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TWO AMERICAS: PUBLIC SECTOR GAINS IN RECESSION

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Over the last two years, as America has experienced the worst economic downturn since the Great Depression, workers have been battered. Employment has fallen sharply, with the employment rolls shrinking 5 percent from their peaks and unemployment around 10 percent. Hourly compensation has approximately kept pace with inflation but has not risen significantly in real terms.

However, this broad picture masks a sharp difference between two classes of employees: those who work in the private sector and those who work for the government. Workers in the public sector have experienced a very different recession from those in the private sector.

While private-sector employment fell sharply in the last two years, the public-sector, civilian workforce continued growing until mid-2008. It has since remained essentially flat. As a result, while private-employment rolls are nearly 7 percent smaller than they were three years ago, public-employment rolls have grown by nearly 2 percent.[1] (Approximately 17 percent of U.S. civilian employment is in the public sector.)

This trend makes sense. Governments do not face the same financial pressures as unprofitable corporations and can avoid layoffs in bad economic times. They can even capitalize on loose labor markets during a recession to hire cheaply. However, that's not what they have been doing.

The problem: During the recession, public employees have continued to see strong wage growth, well ahead of the private sector. From the first quarter of 2007 through the last quarter

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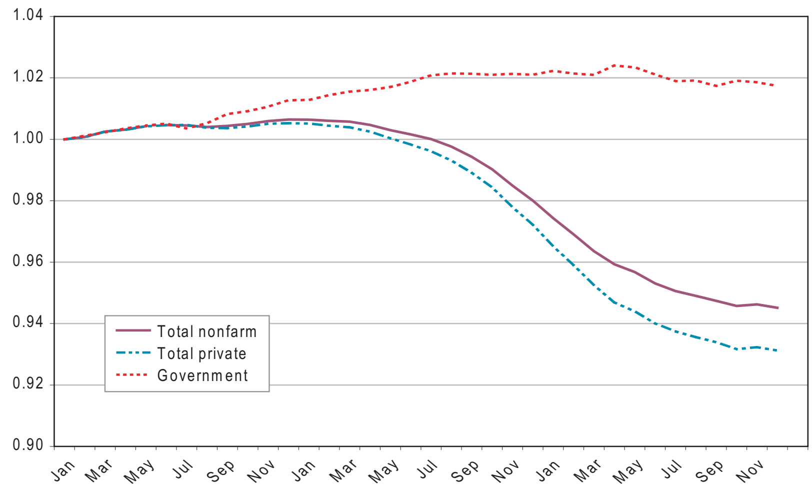
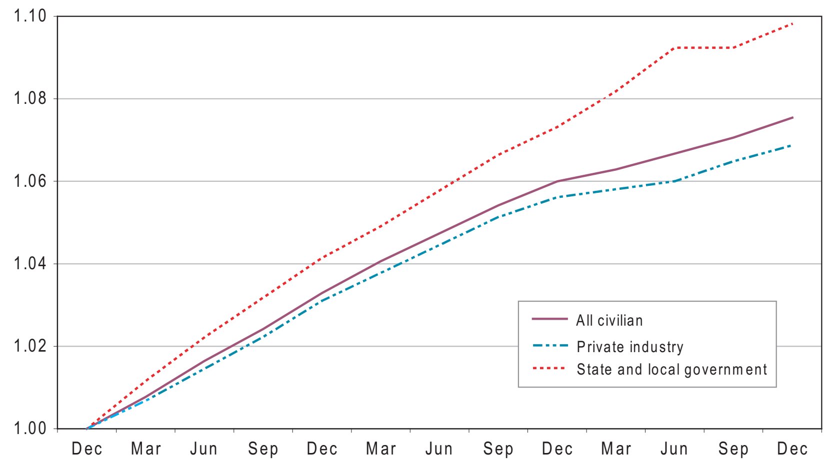
Figure 1. Monthly Seasonally Adjusted Employment, January 2007 - Present (January 2007 = 1.00)



Source: Bureau of Labor Statistics (as of February 5, 2010)

Figure 2. Employment Cost Index, Seasonally-adjusted, Current Dollars, December 2006 - December 2009 (December 2006 = 1.00)



Source: Bureau of Labor Statistics (as of February 5, 2010)

of 2009, the average value of hourly compensation (wages plus benefits) rose by 9.8 percent for employees of state and local governments, compared to 6.9 percent in the private sector.[2] After adjusting for inflation, public employees have seen a rise in real hourly income over this period, while private employees have not.

