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Tools for Better Budgets: Options for State and Local Governments to Manage Employee Costs

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State and local governments all across the country are under financial strain, and lawmakers of both parties are looking to cut spending and balance budgets while maintaining vital services. To make ends meet, cuts must be made where the money is—and since state and local governments spend nearly half their budgets on employee salaries and benefits, public-employee compensation costs will be front and center in budget discussions all over the country.

This Issue Brief lays out policies that state and local governments can enact to reduce and control the cost of employee compensation. These recommendations are heavy on strategies to reduce the cost of employee benefits. Growth in benefit spending has been especially rapid in recent years, and, all things being equal, it is more efficient to pay workers in cash than in benefits.

Not recommended here is one strategy that has been frequently proposed in state capitols and city halls: layoffs. This is not to say that layoffs are always inappropriate; they may be the best choice for some governments, especially those with an unusually large workforce relative to population. But layoffs are usually the most disruptive way to reduce employee compensation costs, as they reduce the quality of public services and de-stimulate the economy. Elected officials often choose layoffs because other options (such as furloughs, wage cuts, and reductions in benefits) are legally

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or contractually unavailable. The reforms listed in this paper would give public-sector managers more options to cut costs, therefore reducing the appeal and likelihood of layoffs.

THE PROBLEM

As of September 2010, state and local governments had 19.4 million employees, earning an average of $40.10 per hour in compensation—$26.25 as wages and $13.85 as benefits.[1] The most recently available census data on total salaries and wages paid are from 2008, when they totaled just over $800 billion. Add that to approximately $414 billion spent on benefits. Together, wages and benefits combine to make up 43 percent of state and local spending.[2]

Benefit spending growth has been particularly out of control. From 2005 to 2010, state and local government workers saw approximately a 14 percent increase in their salaries and wages—somewhat outstripping inflation, which totaled 12 percent. But benefit costs per employee rose by 21 percent over the same period. This increase was driven in large part by rapidly rising costs for health care. Sharp increases in benefit costs can be expected in coming years as public pension funds respond to weak stock-market performance by increasing required contributions from participating governments.

The good news is that governments have many tools at their disposal to control these costs—if only they are willing to do it. In broad strokes, spending less on employee compensation means two things: employing fewer workers; and/or paying them less in total compensation. But the processes by which governments determine employee compensation often push costs upward; structural reforms of how governments set pay can lead to lower costs.

This paper lays out structural reforms in three key areas: retirement benefits; health benefits; and employer-employee relations, a category that includes collective bargaining and civil service reform.

Retirement Benefits

In the state and local government sector, the term "retirement benefits" principally means defined-benefit pensions. Some 84 percent of state and local government workers have access to a defined-benefit pension plan (compared with just 20 percent in the private sector), and roughly 90 percent of retirement benefits earned by public workers come in the form of defined-benefit pension accruals.

The structure of defined-benefit pensions allows for costs to be hidden and shifted across time, with public employers making promises to workers now but not necessarily funding them in full. This problem is compounded by Government Accounting Standards Board rules that allow pension plans to value their long-term liabilities with an aggressively high "discount rate," effectively understating the amounts they owe. These factors have encouraged lawmakers to promise pensions that are more expensive than they realize.

Defined-benefit pensions also have strongly pro-cyclical effects on state budgets and have therefore exacerbated the depth of state budget crises. The typical state pension fund invests a large majority of its assets in equities. When these assets underperform, actuaries direct the participating governments to increase their pension contributions in order to replace the lost value. This direction typically comes right at the time when tax revenues are down and state budgets are most squeezed. Conversely, windfall returns allow governments to reduce pension contributions when the economy is booming and fiscal windfalls are least needed—and they also create the temptation to sweeten pension benefits.

Because of the two problems described above, pension reform in most states should have two key objectives: reducing the cost of retirement benefits and reducing the investment risk borne by taxpayers.

There are two key steps to the reform of public-employee pensions. The first is *pension transparency*—

fixing the accounting of pension funds so that it is possible to answer simple questions such as: How large is our unfunded liability? and How much does it cost to award pension benefits?

Answers to these questions will help build support for the second step, *pension reform*, which, in most cases, should follow the private-sector model of plan termination: new hires are moved to a new, defined-contribution system; existing employees keep what they have earned to date but earn new benefits in the defined-contribution system; and retirees see no change to benefits.

