Policy Reforms to Control Rising Government Compensation Costs

by Wayne Winegarden, Ph.D.

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Executive Summary

California's state and local governments continue to face historic budget crises, as exemplified by the persistent state deficit as well as the bankruptcy of the cities of Stockton, San Bernadino, Mammoth Lakes and, Compton. These crises have many causes; however a key driver of the budget crises is overly generous government compensation packages. Consequently, California's budget crises will never be sustainably resolved without addressing the problem of overly generous state and local government compensation.

Resolving California's budget crises necessitates an accurate assessment of California's government compensation premium and an understanding of the policies that drive the government premium. Biggs and Richwine (2011) made an important contribution toward the former. Leveraging these results, this paper provides perspective on the latter.

Overall, there are three disconcerting compensation trends that threaten California's long-term fiscal solvency:

***1. California's government compensation costs are already excessive*.**

Biggs and Richwine (2011) illustrate that state and local government employees in California, even after adjusting for education and other relevant skills, earn a significant premium compared to their private sector counterparts. According to Biggs and Richwine (2011):

> *In the case of California public employees, wages are slightly lower in the public sector. Initially, benefits appear only slightly higher, implying rough parity in compensation between the public and private sectors. However, properly accounting for retiree health benefits and defined benefit pension plans generates a public compensation premium of around 15 percent. The additional job security granted to public-sector employees is equivalent to an approximately 15 percent increase in public compensation, meaning that the total public-sector pay premium in California may be as high as 30 percent.*

The average private sector compensation represents government workers' opportunity cost (the next best alternative). The large compensation premium earned by government workers compared to workers in the private sector is an economic inefficiency whose costs are borne by California's current and future taxpayers.

***1. California's government compensation premium over California's private sector is widening*.**

The benefit premium of state and local government workers is not a new phenomenon; but while time series data do not incorporate any of the skill adjustment factors included in Biggs and Richwine (2011), over the past 40-plus years California's government compensation premium relative to California's private sector compensation levels has been growing and is currently near historic highs.

***2. California's government compensation premium relative to other states cannot be justified based on California's relatively higher incomes and cost of living*.**

If California's higher cost of living was the primary driver of California's relatively higher government compensation packages vis-à-vis other states, then the compensation premium for California's government workers should be similar to the compensation premium for California's private sector workers. This is not the case. State and local government workers in California receive a compensation premium over state and local government workers in Texas and the U.S. that is consistently greater than the compensation premium received by California's private sector workers compared to private sector workers in Texas and the U.S.

Declining Value of Public Services

Despite California's high and growing state and local government compensation premium over the past 40 years, there is no indication that the value of the public services provided have improved.

Despite California's high and growing state and local government compensation premium over the past 40 years, there is no indication that the value of the public services provided have improved. And, there is ample evidence that it has worsened. For instance, the performance of California's public schools continues to lag the nation. The quality of California's infrastructure - roads, bridges, highways, airports, ports, water facilities and other modern infrastructure requirements – has declined significantly in part because the compensation and retirement costs of current and retired employees is overburdening the state. According to a report from the American Society of Civil Engineers, addressing California's infrastructure problem requires $65 billion worth of investments. California's justice system is another example of the declining value of government services received by taxpayers. Despite having the second highest per capita justice expenditures in the country, there are countless problems with California's justice system. For example, in the U.S. Supreme Court's decision requiring California to lower its prison population, Justice Kennedy "…emphasized that the state's prison ills had been well-documented and that officials had faced court orders to fix the problems for more than 10 years."

Clearly, declining quality of public services provided to taxpayers does not warrant rising compensation costs. Therefore, even if the compensation levels of state and local government workers were equal to their private sector opportunity costs, the declining quality of public services argues that the marginal value to California's taxpayers from those services may be insufficient to justify paying these costs. The Biggs and Richwine (2011) study illustrates that actual compensation levels for state and local employees far exceed their private sector opportunity costs. Consequently, California's taxpayers are paying public workers compensation levels that vastly exceed their opportunity costs while the value of the services received by taxpayers are arguably less than the opportunity cost benchmark.

