisions funded status in red. What matters, is what actually plays out over the next 30 to 40 years. Keep in mind that PERA has generated returns of 17.4, 14.0, 1.9, 12.9, 15.6, 5.7, 1.5, and 7.3 percent from 2009 through 2016; or 4.8 percent over the last three years, 8.5 percent over the last five years, and 5.2 percent over the last 10 years. The 10-year return includes a single-year return of -26.0 percent in 2008, necessitating the policy changes included in S.B. 10-001.

An exogenous, economic downturn with a financial market decline equivalent to 2008 can be characterized as a crisis. Such actual market adjustments to asset values is a *real-time* change and therefore qualifies as a crisis. A repeat event like 2008 will necessitate a crisis policy and funding response. An endogenous or internal adjustment that causes projections over 30 to 40 years to decline is not a crisis. More accurately, this might be termed a necessary or urgent discussion about potential 30- to 40-year policy adjustments; unless there is a belief that a repeat event like 2008 is likely.

All adjustments requested by PERA will improve PERA's funded status as soon as changes are effective. By the PERA Board's projections, PERA's divisions will be fully funded in 30 years with these recommendations. However, if those projections hold up over 30 years, what will the funded status look like in 35, 40, and 50 years?

Staff has a general concern that the current and recent sense of "crisis", particularly since 2008, along with the larger political concern over the health of public pensions is encouraging short term policy proposals which may not serve PERA members or the State beyond addressing a very immediate, 30-year plan to "fill the hole as quickly as possible so we can be done addressing concerns". The last time short term policy proposals were pursued by the legislature was in the late 1990s in the mistaken belief that PERA's funded status was "over-funded" and immediate, short-term giveaways were the appropriate policy response.

Additionally, while staff characterizes a 30-year plan as a short-term policy proposal, it is due to the goal of immediately improving the funded status from day one in order to minimize the annual criticisms about the apparent, continued lack of progress in the funded status. While that goal – improving funded status from day one – may be a reasonable policy goal, the predominant delivery mechanism for that immediate funding injection is changes to contribution rates. As a stable policy tool, contribution rates should have a correlation to actual long-term, actuarial, normal cost of retirement benefits. Addressing the unfunded liability is about addressing an existing shortfall that has preceded the current benefit structure. If the goal is to immediately improve the funded status through an injection of increased funding, then the mechanism should be transparent and not rely on the standard rate mechanism which gives the appearance that current members and employers are underpaying for the cost of the current benefit structure.

Once PERA's funded status begins to approach 90 percent funding it will be a short step – perhaps as few as five years – for each of PERA's divisions to reach full funding. It will be a period in which charts will reflect PERA's funded status "going hockey stick" – steeply vertical – primarily due to the very lean benefit structure that will then be in place for most working members. The "hole" representing the unfunded liability will have been filled. And while AED and SAED have automatic statutory rate declines, those rate declines will not be implemented until funded status is at 103 percent or higher, at which point rates for each will decline by 0.5 percent each year that funded status is greater than 103 percent. But with funded status *going hockey stick* from about the point that it reaches 90 percent funding, those automatic declines will not keep pace with the substantial over-funding that will be occurring at that time.

Keep in mind that normal cost for current PERA members is actuarially calculated to be about 11 percent in 2016. PERA members who started on or after 2011 were identified as having a normal cost of just under 9 percent. The current employee contribution rate of 8 percent is almost fully funding the normal cost for employees hired since 2011. Not even including AED and SAED, the basic employer or state contribution of 10.15 percent is going almost entirely to pay down the unfunded liability. As older PERA members retire, the normal cost for all employed members will continue to approach the normal cost of post-2011 members, while the basic employer contribution rate will be further building the surplus.

The idea of a *surplus* in PERA's funding is a very attractive balance sheet picture from our perspective in the hole we currently find ourselves. Staff's larger concern is the very severe, substantial, and clear imbalance in funding inputs that will be in place at that time relative to the current benefit structure

for members entering employment – not even considering the additional cost reductions in benefits proposed by PERA.

For many states and local governments, contributions to public pension systems are annual budget decisions, while in Colorado, contributions are based on statutory rates. There have been statements made that the State has underfunded the amount that it should be contributing to PERA for employees. The State has funded exactly what statute requires; it definitively has not underfunded the statutory rates. The underfunding relative to actuarial requirements is due to changes in PERA's assumptions since S.B. 10-001. And even by the policy changes made in S.B. 10-001, there was intended to be a slight decline in the State Division's funded status for about 20 years due to a very slight, negative amortization. The assumptions made between the end of 2008 and S.B. 10-001 were overly optimistic relative to staffing/membership growth and member salary growth, in addition to mortality and assumed rate of return.