Pension Transparency

While public pension funds issue thick annual reports containing a lot of data, they often lack the information needed to answer a few basic questions, such as: How well funded is a given state's pension plan? How much does a public-employee's pension in a given state cost? And what effects are pension costs likely to have on budgets over the next few years?

States can take several steps to improve the quality of pension funds' financial disclosures and therefore make it possible to answer the aforementioned questions. Additionally, the federal government should encourage states to do so. The disclosures that pension funds should start making are described in detail in Manhattan Institute Civic Report 63, *Unmasking Hidden Costs: Best Practices for Pension Transparency*, and are summarized below:

1. ***Discount Rates.*** Retirement funds use a "discount rate" to convert pension or other post-employment benefit (OPEB) liabilities due far in the future into a present value. Government Accounting Standards Board (GASB) guidance leads plans to use discount rates that are unreasonably high. Such rates cause funds to understate their true liabilities and claim to be better funded than they really are. Funds should report their liabilities discounted at a lower rate that corresponds to the low risk of nonpayment borne by pensioners, as a disclosure in addition to the method they use today. Doing this would result in funds' reporting a higher (and more accurate) present-value liability and a lower ratio of assets to liabilities (the "funding ratio")—increasing the aggregate unfunded liability by approximately $2 trillion nationally.
2. ***Smoothing.*** Most retirement funds do not recognize unusual gains or losses on assets immediately. Instead, they recognize them over a period of years—most often, five years. Unfortunately, some funds have been changing their smoothing periods opportunistically: shortening them to recognize sharp gains quickly, or lengthening them to delay recognition of losses. Doing this allows funds to overstate the value of the assets they hold and thus make their unfunded liabilities seem smaller than they actually are. Funds have made opportunistic smoothing rule changes in jurisdictions including New Jersey, South Carolina, Arizona, West Virginia, and the City of Los Angeles. Funds should instead use a standardized smoothing period of no more and no less than five years at all times. They should also continue to separately report the market value of their assets as of particular dates and disclose the funding ratio on both a smoothed and an unsmoothed basis.
3. ***Accrual Methods.*** There are several ways to estimate the dollar value of the benefits that a mid-career employee has accrued to date. Each method will generate a different estimate. GASB requires plans to present certain data using a standardized accrual method called "Entry Age Normal." This accrual method is designed to spread the recognition of costs associated with an employee's pension benefits across his or her career in proportion to the wages and salaries paid to that employee. This standard should be maintained and also extended to the disclosures recommended in points 1 and 2 above.
4. ***Projections.*** When a pension fund's financial position deteriorates, actuaries direct the fund's

sponsors (i.e., state and local governments) to contribute more money. But because of asset smoothing, it takes several years before a protracted decline in stock prices is fully recognized, forcing sponsors to deal with the shortfall by increasing their contribution rates. Pension fund managers know that stock-market losses, especially the steep ones of recent memory, are very likely to drive required employer contributions higher in the coming years, as past losses are gradually recognized. However, because funds do not typically issue public projections of contribution rates, legislators do not necessarily have fair warning of these impending increases. Therefore, pension funds should annually issue five-year projections of employer contribution rates, so that lawmakers can plan to accommodate rising pension costs in future budgets—or enact pension reforms to lower costs.

5. ***Normal Cost.*** The factors that obscure the aggregate cost of pension plans also obscure the cost per employee. Employer contributions are the basis for current measures (such as those published by the U.S. Bureau of Labor Statistics) of these costs, but they do not represent the full cost, which is the present value of the pension credit that employees receive for providing service in the current year. Public pension funds should report the market value of this ongoing cost, as private firms already do. This figure is the true "cost" of offering pension benefits, whether it is met with cash in the current year or by incurring a liability that will be covered in the future.

Pension Reform

By taking these steps, lawmakers will gain access to better and more transparent information. But alone, this will not represent an actual change to substantive pension policy. Substantive reform should serve the two key objectives described earlier in this section: reducing costs and reducing market risk.

Pension reform is currently on the agenda in most state capitals, with eighteen states enacting reforms in 2010. In general, however, reform has not been well executed. The most typical style of reform has been to reduce the generosity of defined-benefit plans only for future employees.