The Policy Environment Is Driving the Problem

Table ES1 compares California's policy environment to Texas' in several key policy areas. The first row in Table ES1 provides a comparative compensation benchmark for California versus Texas. While both states pay government employees a total compensation package that is higher than the private sector, California's costs are significantly higher. The higher costs in California are not a random event. California's excessive government compensation costs are the expected outcome of the policies implemented by the state.

Table ES1
A Comparison of California and Texas Policies in Key Areas

	CALIFORNIA	TEXAS
Compensation Premium over Private Sector (2010) (unadjusted for skills)[1]	51.2%	26.0%
Percentage of Workers Unionized[2]	61.9%	12.6%
Collective Bargaining Requirements	Required for all public Employees[3]	Prohibited[4]
Retirement Age (system avg., varies by system)	60[5]	60[6]
Pension Spiking	No Pension Spiking Protections[7]	Pension Spiking Protections[8]
Right to Strike	Yes[9]	No[10]
Arbitration Rules	No Provision[11]	No Provision[12]
Forced Card Check	Yes[13]	No Provision[14]
Health Care Benefits in Retirement	Offered, but unfunded[15]	Offered, but unfunded[16]

As illustrated in Table ES1, California has one of the highest percentages of unionized government workers (61.9 percent), while Texas has one of the lowest percentages of unionized government workers (12.6 percent). And, a high unionized workforce is associated with higher government compensation costs. As noted by James Sherk at the Center for Data Analysis at the Heritage Foundation, the fact that unions are incompatible with public sector work was once widely understood – including by President Franklin Delano Roosevelt and the labor movement itself:

> *"It is impossible to bargain collectively with the government."*
>
> *That wasn't Newt Gingrich, or Ron Paul, or Ronald Reagan talking. That was George Meany -- the former president of the A.F.L.-C.I.O -- in 1955. Government unions are unremarkable today, but the labor movement once thought the idea absurd.*
>
> *Public sector unions insist on laws that serve their interests -- at the expense of the common good.*
>
> *The founders of the labor movement viewed unions as a vehicle to get workers more of the profits they help create. Government workers, however, don't generate profits. They merely negotiate for more tax money. When government unions strike, they strike against taxpayers. F.D.R. considered this "unthinkable and intolerable."*
>
> *Government collective bargaining means voters do not have the final say on public policy. Instead their elected representatives must negotiate spending and policy decisions with unions. That is not exactly democratic – a fact that unions once recognized.*[17]

Public sector unions insist on laws that serve their interests -- at the expense of the common good.

Citing Franklin Roosevelt directly on the issue of collective bargaining and the right for public workers (in this case federal workers) to strike he wrote the following to Luther C. Steward, President of the National Federation of Federal Employees:

All Government employees should realize that the process of collective bargaining, as usually understood, cannot be transplanted into the public service. It has its distinct and insurmountable limitations when applied to public personnel management. The very nature and purposes of Government make it impossible for administrative officials to represent fully or to bind the employer in mutual discussions with Government employee organizations. The employer is the whole people, who speak by means of laws enacted by their representatives in Congress. Accordingly, administrative officials and employees alike are governed and guided, and in many instances restricted, by laws which establish policies, procedures, or rules in personnel matters.

