



Montana Legislative Services Division

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TO: Sen. Joe Tropila, Chairman, State Administration and Veterans' Affairs Interim Committee
Members of the State Administration and Veterans' Affairs Interim Committee

FROM: Dave Bohyer

RE: Follow-up on "salary spiking" within state government

At the Committee's meeting on June 24, several members asked for additional information about various aspects of my June 18 memo on salary spiking and on spiking in general. Please accept this memorandum as my initial response to those questions.

Defining "Salary Spiking"

In the June 18 memorandum, I offered that salary spiking is generally recognized as a substantial increase in the wages or salary of an employee shortly before retiring, the primary purpose of which pay increase is to increase the employee's pension benefit. For the purposes of the memo and for further discussion, I used the following working definition of "salary spiking":

1. *an increase of at least double* the statutorily authorized increase in annual pay is a "substantial increase"; and
2. a substantial increase in an employee's wages or salary over the 5 years preceding an employee's retirement *could be an indication* of salary spiking (but would not necessarily be evidence of spiking).¹

¹ In my oral comments to the Committee on June 24, I noted that I didn't find a universal definition of salary spiking in the literature, but that the common thread seemed to be that the substantial increase in pay shortly before retirement was more or less illegitimate, i.e., that the purpose of the increase was primarily to increase the pension benefit rather than for a legitimate business purpose. For example, the Utah Retirement System defines salary spiking as "... improperly increasing salary before an individual retires. This activity increases contribution rates since pension benefits for retirees are based on the highest average salary. Some employers could defer increases or convert benefits to salary in the final years before an individual retires in an attempt to improve his or her pension....". (See http://www.urs.org/fraudandabuse/salary_spiking.shtml.)

Sen. Balyeat suggested a broader definition and argued that his broader definition would be a better gauge of salary spiking in PERS-covered or other public employment covered by a public retirement system. Sen. Balyeat's suggested definition is:

A "salary spike" is any activity that drives up an employee-retiree's pension benefit to a level above the amount expected by the contributions from the employer and employee and the earnings on the contributions.

The difference between the two definitions offered points up a potential need for a clear definition of salary spiking if the Committee, the legislature, or either of the retirement boards chooses to monitor, measure, or limit salary spiking.

In that light, if the SAVA wishes to propose legislation regarding salary spiking, the definition should address, at a minimum:

1. a dollar amount or percentage amount of change in pay above which salary spiking is indicated or limited; and
2. a time period during which the increase in pay occurs. (The committee could consider, for example, a rolling 3-year or 5-year period or a set period relative to the employee's retirement date.)

If the SAVA is interested in only monitoring or measuring salary spiking, rather than limiting or banning the practice, the members may also wish to consider if a method should or even can be prescribed to determine if the intent of the "salary spike" was primarily to enhance the employee-retiree's pension benefit.

Retirement Conditions Specific to Legislators

During the discussion of salary spiking, an example was outlined whereby a legislator having served perhaps 16 years combined in the House and Senate, who typically is paid about \$9,000 during a session year² and considerably less in the non-session year, who is appointed to or competitively selected for a full-time position in state government would stand to benefit from an increased pension benefit. In many,

² At the statutory rate of \$82.64 per day (\$10.33 per hour), a legislator would earn \$7,437 for a 90-day session, plus an additional \$82.64 for each day working on legislative committee business during the interim or while meeting in a special session.

perhaps most cases, the example would be true.

Legislators are currently paid at the rate of \$82.64 per day, i.e., the equivalent of \$10.33 per hour for an 8-hour day or \$21,486 annually.³ Contributions made to the retirement plan of a participating legislator are based on that rate of pay and, absent other membership service at which the legislator is or was paid at a higher compensation, a legislator's pension benefit is based on that rate of pay when the highest average compensation (HAC) is determined.⁴

Therefore, a PERS-participating legislator retiring December 31, 2010, after having served a combined 16 years in the House and Senate and without earning membership service elsewhere would receive a pension benefit based on 16 years of service at \$21,486 annually (or \$1,790 monthly). Using the standard formula for determining the pension benefit for a PERS employee--Years of Service x HAC x 1/56--the legislator's pension benefit would be \$6,139 annually (or \$511 monthly).