There are several problems with this approach. Because it applies only to workers hired in the future, it produces very little in the way of near-term fiscal savings. Also, retaining the core defined-benefit plan structure means that taxpayers remain exposed to market risk. Finally, staying with defined-benefit increases the risk that reforms will be reversed in the future, erasing any savings to taxpayers; New York State, in particular, has seen several cycles of pension tightening and sweetening since the 1970s.

To save real money quickly, pension reform will have to *reduce the benefits being earned by employees on the payroll today*. Active employees should be allowed to keep benefits that they have already accrued to date but should face cuts to the benefits that they will earn for future years of service to the extent that reducing future benefit accruals is possible while retaining quality talent.

This does not have to involve breaking promises that we have made to government workers.[3] Indeed, governments not facing insolvency should be honoring in full those benefits that have already been accrued, which means no pension benefit changes for workers who are already retired. Essentially, governments should copy the private-sector model for pension plan termination, "freezing" benefits that workers have already earned but changing the benefits that they earn for future work.

To reduce taxpayers' exposure to market risk and reduce the likelihood that cost-saving reforms will be reversed, pension reform should also *abandon the defined-benefit model in favor of defined-contribution benefits*, such as by implementing a 401(k) plan with matching employer contributions. Defined-contribution plans must be fully funded up front.

This rules out the possibility of an unfunded liability.

There are significant legal and political barriers to pension reform, which is why no state has enacted a reform that meets both these benchmarks. However, it is important to note that the legal barriers are creatures of state law, meaning that they can be removed if state lawmakers have the will to enact reform. The political barriers (essentially, the strength of public-employee unions) are the thornier problem. However, as required pension contributions rise over the next several years,[4] lawmakers may find it necessary to take them on.

It is worth noting that several states have managed to enact defined-contribution shifts applying only to future workers. Michigan and Alaska have started moving new government workers to defined-contribution plans, in 1997 and 2006, respectively. Utah also recently enacted a reform that will move most new workers to a defined-contribution retirement plan beginning in July 2011. Though these reforms apply only to workers hired after the date of implementation, Michigan's reform was saving the state $210 million per year by fiscal 2010, with half the state's workforce now outside the defined-benefit system.[5]

Health Benefits

Health benefits are the largest noncash component of state and local government employee compensation, accounting for over 11 percent of public workers' earnings as of 2010. And, as in the private sector, the cost of providing health benefits has been exploding.

State and local governments are, to a significant extent, at the mercy of high health-care cost inflation. However, one important aspect of the high cost of employee health-care benefits is entirely optional: government workers tend to receive much more generous health benefits than their counterparts in the private sector.

The average government worker earns $4.65 per hour in health benefits, compared with $2.10 per hour in the private sector. Part of that difference is attributable to higher coverage rates in the public sector (73 percent of state and local government workers receive health insurance through work, compared with 51 percent of private-sector workers). But part is attributable to the higher value of benefits per employee.

Much of that higher benefit value is the result of lower employee contributions toward insurance premiums. For employees taking single coverage, state and local government workers are typically responsible for paying just 11 percent of the insurance premium; in the private sector, the average figure is 20 percent. For family coverage, there is a smaller gap: 27 percent versus 30 percent.

To reduce the cost burden of health benefits, state and local governments should aim to be competitive with the private sector in terms of benefit value. States can achieve this by explicitly capping the value of health benefits for public workers at a fixed ratio of the average benefit value for private-sector workers in the state. This need not be a 1-to-1 ratio; if a government determines that providing higher-quality benefits is appropriate in the labor market, benefit value could be set at, say, 120 percent of the average private-sector benefit in the state.

Often, reforms in the states have focused on raising the employee contribution toward health premiums. This is one approach to cutting the cost of health benefits, but it is not the only approach. What matters to taxpayers is the *employer* contribution toward health insurance; that can be reduced by increasing the employee share or by reducing the value of the health plan provided—for example, by raising deductibles and co-payments.

Governor Mitch Daniels has taken this approach in Indiana, offering state employees two options: a combination health savings account / high-deductible health plan (HAS/HDHP)—for which employees set aside money tax-free for routine health expenses and receive insurance only for expenses above a large deductible—with a low employee contribution toward premiums; or a more traditional Preferred Provider Organization (PPO) plan—for which the insurer pays the lion's share even of routine health costs—with a higher employee contribution. Introduced in 2005, the HSA option is now chosen by 70 percent of Indiana state workers. Mercer Consulting estimates that moving a majority of employees to HSA/HDHP has saved the state approximately 11 percent on health benefits.