Particularly, I want to emphasize my conviction that militant tactics have no place in the functions of any organization of Government employees. Upon employees in the Federal service rests the obligation to serve the whole people, whose interests and welfare require orderliness and continuity in the conduct of Government activities. This obligation is paramount. Since their own services have to do with the functioning of the Government, a strike of public employees manifests nothing less than an intent on their part to prevent or obstruct the operations of Government until their demands are satisfied. Such action, looking toward the paralysis of Government by those who have sworn to support it, ***is unthinkable and intolerable****. It is, therefore, with a feeling of gratification that I have noted in the constitution of the National Federation of Federal Employees the provision that "under no circumstances shall this Federation engage in or support strikes against the United States Government."*[18]

The evidence substantiates Roosevelt's concerns. Lewis (1988) reviewed the academic studies examining the impact of government unionization and compensation costs. Lewis found that between 1973 and 1984, the wage gap between public union workers and non-union workers was between 8 percent and 12 percent. More recently, Edwards (2010) confirmed the strong relationship between unionized public sector workers and higher compensation levels: "Unionized public sector workers have far higher wages and benefits, on average, than nonunionized public sector workers. Their wages are 31 percent higher, on average, and their benefits are 68 percent higher. Overall, the union compensation advantage in the public sector is 42 percent."[19] California's high rate of public sector unionization is an important driver of its high compensation costs.

And, California's collective bargaining requirements compared to Texas' prohibition on collective bargaining is an important driver of the state's high unionization rate. Hardgrave (2010) categorizes the 50 states into four general legal environments for collective bargaining: collective bargaining required for all public employees, collective bargaining required for some groups, no guaranteed collective bargaining, and collective bargaining prohibited. Whereas,

- The average of the state unionization rates is 34.3 percent;
- Those states that require collective bargaining have an average unionization rate of 50.9 percent;
- Those states that require collective bargaining for some groups have an average unionization rate of 18.4 percent;
- Those states with no guaranteed collective bargaining have an average unionization rate of 15.7 percent; and,
- The two states that prohibit collective bargaining have an average unionization rate of 6.7 percent.

The combination of higher unionization and strong collective bargaining rights has led to the implementation of policies that are driving the high compensation costs in California. Sustainably addressing California's excessive compensation of government employees requires a reversal of the policies driving these trends – the excessive power granted to public unions and the collective bargaining system. Like Texas, California should remove the guarantee for collective bargaining, and ideally, as FDR might counsel, prohibit the practice all together. Similarly, the right to strike and to arbitration should be severely limited and ideally removed. These reforms will remove the system's current biases toward excessive compensation levels for state and local government employees. They do not address the current levels, however.

California should also pursue reforms that, over time, bring current government compensation levels into balance with the private sector. Biggs and Richwine (2011) documented that it is the overly-generous benefits driving the excessive compensation levels. Consequently, the reform policies should address current benefit levels – especially the retirement health and pension systems.

Instead of attempting to change the Rube Goldberg that is California's current defined benefit systems, California should consider switching all employees to a defined contribution plan. In lieu of terminating the government plans, an option used by the private sector is to freeze their current retirement plans. Ideally, California would pursue a hard pension freeze. A hard pension freeze pays current employees the benefits that have already accrued in the defined benefit plan, but does not allow any employee to accrue any new benefits. Instead, all future benefits accrue to a defined contribution plan. A soft freeze, on the other hand, allows current employees to continue accruing benefits under the current defined benefit plan, but prohibits any new workers from joining the defined benefit system. A hard pension freeze will improve California's finances more quickly, end the unknown "entitlement" nature of the current define benefit plans, and provide state and local government workers with defined contribution retirement plans similar to the private sector.

A primary defined contribution benefit system for public sector workers is not an untried phenomenon—Michigan and Alaska have defined contribution plans as their primary retirement plan; and Washington, Oregon, Indiana, and Georgia have hybrid plans that contain elements of both a defined benefit plan (a minimum guaranteed benefit) and a defined contribution plan (an investment component that provides benefits based on the market returns).[20]

All new employees or current unvested employees should be transferred to a defined contribution plan that should meet the average standards for a large private sector defined contribution plan. According to a Watson Wyatt survey of the defined contribution plans of the Fortune 100 companies, these standards could include (i) no minimum length of service requirement for eligibility in the defined contribution pension plan, and participation in the defined contribution plan should be permitted upon hire; (ii) non-matching contributions of up to 6.0 percent of pay should be available to all employees with immediate eligibility, and (iii) employer match up to a set percentage of pay, with immediate eligibility.[21] California should also implement Health Savings Accounts to cover employees and pensioners health costs. All vested public employees should also be transferred to the defined contribution plan subject to the same benefits as all new employees or current employees who were not vested. The defined benefit plan would continue operating with the purpose of paying out current obligations.

