CATO INSTITUTE

Tax & Budget BULLETIN

`No. 59 • January 2010

Employee Compensation in State and Local Governments

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State and local governments face large budget deficits as revenues have stagnated and spending has remained at high levels. To reduce deficits, large savings can be found in the generous compensation packages of the nation's 20 million state and local workers. In 2008, wages and benefits of $1.1 trillion accounted for half of total state and local government spending.[1] This bulletin examines state and local compensation costs, with a focus on the lucrative pensions enjoyed by public sector workers.

Public Sector vs. Private Sector Compensation

Table 1 shows average compensation per hour worked in state and local governments and the U.S. private sector.[2] Public sector pay averaged $39.66 per hour in 2009, which was 45 percent higher than the private sector average. The public sector advantage was 34 percent in wages and 70 percent in benefits.

Table 1. Average Compensation, 2009
Dollars per Hour Worked

	A. State and Local	B. Private Sector	Ratio A / B
Total compensation	$39.66	$27.42	1.45
Wages and salaries	26.01	19.39	1.34
Benefits	13.65	8.02	1.70
Paid leave	3.27	1.85	1.77
Supplemental pay	0.34	0.83	0.41
Health insurance	4.34	1.99	2.18
Defined-benefit pension	2.85	0.41	6.95
Defined-contribution pension	0.31	0.53	0.58
Other benefits	2.53	2.40	1.05

Source: U.S. Bureau of Labor Statistics. Data for June.

The table shows that public sector workers have the largest advantages in health insurance, defined benefit pension plans, and paid leave. Those advantages stem both from the more expensive features of public sector benefit packages and from the greater availability of benefits in the public sector, as shown in Table 2.[3]

Table 2. Share of Employees Offered Benefits, 2009

	State and Local Governments	Private Sector
Health insurance	88%	71%
Retirement benefits	90%	67%
Life insurance	80%	59%
Paid sick leave	89%	61%

Source: U.S. Bureau of Labor Statistics. Data for March.

Aside from the monetary benefits of public sector employment, government workers enjoy very high job security. During good times and bad, "layoffs and discharges" in the public sector occur at just one-third the rate of the private sector.[4] Public sector workers are rarely terminated for cost-cutting or job performance reasons.

One way to assess whether overall public sector compensation is too high is to look at voluntary job quit rates. U.S. Bureau of Labor Statistics data show that the average quit rate in the state and local workforce is just one-third the rate in the private sector.[5] That suggests that state and local pay is higher than needed to attract qualified workers.

Regional Variations in Compensation

There are large public sector pay variations between regions in the United States. Table 3 shows that average compensation per hour for government workers varies from $49.02 in the Pacific region to $30.73 in the West South Central region. Part of this variation results from general differences in pay levels, as reflected in private sector pay differences between the regions.

However, the data in the table also show that the ratio of public to private sector pay is generally higher in the high-pay regions. For example, the Pacific region has the highest public pay and a public pay advantage of 59 percent, while the West South Central region has the lowest public pay and a public pay advantage of just 26 percent.

Table 3. Average Total Compensation, 2009
Dollars per Hour Worked

	A. State and Local	B. Private Sector	Ratio A / B	Union Share
1. Pacific	$49.02	$30.78	1.59	64%
2. Middle Atlantic	$48.53	$31.69	1.53	67%
3. New England	$43.22	$33.29	1.30	57%
4. East North Central	$43.00	$26.72	1.61	47%
5. Mountain	$36.14	$26.18	1.38	21%
6. South Atlantic	$34.90	$25.33	1.38	18%
7. East South Central	$32.14	$20.76	1.55	16%
8. West North Central	$32.00	$25.35	1.26	26%
9. West South Central	$30.73	$24.35	1.26	13%

Source: Author, based on U.S. Bureau of Labor Statistics data for June. Regions include the following states: 1) AK, CA, HI, OR, WA, 2) NJ, NY, PA, 3) CT, ME, MA, NH, RI, VT, 4) IL, IN, MI, OH, WI, 5) AZ, CO, ID, MT, NV, NM, UT, WY, 6) DC, DE, FL, GA, MD, NC, SC, VA, WV, 7) AL, KY, MS, TN, 8) IA, KS, MN, MO, NE, ND, SD, and 9) AR, LA, OK, TX.