Once vested, a legislator should receive about \$384 in annual pension benefits for each year of legislative service.⁵ So a legislator who has served for a total of 6 years prior to retirement would receive an annual pension benefit of \$2,302 (\$192 monthly) and a legislator who served 10 years would receive an annual benefit of \$3,837 (or \$319 monthly).

Under the example in which a legislator with 16 years of legislative service subsequently enters other PERS-covered retirement, the legislator would receive upon retirement a pension benefit calculated on a larger number of "years of service", adding for each additional year of service about 1.786% of highest average compensation (HAC). Thus, even at the same compensation earned as a legislator, the legislator-retiree could expect an additional \$384 annually (\$32/month) in PERS pension for each additional year of service in excess of the 16 years earned as a legislator.

A legislator accruing additional service at a higher rate of pay (than legislators' pay) would receive a pension benefit that is larger still than additional years of service alone.

³ Section 5-2-301, MCA.

⁴ A legislator's highest average compensation is calculated in the same way as any other employee of the same retirement system. For the PERS, HAC is the member's highest average monthly compensation during any 36 consecutive months of membership service. (See section 19-3-108(6), MCA.) As pay for legislators increases pursuant to statute, an individual legislator's HAC will also change accordingly.

⁵ This amount assumes that the legislator is a member of the PERS and has fewer than 25 years of membership service and is based on the current PERS benefit formula and the current rate of pay for legislators. The amount does not include the effect of the statutory "guaranteed annual benefit adjustment" or GABA.

To illustrate, if the same 16-years-of-service legislator works an additional 3 years following his or her legislative service and earns an average of \$42,474 annually,⁶ the annual pension benefit would increase to \$14,411 (or \$1,201/mo). That amount is derived from the basic formula: YoS x HAC x 1.786%. Substituting dollar amounts for the variables in the formula, the example from above would now show 19 (rather than 16) years of service times \$42,474 (rather than \$21,486) highest average compensation times 1.786%. The result equals the \$14,411 annual pension benefit (rather than \$6,139).

The example also stipulates a larger "highest average compensation" for the (former) legislator in post-legislative employment, which would also translate into a higher pension benefit, about \$17.86 annually for each \$1,000 additional highest average compensation.⁷

Effect of Broadband

Also at the June 25 SAVA meeting, I commented on the potential effects to an individual's pay of the implementation of the broadband pay plan.

Senator Lewis asked if I had additional information or statistics regarding the implementation of broadband and I responded that I didn't, other than what was reported in the memo. Sen. Lewis speculated that implementing broadband workforce-wide may have had the single largest effect on state employee pay (between 2004 and 2009) and I inferred from his comments that he would like to have whatever additional information or analysis might be available.

To that end I contacted staff at the State Human Resources Division (SHRD) within the Department of Administration and inquired if they had conducted any research into the budgetary effects of broadband implementation. I was informed that they had not conducted any such research.⁸

Subsequently I contacted staff of the Legislative Fiscal Division (LFD) and posed the

⁶ \$42,474 was the average annual salary of all non-University System state employees reported in 2009. See State of Montana *Employee Profile*, January 2009, Montana Department of Administration, SHRD, p. 2. The *Employee Profile*, updated for 2010, shows a decline in the average salary to \$42,457.

⁷ The additional \$17.86 in annual pension benefits for each \$1,000 of HAC is at least partially paid for through employee contributions of \$69 per \$1,000 compensation and \$71.70 per \$1,000 compensation in the year earned, plus compounded earnings on the contributions and accumulated earnings.