While eliminating the defined benefit pension systems is the ideal reform, such a reform may be politically unattainable. However, the need to bring public compensation in line with the private sector remains. Assuming that the defined benefit plans are not going to be eliminated, reforms to the current generosity of the defined benefit system should include: (i) increasing the number of years used to calculate retiree pension benefits; (ii) raising the retirement age, while accounting for the different needs of different professions; (iii) disallowing retirees to draw both a state salary and a state pension; (iv) create salary increase caps for the purpose of calculating pensions to protect taxpayers against pension spiking; and (v) increasing employee contributions to their own retirement.

Following this reform model will not only help address California's pension funding problem; it will also help level the playing field between public sector compensation and private sector compensation by eliminating a key driver of the excessive state and local government compensation.

Introduction

California's fiscal woes continue to worsen despite the stabilization in most state budgets across the country. According to the U.S. Census Bureau, total state tax collections across all 50 states between October and December 2011 rose 3.5 percent compared to the total tax revenues collected between October and December 2010.[22] In California, however, total tax revenues were down 8.3 percent over the same time period. And, the bad news did not end in 2011; California's large budget deficit problems have persisted into 2012. While California's budget deficit was expected to be a staggering $9.2 billion as of January 2012, by May 2012 it was an even higher $15.7 billion.[23]

The budget mess in Sacramento is a manifestation of California's larger competitiveness problem. Ultimately, the desirability of each state is measured by people choosing to live there. For instance, by their actions, people are saying that Texas is a desirable place to live. According to the U.S. Census, nearly 850 thousand Americans chose to move to Texas between April 1, 2000 and July 1, 2009.[24] Some may have come for the weather; others for the growing economic opportunities. Regardless of the justification, on net, people are choosing to live in Texas. This used to be the case for California, but not anymore. Over the same time period, over 1.5 million Americans chose to leave California.[25]

From a state budget perspective, the net migration is an erosion of the tax base. And, the eroding tax base problem is even worse than just a net loss of people. Between 1992 and 2008,

> *California has on balance lost some 869,000 tax filers. About 3.5 million tax filers have moved into California while some 4.4 million tax filers have fled the state…*
>
> *The key states to which Californians most frequently move represent both geography and economics. The top three destination states are the neighboring states of Nevada, Arizona, and Oregon, and four other states in the top nine are close as well – Washington, Colorado, Idaho, and Utah. The other two top destination spots of the top nine come as no surprise – Texas and Florida – both zero income tax, pro-growth states.*
>
> *Of these nine top destination states, the average adjusted gross income (remember this is over 16 years) of out-migrants was $44,700 while for in-migrants the average adjusted gross income was $38,600, yielding an income premium to the out-migrants of 16 percent.*
>
> *For the nine destination states, the average top personal income tax rate of 3.44 percent versus California's 10.3 percent [soon could be 13.3 percent], top corporate tax rate was 4.59 percent versus California's rate of 8.84 percent. Six of the nine destination states are right-to-work states and have an average 11.6 percent of their workforce represented by unions versus California's 19.5 percent. And finally, the nine top destination states have an average state and local tax burden of 9 percent versus California's 11 percent. That says it all.*[26]

California is not only a net loser of people; California is also a net loser of income. The net loss of income compounds the problem from the net loss of people, creating an even larger budget problem for the state. California is losing people and income to states that tax less and exhibit greater controls over government expenditures. The responses to the budget mess – raising taxes – only compounds the problem by driving away even more people and income that makes the budget problem only harder to solve. To correct the problem, California has to regain control over state expenditures.