One factor driving these regional differences is the degree of unionization of the workforce. Table 3 shows that the four regions with the highest public pay have a high share of union members in their public sector workforces.[6] Also, regions with the highest public pay advantage (measured by the ratio shown) generally have the highest union shares, but with some exceptions. A related study explores public sector unions in more detail.[7]

Excessive Retirement Benefits

Table 1 indicated that state and local workers have very generous defined-benefit (DB) pension plans compared to private sector workers. These plans have been overpromised and underfunded, which has created huge long-term gaps in government budgets. Indeed, these gaps are not reflected in the Table 1 data, and thus the ultimate costs of DB plans will be higher than indicated.

According to official estimates, state and local pension plans are underfunded (or overpromised) by about $1 trillion.[8] But these estimates greatly understate the poor shape of pension plans because they rely on optimistic assumptions to value future liabilities, a practice Warren Buffett has called “accounting nonsense.”[9]

A recent study by Robert Novy-Marx and Joshua Rauh found that governments are “severely underestimating” their pension liabilities by the use of high discount rates.[10] Using more realistic assumptions, the authors found that state and local pensions were underfunded by $3.2 trillion, or three times more than the officially reported amount. At more than $27,000 for every U.S. household, that indicates a huge exposure for state and local taxpayers.

In 2009, DB plans were available to 84 percent of state and local workers but just 21 percent of private workers.[11] And public sector DB plans are generally much more generous than the remaining private plans. One study found that the median public sector DB plan paid benefits more than twice as high as the median private plan.[12]

A flood of news articles has highlighted the excesses in public sector pension plans, with some cities and states providing truly outlandish benefits.[13] Some of the factors driving up costs in public DB plans include:

- *Early Retirement*. Public sector workers generally retire earlier than private sector workers and enjoy generous pension benefits for life indexed for inflation. They can typically retire at age 55 after 30 years of work, as in California’s CalPERs system.[14] In CalPERs, workers receive an annual pension equal to 60 percent of final salary after 30 years. Public safety workers in CalPERs can retire at age 50 after 30 years of work with benefits equal to 90 percent of their final salary. These lucrative benefits have put CalPERs in deep financial trouble.

- *Pension Formulas*. Virtually all public sector plans calculate benefits based on pay in the last one to three years of work. Private plans are more likely to use a lower-cost approach such as the last five years of pay or career-average pay.[15] Also, public plans typically have a more generous factor to adjust pension benefits for number of years worked. In the public sector, benefits equal to about 60 percent of pay after 30 years of work is typical. In some jurisdictions, government workers inflate or “spike” their pension earnings by getting themselves big raises or working overtime in their final year or two on the job.[16]

- *Double Dipping*. In California, New Jersey, Utah, and other states, public workers can “retire” early and then either resume their existing job or take a new job, thus receiving a salary and pension at the same time.[17]

- *Disability Claims*. Excessive and fraudulent disability claims are a growing problem. In Nevada, “firemen hobbled by heart disease can collect an inflation-protected $40,000 a year for life on top of their pension. That applies even if they're healthy enough to work in another occupation.”[18] *Governing* notes that “hundreds of local governments and several states are wrestling with what some view as out-of-control disability pension and health insurance systems hard-wired to allow police and fire personnel to retire early and with very generous benefits. At the same time, they may pursue other full-time careers.”[19]

- *Excessive Benefits*. News articles have revealed eye-popping annual pension amounts received by civil servants in run-of-the-mill positions in cities across the nation. In California, there are 6,144 retired public employees in the CalPERS plan and 3,090 retired teachers in the state teacher's plan receiving annual pension benefits of more than $100,000.[20]

- *Pay-to-Play Scandals*. The reliance on DB plans means that governments hold huge financial portfolios. That has encouraged "pay-to-play" schemes whereby Wall Street firms bribe public officials to get a slice of the government's financial business. New York's pension fund, for example, is currently engulfed in scandal: "Money manager Elliott Broidy … admitted to making nearly $1 million in gifts to benefit four former top officials in the office that oversees New York State's pension fund, including one-time state comptroller Alan Hevesi."[21] To drain this swamp of corruption, government workers should be moved from defined-benefit to defined-contribution plans.