⁸ Conversations with Paula Stoll, Administrator, SHRD, June-July 2010.

same question. I was informed that LFD staff had also not conducted research on broadband implementation and that their familiarity with available compensation data suggests such research or analysis would be very difficult and perhaps impossible.⁹

Highest Pensions

The data provided by the PERA to me, and by me in my June 18 memorandum to you did not include information on pension benefits paid to any retiree or beneficiary. During discussion by the SAVA, the members asked staff to attempt to obtain the pension benefit amounts paid to the 100 retirees or beneficiaries with the highest pensions from each state-sponsored retirement system.

Subsequent to the June 24 SAVA meeting I asked the executive directors of the PERA and TRS, respectively, for the salary information on which retirees' pensions were calculated and was informed that the data from which the information could be obtained had been provided to the Legislative Audit Division (LAD) staff in response to a separate information request received by LAD at some point prior to the June 24 SAVA meeting. The LAD staff confirmed they had received the request and have responded to it. Consequently, I have relied upon the LAD analysis and can report the highest 100 pension benefit amounts from the state's TRS and PERS defined benefit retirement plans as identified by LAD staff.¹⁰ (See Appendix A for the full lists.)

To provide some context for the 100 highest pensions among state employee-retirees, I have also provided the 100 lowest pensions for the same groups (Appendix B), as well as the median pension and the 50 pension amounts both above and below the median (Appendix C).

Tables 1-A and 1-B show summary pension data for the Top 100, Bottom 100, and Median 100 of both PERS and TRS retirees (2005 through 2009) and for all PERS and TRS retirees (2005 through 2009).

⁹ Conversation with Terry Johnson, Principal Fiscal Analyst, Legislative Fiscal Division, July 13, 2010.

¹⁰ The pension data cover 2005 through 2009, i.e., the most recent 5 years for which annual reports of the retirement systems and, therefore, retirement data are available. For that time period, the data show 2,981 TRS retirees and 5,689 PERS retirees.

Table 1-A: Summary of Annual Pension Benefit Data for Employees Who Retired in 2005 through 2009

Measure		Top 100		Median 100		Bottom 100		All Retirees	
		PERS	TRS	PERS	TRS	PERS	TRS	PERS	TRS
Range	Low	\$55,496	\$48,872	\$11,945	\$22,009	\$194	\$614	\$194	\$614
	High	\$116,587	\$96,759	\$12,500	\$23,034	\$1,350	\$2,134	\$116,587	\$96,759
Mean		\$65,031	\$58,369	\$12,242	\$22,547	\$993	\$1,352	\$16,484	\$22,631
Median		\$61,590	\$55,702	\$12,240	\$22,553	\$1,033	\$1,303	\$12,238	\$22,548
Std. Dev.		\$10,950	\$9,392	\$161	\$303	\$275	\$400	\$13,806	\$13,237

Information covers 2,981 TRS retirees and 5,689 PERS retirees for years 2005 through 2009.

Table 1-B: Summary of Monthly Pension Benefit Data for Employees Who Retired in 2005 through 2009

Measure		Top 100		Median 100		Bottom 100		All Retirees	
		PERS	TRS	PERS	TRS	PERS	TRS	PERS	TRS
Range	Low	\$4,625	\$4,073	\$995	\$1,834	\$16	\$51	\$16	\$51
	High	\$9,716	\$8,063	\$1,042	\$1,920	\$113	\$178	\$9,716	\$8,063
Mean		\$5,419	\$4,864	\$1,020	\$1,879	\$83	\$113	\$1,374	\$1,886
Median		\$5,133	\$4,642	\$1,020	\$1,879	\$86	\$109	\$1,020	\$1,879
Std.Dev.		\$913	\$783	\$13	\$25	\$23	\$33	\$1,151	\$1,103

Information covers 2,981 TRS retirees and 5,689 PERS retirees for years 2005 through 2009.

Prevalence of Salary Spiking at Higher Pay Levels

Rep. Mehlhoff noted during Committee discussion of my June 18 memo that the salary data suggested that spikes in pay seemed to occur more frequently or robustly among employees at higher levels of pay (rather than among employees at lower or average levels of pay).