One key driver of the expenditure mess that must be addressed is the overly-generous compensation of government employees – the subject of this paper. In FY 2010-11, California employed nearly 372,000 employees, spending $24.6 billion.[27] These figures illustrate that, on average, the government of California spends over $66,000 dollars per position. To put these expenditures into perspective, the salary costs alone of state government employees equated to 27 percent of the general fund in FY 2010-11 – expenditures for the general fund in FY 2010-11 was $91.5 billion.[28] And, these costs do not even include employee benefits or retiree costs.

As Willie Sutton might say, addressing the state budget crisis requires reforms to state and local government compensation policies because *that is where the money is*. Stockton, San Bernadino, Mammoth Lakes and, Compton California exemplify the problem. For instance, Stockton's bankruptcy has resulted from a myriad of problems including "multi-year labor contracts for city workers with escalating costs and generous retirement plans…"[29] And, Governor Brown appears to have recognized this reality as well. In his response to the higher than expected budget deficit, Governor Brown proposed "a 5 percent cut in hours for state employees"; but he is also proposing a growth killing increase in the top marginal tax rate to an unprecedented 13.3 percent.[30] Additionally, moderate changes to the current employee compensation packages will not address the long-term policies that are driving California's high employment compensation costs. As Wisconsin Governor Scott Walker noted:

> *…some have questioned why we have to reform collective bargaining to balance the budget. The answer is simple the system is broken: it costs taxpayers serious money – particularly at the local level. As a former county official, I know that first hand.*
>
> *For years, I tried to use modest changes in pension and health insurance contributions as a means of balancing our budget without massive layoffs or furloughs. On nearly every occasion, the local unions (empowered by collective bargaining agreements) told me to go ahead and layoff workers. That's not acceptable to me.*[31]

The June 5th ballot results from San Diego and San Jose are further signs that voters implicitly understand that government employee compensation is both excessive and unaffordable. San Diego's Proposition B was supported by two-thirds of the voters, and San Jose's Measure B was supported by 70 percent of the voters.

> *The measures both address pensions for current employees as well as new hires, but are slightly different. San Diego will now freeze the base pay used for pension calculations over the next six years, eliminate pension spiking, and put all new hires except for police officers into 401-k type retirement plans. It is estimated that the plan would save the city nearly $1 billion over 30 years.*
>
> *Under San Jose's measure, current workers have to pay up to 16 percent of their salaries to keep their retirement plan or accept more modest benefits. New hires would get less generous benefits.*[32]

The reforms in San Diego and San Jose are the exact reforms California needs statewide. These reforms are necessary whether state and local budgets are tight or plentiful. It is an irresponsible use of taxpayers' money – many of whom earn less than government employees – to offer government employees such a large compensation premium relative to the private sector. Therefore, even if there were no budget crisis, it would still be the responsibility of California's leadership to get its compensation policies correct – just as it is with the leadership of private organizations. But, when the budget path is unsustainable, as they are today across California, spending money irresponsibly is an even larger problem.

In the private sector managers operate public companies for the benefit of its shareholders – in economic terms the managers are known as the "agents" and the shareholders are known as the "principals." It is the fiduciary

responsibility of the agents of private companies to structure total compensation packages that are high enough to attract and retain the right people to run the company as effectively as possible, but no higher. The same compensation principles hold true for the state and local governments in California. In this case the principals of the state are the taxpayers and the agents are the politicians who establish the compensation rules and policies. As the agent representing the taxpayers (the principals), California's state and local politicians have a fiduciary responsibility to establish compensation policies that are generous enough to attract and retain the right people to effectively produce the necessary public goods and services, but no more.

There is mounting evidence that California's state and local government compensation policies fail the taxpayers in this basic fiduciary responsibility.