The excessive benefit levels of public pension plans are creating a looming crisis for government budgets and state taxpayers. To make matters worse, governments have also built up large unfunded costs in their retiree health care plans, a type of benefit that is rare in the private sector. I have estimated that these state and local health obligations are underfunded by at least $1.4 trillion.[22]

A final looming threat to taxpayers is the large amount of bond debt that governments are building up. Total state and local bond debt jumped 92 percent between 2000 and 2009—from $1.2 trillion to $2.3 trillion.[23] Governments are using debt to fund investments that used to be funded on a pay-as-you-go basis, and some governments are using debt to paper over routine budget shortfalls, which is the height of fiscal irresponsibility.

Major Cost-Cutting Needed

State and local governments across the nation face huge fiscal challenges. Spending on Medicaid is soaring, debt is rising rapidly, and many governments have massive gaps in their pension and health care funding. To solve these problems, governments need to make major budget cuts. They should privatize services, cut staffing levels, and terminate low-value programs. And with employee compensation representing half of total state and local spending, large savings could be found by freezing wages and overhauling excessive benefit packages.

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[1] U.S. Bureau of Economic Analysis, National Income and Product Accounts, Tables 3.3 and 6.2D.
[2] U.S. Bureau of Labor Statistics, "Employer Costs for Employee Compensation—June 2009," September 10, 2009. Table includes full-time and part-time workers.
[3] U.S. Bureau of Labor Statistics, "Employee Benefits in the United States, March 2009," July 28, 2009. Retirement benefits include either a defined-benefit or defined-contribution plan.
[4] U.S. Bureau of Labor Statistics, "Job Openings and Labor Turnover Survey: September 2009," November 10, 2009.
[5] U.S. Bureau of Labor Analysis, "Job Openings and Labor Turnover Survey: September 2009," November 10, 2009.
[6] Public sector union share data is estimated by the author based on BLS data reported at www.unionstats.com.
[7] Chris Edwards, "Public Sector Unions and the Rising Costs of Employee Compensation," *Cato Journal*, forthcoming.
[8] Robert Novy-Marx and Joshua D. Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives* 23, no. 4 (2009): 191–210.
[9] David Cho, "Growing Deficits Threaten Pensions," *Washington Post*, May 11, 2008, p. A1.
[10] Robert Novy-Marx and Joshua D. Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives* 23, no. 4 (2009): 191–210.
[11] See U.S. Bureau of Labor Statistics data at www.bls.gov/ncs/ebs.
[12] Pew Center on the States, "Promises with a Price: Public Sector Retirement Benefits," 2007, p. 11.
[13] See www.pensiontsunami.com for recent articles.
[14] Arlene Dohm, "Gauging the Labor Force Effects of Retiring Baby Boomers," *Monthly Labor Review*, U.S. Bureau of Labor Statistics, July 2000, p. 21.
[15] Ann C. Foster, "Factors Affecting Employer-Provided Retirement Benefits," *Compensation and Working Conditions*, U.S. Bureau of Labor Statistics, Winter 1998.
[16] For example, see Janice Revel, "The $366 Billion Outrage," *Fortune*, May 31, 2004.
[17] Brad Heath, "States Act to Curb Double Dipping," *USA Today*, December 3, 2009.
[18] Stephane Fitch, "Gilt-Edged Pensions," *Forbes*, January 22, 2009.
[19] Jonathan Walters, "The Disability Dilemma," *Governing*, May 1, 2007.
[20] See http://californiapensionreform.com.
[21] Craig Karmin and Peter Lattman, "Hevesi Tied to Pay-to-Play as Financier Enters Plea," *Wall Street Journal*, December 4, 2009. CalPERS in California is also embroiled in a pay-to-play scandal. See Girard Miller, "California Pensions' $65 Million Middle-man," *Governing*, November 5, 2009.
[22] Chris Edwards and Jagadeesh Gokhale, "Unfunded State and Local Health Costs: $1.4 Trillion," Cato Institute, October 2006.
[23] Federal Reserve Board, "Flow of Funds Accounts of the United States," December 10, 2009, Table D.3.