Over this period, public-employee compensation has risen nearly 50 percent faster than private-employee compensation. Governments are aggressively increasing public-employee compensation even though labor markets are loose and states face record budget deficits.

Why are governments paying so much? In part, continued strong compensation growth is attributable to contracts negotiated prior to the economic downturn: for example, New York State employees are scheduled to receive a 4 percent wage increase in April under a contract signed in the middle of the last decade.[3] Because of higher unionization rates

(37 percent in the public sector and just 7 percent in the private sector) public employees are much more likely to have their compensation governed by multi-year contracts.

However, in some cases, governments have agreed to substantial pay increases even in the face of economic woe. For example, New York Mayor Michael Bloomberg announced a contract agreement for 4 percent annual pay increases for city employees just one day after the Lehman Brothers bankruptcy in September 2008. Just two months ago, Congress passed and the president signed a 2 percent pay increase for federal civilian employees.

Government agencies impacted by binding arbitration have also seen their employee-compensation costs rise. Transit agencies in New York and Washington, D.C., have both been forced recently into new employee contracts with significant annual wage increases, exacerbating budget crises at those agencies.

Are wage rises properly understood as Keynesian stimulus? Many economists advocate counter-cyclical government spending as a strategy to boost economic growth. But if your objective is to stimulate the economy through added government spending, paying above-normal wages is a bad way to go about it. Here's why:

- Stimulus is supposed to be temporary, but wage rises are permanent. It's unlikely that rapid rises in government wages will be offset by wage restraint when times are good; so, instead of a temporary boost in spending, we get a permanently higher baseline for public-employee compensation.

- Employee retention is more stimulative than wage increases. Rises in unemployment are "de-stimulative" because unemployed people drastically cut their spending, sending negative ripples through the economy. But some governments have imposed hiring freezes or are even laying off employees while they give out wage increases. Given a certain budget for employee compensation, there will be greater economic growth if governments employ more people at lower wages.

- A similar stimulus could be achieved with tax cuts. A temporary income tax reduction or rebate would raise the after-tax earnings of all employees, not just those who work in the public sector. Many legislators would respond that they can't afford to cut taxes right now, which is a fair point, but then how can they afford to raise employee wages?

What should be done? The trend in the third quarter—when public-employee compensation was flat—shows that a freeze on public-employee compensation is possible. States and localities should take the following steps to get employee compensation under control:

- Governments should freeze employee compensation at least until public-employee wages have returned to levels matching the private sector trend. They should take this action when negotiating new public-employee contracts. In some states, governments may have powers to freeze pay even in the middle of an existing contract.

- States should also look at reforming binding arbitration laws that force governments to pay unaffordable wage increases. Such laws should be repealed or reformed to properly take into account private-sector wage trends and the ability of governments to pay wage increases.

Unfortunately, the trend reverted to form in the fourth quarter, with public-employee compensation again rising faster than private sector pay. Getting budgets under control will require state and local lawmakers to put taxpayer interests ahead of the interests of public-employee unions.

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[1] This figure represents direct payroll employment in the public sector. It does not include the significant universe of private nonprofit and for-profit employees whose principal support is obtained through contracts with government.

[2] Federal civilian employees, about 10 percent of the public sector workforce, are excluded from these data, but they saw wage increases averaging 9.9 percent over the same period. (Source: Office of Personnel Management)

[3] http://www.empirecenter.org/Reports/2010/01/blueprint2010410.cfm