There is mounting evidence that California's state and local government compensation policies – including policies regarding the power of unions, tenure rules, retirement rules, and pension payment protections – fail the taxpayers in this basic fiduciary responsibility. Biggs and Richwine (2011) made a significant contribution to this debate by illustrating that after adjusting for the education and skills of government workers, the compensation package offered to California government employees are excessive. These results are presented in this paper. This paper then expands upon the Biggs and Richwine contribution in several ways.

The current debate about government compensation levels compares the compensation levels between the public and private sectors today. An additional perspective regarding the generosity of public compensation is evident when viewed within a historical context. Consequently, this paper provides perspective on the connection between the compensation levels of California's public sector workers compared to workers in California's private sector over time. Then, the paper discusses the important link that should exist between the cost of the employees to taxpayers compared to the value of the goods and services received by the taxpayers. When viewed from the perspective of the marginal value of services received by taxpayers, the compensation levels paid to the public sector workers look even less favorable. Lastly, leveraging the previous two insights and the findings of the Biggs-Richwine study, this paper illustrates that the policies that California has implemented over the past several decades are driving the excessive rise in public sector compensation costs in California. Therefore, temporary fixes (such as arbitrary and across the board cuts in the hours worked by government workers) cannot solve the long-term compensation problem. Instead long-term control over government compensation costs requires fundamental reforms of the policies that are the root cause of the problem.

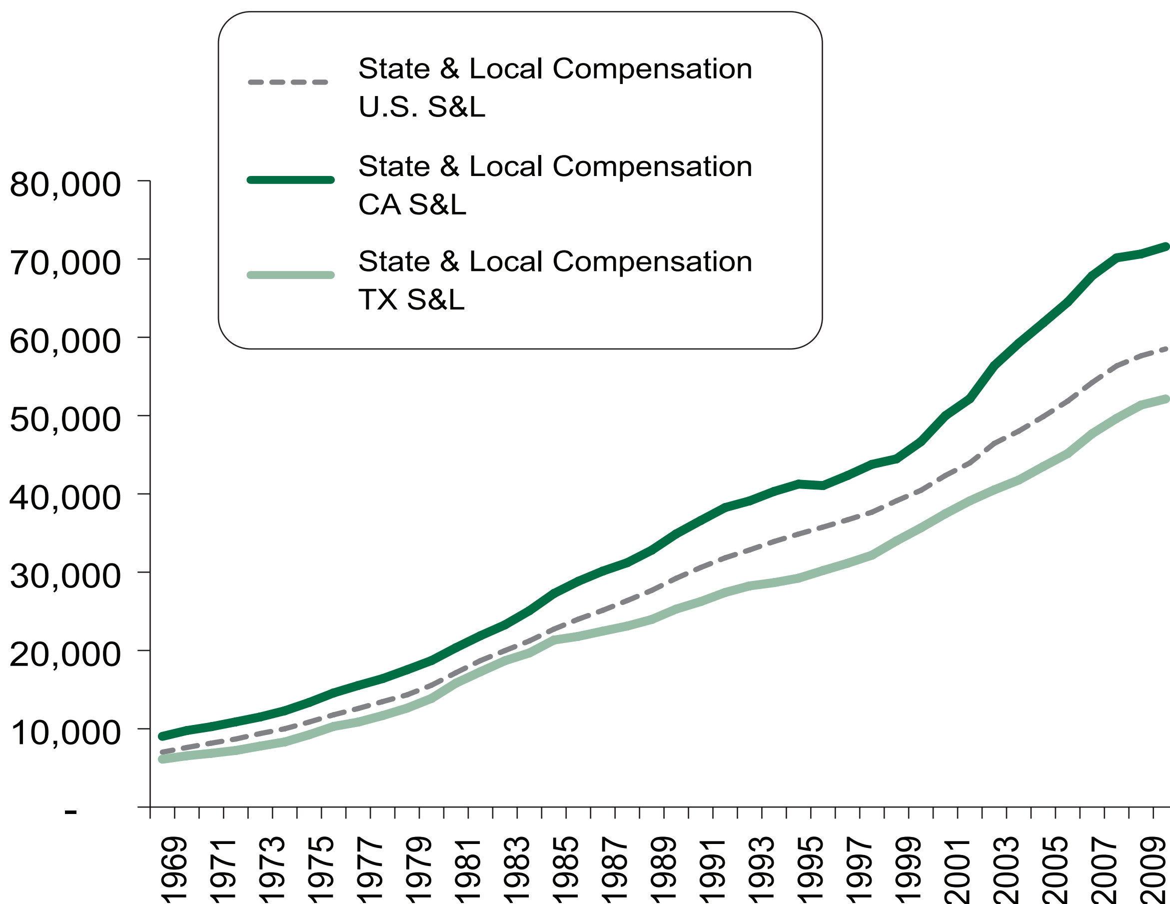
The Changing Relationship between Public and Private Employee Compensation