So first, staff recommends that the Committee and General Assembly approach the discussion over policy adjustments with reserve and discernment and not out of a sense of panic or crisis. Short of a market downturn like 2008, what is being addressed or fixed is what will actually play out in a gradual and incremental manner over the next 30 to 40 years.

A 30-YEAR OR 40-YEAR FUNDING HORIZON

Traditionally, the pension funding horizon is projected to 30 to 40 years. An employee who begins work at 25 and retires at 65 would pay contributions over a 40-year period. If a pension is in an underfunded condition relative to current actuarial assumptions, the goal is to have a plan to fully fund the pension over a full-career employee's work life.

Section 24-51-211 (1), C.R.S., provides a maximum amortization period of 30 years to be deemed actuarially sound. Similarly, the PERA Board policy matches the 30-year statutory requirement. Thirty years is a more aggressive and therefore conservative fiscal policy regarding achieving full funded status relative to 40 years. It is also more expensive; and could be adjusted in statute to 40 years.

One of PERA's requested changes is to increase full service retirement benefits to age 65. This partially reflects longer mortality in which retirees are living longer, therefore benefits are paid out longer than originally projected. With this change, the implication is that members should work until age 65 to collect full service benefits, which may be paid out for as many as 30 or more years. This also means that employees who begin employment at age 25 will work 40 years. **It may be reasonable and appropriate in light of extended mortality and work years expectations, that the funding horizon should be considered over 40 years rather than 30 years.**

FAIRNESS AND LOW-HANGING FRUIT

PERA requests two components related to the alignment of contributions: Redefine PERA salary from net pay to gross pay to include Section 125 or "cafeteria plan" deductions; and change service credit accrual standard for part-time work based on the percentage of full-time employment actually worked. **Staff recommends that the General Assembly adopt both of these requested changes.**

Calculating PERA contributions on gross pay rather than net pay will incrementally improve actual dollars paid to PERA. In the current budget, appropriations for PERA contributions are calculated on gross base salary. This means that actual PERA payments made by state agencies is reduced from the appropriation based on the net pay calculation. From the budgeting perspective, this change

would cost no more to the state budget, but would increase actual dollars paid to PERA from appropriations already made. This would simply reduce reversions experienced in state agency budgets. (At this time reversions of General Fund are transferred to the State Employee Reserve Fund, which is intended for merit pay but has not been used for its purpose since its creation.)

However, simply out of a sense of fairness, staff would recommend that the General Assembly adopt the requested change to the calculation on gross pay. The calculation of PERA contributions on net pay benefits higher paid state employees, who have the opportunity to aggressively set aside pre-tax income over all but the final *Highest Average Salary* years. This does not require higher paid employees to pay more for their PERA benefits; this merely requires all employees to pay for their PERA benefits on a level playing field regardless of the amount of pre-tax income set aside and regardless of the ability to set aside pre-tax income.

The requested change to the service credit accrual standard for part-time work is a straightforward and fair policy change to award service credit based on the percentage of full-time employment actually worked. It is staff's understanding that currently part-time work qualifies for full-time PERA service credit if it meets the 40-hour minimum wage standard. Again, this policy primarily benefits higher paid, part-time employees.

Similarly, out of a sense of fairness, **staff recommends that the General Assembly adopt the requested increase in the number of years of *highest average salary*.** Staff would suggest that an even longer *highest average salary* period of seven years or more may be reasonable and appropriate.

Normal cost is the actuarial cost of benefits earned in a single year of work. Normal cost will track as a percentage of pay for all employees with the same benefit structure regardless of actual salary. Over a 20-to-40-year career, contributions will be based on the employee's salary over the entire period. But under current policy, retirement benefits are calculated on the three highest years of the employee's salary; while contributions were made over the entire career – potentially 37 additional years at a lower contribution rate than benefits earned. It is reasonable that the adjustment to the *highest average salary* calculation, as a policy, is more fair by an actuarial standard than simply reducing the benefits structure to generate a lower cost.

REDUCE THE COLA CAP

PERA requests a reduction of the Annual Increase or *cola* cap from 2.0 percent to 1.5 percent. The Governor has proposed a reduction to 1.25 percent. Based on case law, this change is an allowed change to current retiree benefits. Retirees currently enjoy a benefit structure that was and is more generous than PERA members currently entering employment. PERA calculates that 18 percent of the cost of the requested changes falls on retirees while 63 percent of the cost of the requested changes fall on current and future employees. The policy choice to reduce the cap will reduce cost of living adjustments for current and future retirees that does adversely affect retiree income. However, it is not apparent that PERA retirees as a class are more likely than non-PERA elderly in the State to experience poverty issues generally associated with the elderly, and particularly as compared to those without an established retirement income aside from Social Security. **Staff recommends that the General Assembly adopt the Governor's proposal.**

PERA requests a two-year suspension of Annual Increase adjustments for retirees and a two-year extension of the waiting period following retirement for current and future members to receive adjustments. PERA reports that annual increase adjustments have overpaid relative to actual inflation

by approximately two years and so makes this recommendation. Extending the waiting period for future retirees makes this change fair to all members. **Staff recommends that the General Assembly adopt this request.**

FULL SERVICE AND REDUCED SERVICE RETIREMENT INCREASES

PERA requests that eligibility for full service retirement increase to age 65 and eligibility for reduced service retirement increase to age 55 with 25 years of service. Staff's largest concern with continued adjustments to the future members' benefits structure, which effectively reduces benefits, is the correlated reduction in the normal cost for these members.