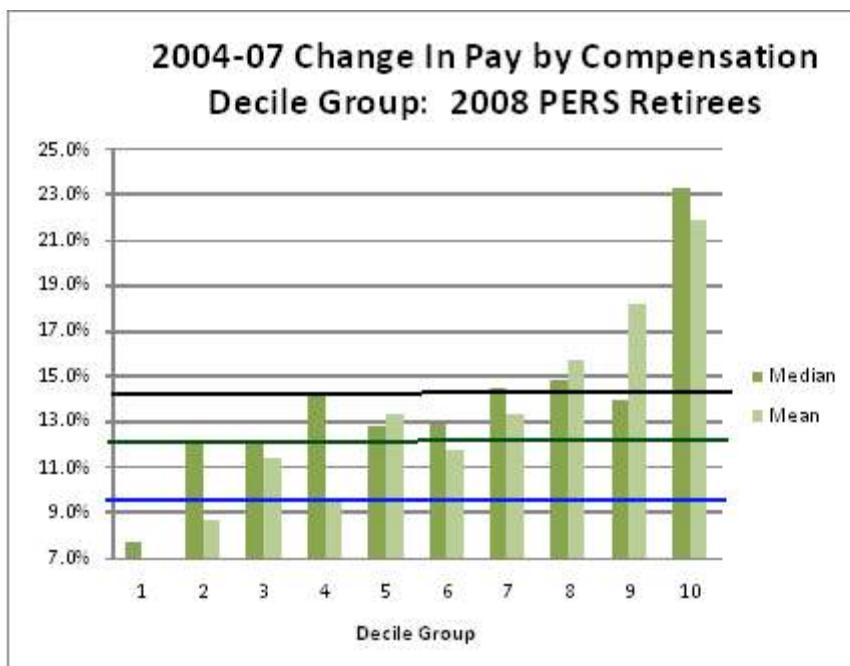
Analyzing the pay data provided by PERS, it appears that Rep. Mehlhoff's perception is probably correct. Generally speaking, among PERS employees who retired in 2008, those employees whose pay in their year of retirement was in the top three deciles increased by a larger average percentage than those employees whose pay in their year of retirement was in the middle- or bottom-three deciles.

Notable, perhaps, are the ranges of increases in pay within and among the decile groups. For example, the range of increases among the lowest decile (ranked by

annual pay in 2007) varies from a low of -92% to a high of +1,514%. Comparatively, the range of increases among the highest decile (by pay in 2007) varies from a low of -7% to a high of +617%. While each of those specific data points is an anomaly, each works well to illustrate the variation in pay increases (and decreases) in years prior to retirement among state employee-retirees at various levels of income.

Chart 1 illustrates the mean and median changes in pay between 2004 and 2007 among deciles of PERS employee who retired in 2008 (based on 2007 salary). The heavier horizontal lines in the chart, from top to bottom, represent: (1) the mean (14.3%) and median (14.1%) pay increases among all PERS employees (top); (2) the actuarially-assumed general pay increase (10.07%, middle); and (3) the statutorily-provided general pay increase (9.25%, bottom).

Chart 1: Change in Annual Pay of 2008 PERS Retirees



The 14.3% increase in mean pay equates to annualized increases (2004-2007) of 4.55% while the 14.1% increase in median pay equates to annualized increases of 4.50%. The actuarially-assumed 10.07% increase derives from annualized general

increases of 3.25%, and the statutory 9.25% increase corresponds to annualized increases of 2.99%.¹¹

Imposing Caps to Mitigate Spiking

The Committee members discussed--questioned is perhaps more accurate--whether there is a need for the legislature to impose caps on pay increases to mitigate salary spiking prior to retirement.

In considering whether to recommend legislation to cap pre-retirement pay increases to mitigate salary spiking that negatively affects the actuarial status of the defined benefit retirement systems, it would seem appropriate that the SAVA should first determine whether salary spiking occurs at such frequency or to such a degree, or both, that it is a problem that needs to be fixed. Such was the case when the 55th Legislature (1997) imposed a cap on pre-retirement pay increases within the Teachers' Retirement System.¹²

19-20-715. Compensation limit. (1)....