It is widely agreed that comparing the average wages of state and local employees to the average wages in the private sector is problematic. The traits of the average state and local employee (e.g., educational attainment) vary significantly from the average worker in the private sector. Studies comparing the compensation level of public versus private employees, consequently, account for these trait differences. Such adjustments provide important perspectives on the appropriateness of public compensation or the alternative market wage available to public sector employees (an issue we return to later in this paper). There are other perspectives that matter as well.

For instance, while time series data do not incorporate any skill adjustment factors – the data simply represent the average total compensation of state and local workers and private workers – this relationship has changed over time. Public sector compensation is now significantly more generous than private sector compensation compared to just 10 years ago; and even higher than the relative premium over 40 years ago. Additionally, while there is a market wage (or opportunity cost) for public sector workers, the key question for taxpayers is whether the marginal value of the services provided is high enough to justify paying the market wage. Connecting these themes, the data illustrate that while the average California public sector compensation premium has increased compared to the average California private sector compensation, measures of public services received by taxpayers has declined. In order to gain these additional perspectives on the public versus private compensation debate, this section reviews these themes prior to discussing the specific current compensation premium California's public sector workers earn as well as potential policy reforms that address these inequities.

In this section we review the level and growth of state and local government compensation compared to compensation levels in the private sector. The comparisons are calculated for California, Texas – a proxy for a low compensation cost state – and the U.S. as a whole between 1969 and 2010. Figure 1 presents the total dollar amount of state and local compensation in California, Texas, and for the U.S. divided by the total number of state and local employees (including full-time and part-time employees). Figure 1 illustrates that California has maintained a constant state and local compensation premium compared to Texas and the U.S. overall throughout the 1969 – 2010 period.

Figure 1
Total State and Local (S&L) Compensation per Worker
U.S., California, and Texas | 1969 – 2010
(Total S&L Compensation Divided by Total S&L Employment)