Indiana achieved this reform in part because it does not have collective bargaining for state workers. Public-employee unions in many states have opposed reforms to control health-benefit costs and are a key reason that HSA participation is just 2 percent among state and local government employees nationwide. As discussed in the section on collective bargaining below, restricting unions' ability to block health-plan changes in collective bargaining can make it easier to control these costs.[6]

Employer-Employee Relations

The first line of defense against overly generous employee contracts is for elected officials not to agree to them. But too often, the playing field in bargaining is slanted in favor of public-employee unions. As the American Federation of State, County and Municipal Employees (AFSCME) puts it on its website, "we elect our bosses."[7] By influencing the political process, unions are able to sit on both sides of the negotiating table. Some states enact laws that make this situation worse—for example, by allowing binding arbitration that does not properly account for taxpayers' ability to pay. Fortunately, state and local governments have options to reform their bargaining institutions to make cost control easier.

Collective Bargaining

The boldest and most effective option is to prohibit collective bargaining entirely in the public sector. Virginia and North Carolina do this. Twenty-two other states forbid collective bargaining for some classes of public employees or allow it only by local option.

Not having to bargain employee contracts makes it easier for elected officials to control employment costs. The *Washington Post* has written extensively about the different budget environments in Fairfax County, Virginia, which does not use collective bargaining, and Montgomery County, Maryland, which does:

> Virginia law denies public employees collective bargaining rights; that's helped Fairfax resist budget-busting wage and benefit demands. As revenue dipped two years ago, Fairfax officials froze all salaries for county government and school employees with little ado. By contrast, Montgomery leaders were badly equipped to cope with recession.[8]

Fairfax and Montgomery Counties are socioeconomically and geographically similar, and both have been under Democratic leadership for years. But because Fairfax Democrats are empowered to enforce cost discipline as necessary, that county entered 2010 with only one-quarter the budget gap that Montgomery had, and with more tools at its disposal to close it.

But ending collective bargaining won't be politically feasible everywhere. For example, new Michigan governor Rick Snyder has said that it's probably "not a viable option in the Michigan system." There are a wide variety of intermediate options that are available to strengthen the hand of lawmakers while retaining collective bargaining. Briefly, policymakers could:

- **Implement home rule on collective bargaining.** As noted above, many states allow local governments to decide whether to bargain collectively with public-employee unions.
- **Limit the scope of collective bargaining.** Some areas of compensation where costs have been particularly difficult to control—such as health and retirement benefits—can be excluded from collective bargaining and set

directly by statute. This makes particular sense for retirement benefits, as otherwise lawmakers can be tempted to bargain away higher retirement benefits (which do not have an immediate cash cost) in order to achieve short-term savings. Notably, federal employees are entitled to collective bargaining, but it is sharply limited in scope: for most workers, neither wages nor benefits are bargained. President Obama's budget proposal for a two-year wage freeze on federal civilian workers is only possible because federal employee pay is set by statute instead of through bargaining.

- **End or reform binding arbitration.** Some states allow certain classes of employees the right to binding contract arbitration when negotiations are at an impasse. This impinges on lawmakers' ability to control compensation costs. The terms of binding arbitration are also sometimes tilted in unions' favor—for example, by failing to place weight on a government's ability to pay in determining contract awards. States should reduce the use of binding arbitration, or reform it to place more weight on taxpayers' concerns. Alternatively, they can reform it to cap award costs, as New Jersey did in a recently passed law. States may also consider Last-Best Offer arbitration, which obligates arbitrators to enact either management's or the union's final proposal in full; this encourages both sides to moderate their demands.
- **Stop giving automatic raises to out-of-contract workers.** In New York State, public workers continue to receive annual "step and lane" salary increases even when their contracts have expired, which reduces unions' willingness to agree to contract deals. This law (the Triborough Amendment to New York's Taylor Law) and similar ones in other states should be repealed.
- **Prohibit public-employee strikes.** A ban on strikes makes public-employee labor disputes less likely to turn into crises. Even New York's imperfectly enforced Taylor Law, which bans public-worker strikes, has made actions like the Transit Workers' Union 2005 strike (which shut down New York's subways for three days) rare because it imposes significant costs on unions that choose to flout the law.
- **Eliminate the dues checkoff.** Public-employee unions derive their political power in significant part from the money they raise through employee dues. Requiring unions to collect dues by voluntary agreement of their members can reduce their financial resources.