As previously discussed, normal cost is the actuarial cost of benefits earned in a single year of work. As discussed in the General Factors section, the normal cost for all state employees in 2016 was actuarially calculated at 11.01 percent. The June 2015 PERA cost and effectiveness comparison study identified that employees hired after January 1, 2011, experience a normal cost of 8.82 percent based on the reduced benefits enacted in S.B. 10-001. Additional benefit structure reductions will further reduce the normal cost for future members, exacerbating the structural imbalance between funding inputs and costs once the unfunded liability has been addressed.

Reduced costs will help PERA's funded status. But in following PERA's requested adjustments, future employees may be paying 10 percent for an 8- or below-8-percent normal cost benefit structure. While participating in the defined benefit plan may still be the more attractive option for future employees, staff is concerned that future employees may be paying a portion of their own salary for prior generations' retirement benefits while earning reduced benefits relative to their predecessors. **Staff is concerned about the cross-generational fairness of these requested changes.**

EMPLOYER CONTRIBUTION INCREASES

PERA requests that the employer contribution increase by 2 percent. This increase would be added to the standard, 10.15 percent contribution, and would not change the AED and SAED contributions of 5 percent each. The Governor recommends no changes to current employer contribution rates.

Staff recommends neither for nor against a request for additional state funding. The amount of the state contribution to address PERA's funded status is a larger policy issue that can be debated in the context of available resources. **However, along with ongoing reservations about the structure of the AED and SAED, staff does not recommend increasing standard contribution rates for the purpose of making payments toward the unfunded liability.**

AED and SAED were structured to appear as if they are contributions for the cost of current employees. AED and SAED are simply payments made to improve the unfunded liability but structured to be calculated on payroll and to make it appear as if a portion of the prior generational cost is being borne by current state employees. This funding mechanism is fundamentally flawed in its lack of transparency. Similarly, increasing the contribution rate makes it appear as if current employees' PERA benefits cost more than they actually do. In fact, they cost much less since the changes in S.B. 10-001, as has been addressed at multiple points in this document.

Staff recommends that if the Committee and the General Assembly wish to make adjustments to the employer or state contribution rates in order to better fund and address PERA's funded status, that a payment structure be implemented in statute that makes it clear the payments are expressly for that purpose and not to channel, disguise, or otherwise "launder" those payments

through the state employee compensation system. The particular challenge is that PERA's employers include more than just the State. However, staff makes this recommendation in the context of State budget issues, and assumes that other employers and their employees experience the same lack of transparency in this policy structure. **Staff recommends that the State be open and transparent about the reason for and method of the payments; and establish a certain stop date for such payments at the point the unfunded liability has been paid.**

EMPLOYEE CONTRIBUTION INCREASES

PERA requests that employee contributions increase by 3 percent for *current members* and by 2 percent for *2020 members*, effective January 1, 2020. This increase would be added to the standard, 8 percent contribution. The Governor has proposed a 2 percent increase, effective January 1, 2019.

As previously expressed, staff is concerned that the normal cost of benefits is identified as 9 to 11 percent for current employees. Increasing employee contributions by 3 percent will cause employee contributions to fully fund the average normal cost of benefits for current employees. However, employees who started on or after 2011 will be overpaying by at least 2 percent. Similarly, employees starting on or after 2020 will similarly be overpaying by at least 1 percent. This overpayment functions essentially as a tax on state employment compensation for members paying into the defined benefit plan. For members paying into the defined contribution plan, the additional contribution will accrue and remain within their individual accounts.

On the basis of fairness, staff cannot recommend increasing employee contribution rates by more than 1 percent. Staff would also recommend no changes to benefits structure for employees hired on or after 2020, in conjunction with such an increase. Staff would further recommend that increases be implemented gradually by no more than 0.5 percent per year, beginning in 2020 to better allow employees to absorb the adjustments. Staff would also encourage that the General Assembly include either a statutory prohibition or a legislative declaration that employee contribution rates should not be higher than the average normal cost of benefits.

If the General Assembly chooses to increase employee contributions above normal cost, staff recommends that any amount of overpayment be treated transparently in statute; that it not be included in the standard employee contribution; and that instead it be structured in statute as a payment above and beyond the normal cost, intended to pay for the unfunded liability, as a cost of membership in the PERA defined contribution plan.