(2) In determining a member's retirement allowance under 19-20-802 or 19-20-804, the compensation reported in each year of the 3 years that make up the average final compensation may not be greater than 110% of the previous year's compensation included in the calculation of average final compensation or the earned compensation reported to the retirement system, whichever is less, except as provided by rule by the retirement board....

The Teachers' Retirement Board (TRB) has adopted administrative rules that implement section 19-20-715, MCA, and that provide for seven exceptions to the cap as authorized by the statute. The seven exceptions are increases that result from:

- (1) collective bargaining agreements;
- (2) a change or adjustments in a salary schedule covering a certifiable group of employees not covered under a collective bargaining agreement. The employer must certify the group of employees affected by the change or adjustment in the salary schedule, the increase received by

¹¹ Because the statutory pay increase in 2005 was 25-cents per hour, the corresponding percentage increase varied by an employee's base pay. The 9.25% compounded increase assumes the 25-cents per hour was, on average, a 1.5% increase in base pay, indicating base pay of ~\$16.67/hour or \$34,667 annually in 2004. On base pay less than \$16.67/hour, the percentage increase would be greater than 1.5%; on base pay exceeding \$16.67/hour the percentage increase would be less than 1.5%. Statutory increases in 2006 and 2007 were 3.5% and 4% respectively.

¹² Ch. 442, L. 1997.

each employee, and the methodology for determining the increases;

(3) compensation received for summer employment, provided summer compensation does not exceed one-ninth of the academic year contract for each full month or prorated for each portion of a month employed during the summer;

(4) change of employer;

(5) re-employment for a period of not less than one year following a break in service;

(6) a promotion to an existing permanent position with the same employer. The assignment of temporary duties or a new job added to existing duties, an acting or interim appointment, a change in classification or title, or an increase in compensation received would not qualify as a promotion; or

(7) the combination of salary from multiple employers that when reviewed separately does not exceed 10%.

(From section 2.44.518, ARM)

David Senn, Executive Director of the TRS, has indicated that the statute and rules capping pay increases for TRS members have probably not eliminated spiking completely. Information he provided to the SAVA notes that "[b]etween July 1990 and April 2010, 747 exceptions to the 10% cap were authorized, with an average benefit increase was (sic) \$44.04 per month. The actuarial cost over this period of time has been approximately \$4.8 million."¹³

In following up on his testimony and the information he provided to SAVA in June, I asked Dave how successful the attempt to cap salaries has been and what have been the pitfalls?

Dave responded that he doesn't have answers to either question because he has no way to identify salaries that have been capped, the amounts, or how many people just worked an additional year to avoid the cap.¹⁴

Nevertheless, in potential legislation proposed by the TRB and submitted for SAVA consideration at the June 24-25, 2010 meeting, the Board, through Mr. Senn, offered several options to improve the statutory cap on pay increases in the context of TRS pension calculations.

Repeal all or most exceptions to the 10% cap, §19-20-715, MCA. There may be a need to allow exceptions for increases resulting from movement on a collectively

¹³ *TRS Board 2011 Legislative Concepts*, SAVA Committee Meeting June 24 & 25, 2010, p. 3, submitted by David Senn, Ex. Dir., TRS.

¹⁴ Email exchange, July 14 & 19, 2010.

bargained salary matrix, or for increases resulting from a move from part-time to full-time employment or part-time positions in general. An alternative to exempting increases in excess of 10% that result from causes other than collective bargaining would be to allow the excess to exceed the cap by a certain dollar amount, e.g., \$100, or to increase the cap to 12 or 15 percent and not provide for any exceptions.

Conclusion

There are myriad questions stemming from the SAVA's engagement with the subject of public employee retirement. I have attempted in this memorandum to provide answers to or at least information bearing on some of those questions, as posed by members of the Committee. I will be happy to provide additional research and analysis at the Committee's request.

Respectfully submitted.

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