Paul Kersey also outlines a number of options in more detail in a recent paper from the Mackinac Center for Public Policy, with a particular focus on Michigan.[9]

Civil Service Reform

Closely related to the issue of collective bargaining are the civil service protections enjoyed by many public employees. New Jersey governor Chris Christie has not sought to reduce the collective bargaining rights of New Jersey's public workers (except by capping binding-arbitration awards), but he is seeking to loosen civil service rules. As Christie notes, many of the protections offered by unions and by civil service are duplicative.

Christie has proposed to allow New Jersey municipalities to opt out of the state's civil service system; currently, municipalities may opt in but cannot then reverse that decision. Christie is also proposing several more technical changes, such as recategorizing certain classes of punitive actions to make it easier for employers to discipline employees.

If retaining civil service protections, the most important reform that states and cities can undertake is to end the "last in, first out" (LIFO) layoff system that many states' civil service rules require. Requiring managers to lay off employees solely on the basis of seniority is severely disruptive to the provision of public services. This is because the newest employees tend to be the lowest paid, meaning that more layoffs are required to achieve a given amount of budget savings.

LIFO leads to particularly perverse outcomes in schools, where excellent but junior teachers may be laid off while more senior but underperforming (and more highly paid) teachers are retained. New York City mayor Michael Bloomberg has rightly campaigned for New York State to repeal its LIFO law in order to help the city cope with a $570 million cut to the city's share of education aid in Andrew Cuomo's proposed 2012 budget.

A Menu of Options

Benefits paid or owed to public-employee unions are not the sole source of fiscal trouble in the states. But employee compensation accounts for nearly half of state and local spending, making reforms to compensation a necessary part of the solution. We have seen this over the last two years, with state and local elected officials from both political parties showing a new willingness to seek cost control in employee compensation. Their hands are being forced by budget realities.

That said, some ways of cutting costs are better than others—and some that are good in one state may be inappropriate (either politically or practically) in another. If mayors, governors, and state legislators choose wisely from the menu of options laid out in this paper, they can put their jurisdictions on better fiscal footing while continuing to provide quality public services.

ENDNOTES

[1] Bureau of Labor Statistics (BLS), Employer Costs for Employee Compensation data, September 2010.

[2] These calculations actually understate the true cost of benefits for public workers because they do not fully account for the cost of public-employee pensions and omit entirely the cost of retiree health care. However, because of the unavailability of data that account properly for these costs, we cite the BLS data. For more information, see Andrew Biggs, "Government Employees: Still Overpaid," *The American*, October 23, 2010, http://www.american.com/archive/2010/october/government-employees-still-overpaid.

[3] Josh Barro, "Pension Promises, Real and Imagined," Public Sector Inc., January 2, 2011, http://www.publicsectorinc.com/psi_articles/2011/01/pension-promises-real-and-imagined.html.

[4] See, e.g., E. J. McMahon and Josh Barro, "New York's Exploding Pension Costs," Empire Center for New York State Policy, December 7, 2010, http://www.empirecenter.org/Special-Reports/2010/12/pensionexplosion120710.cfm.

[5] Ibid.

[6] This doesn't have to be just a Republican agenda item: in Massachusetts, Governor Deval Patrick and House Speaker Robert DeLeo, both Democrats, are advocating a bill that would make it easier for municipal governments to require employees to participate in a lower-cost regional health plan over unions' objections. This idea is the brainchild of Boston mayor Thomas Menino, also a Democrat.

[7] See http://www.afscme.org/about/906.cfm.

[8] See "A Tale of Two Counties," *Washington Post*, May 30, 2010, http://www.washingtonpost.com/wp-dyn/content/article/2010/05/29/AR2010052903132.html.

[9] Paul Kersey, "Reconsidering Michigan's Public Employment Relations Act," 2011, Mackinac Center for Public Policy, http://www.mackinac.org/archives/2011/S2011-02FinalWEB.pdf.