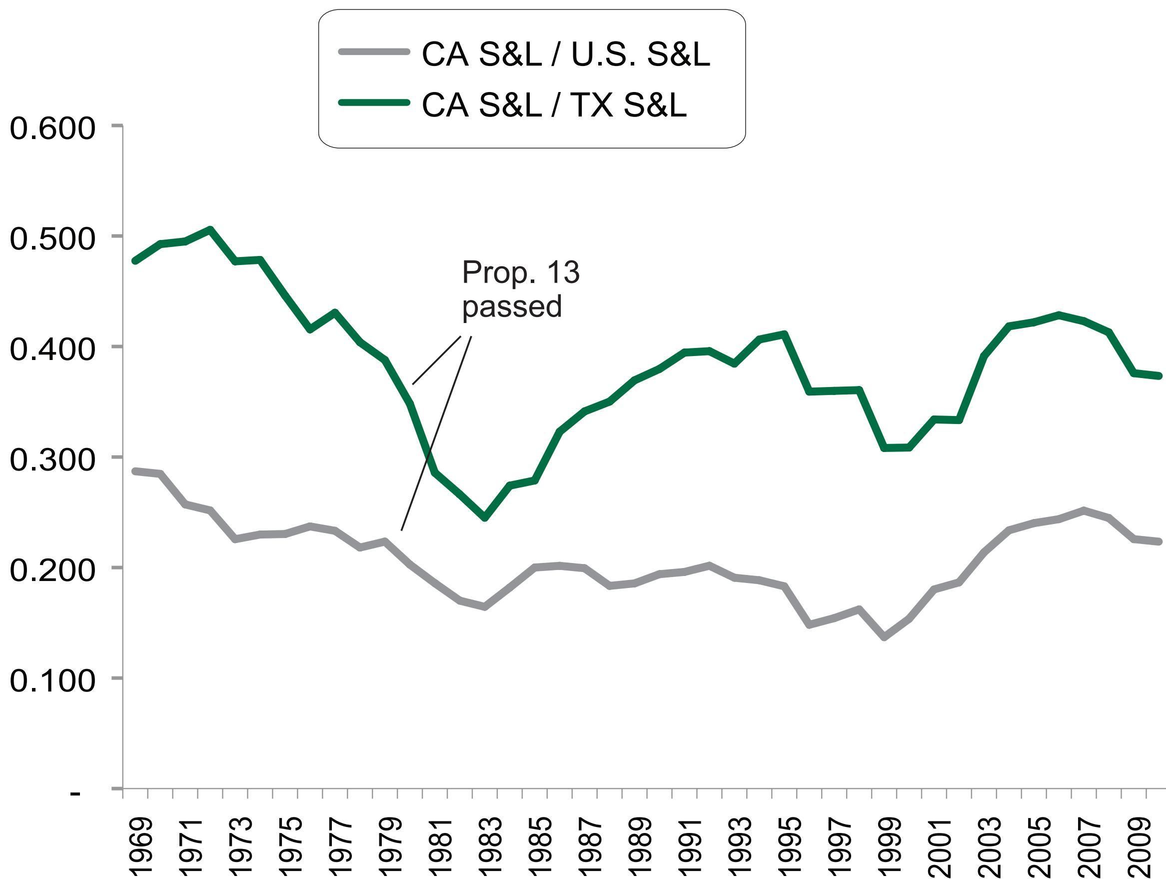
Author calculations based on U.S. Bureau of Economic Analysis, Regional Data, Personal Income and Employment Tables: SA06N Compensation of employees by NAICS industry

However, while California has always paid a compensation premium compared to Texas and the U.S. average, the size of the premium has varied. To see these variations more clearly, Figure 2 displays the percentage premium of state and local compensation in California compared to the average U.S. state and local compensation levels (the red line) and the average state and local compensation levels in Texas (the black line). For instance, the red line illustrates that in 2010 the total compensation package of state and local workers in California was 22.3 percent more than the average U.S. state and local compensation package. The black line indicates that in 2010 California's total state and local compensation package was 37.3 percent more than the average state and local compensation package in Texas.

Figure 2 illustrates that compared to the average state and local employee, the premium earned by California state and local employees was declining during the 1970s (declining at an even faster rate after the passage of Proposition 13), flat during the 1980s, declined slightly during the 1990s, and rose sharply during the 2000s. As California has entered its current budget crisis in 2008, the state and local compensation premium has once again began to narrow. Over the 1969 through 2010 period, state and local compensation in California has averaged around 21 percent higher than the U.S. average.

A similar pattern held between California and Texas; however California's compensation premium versus Texas widened during the early 1980s all the way to the early 1990s instead of remaining flat. Over the 1969 through 2010 period, the state and local compensation premium in California has averaged around 38 percent higher than in Texas.

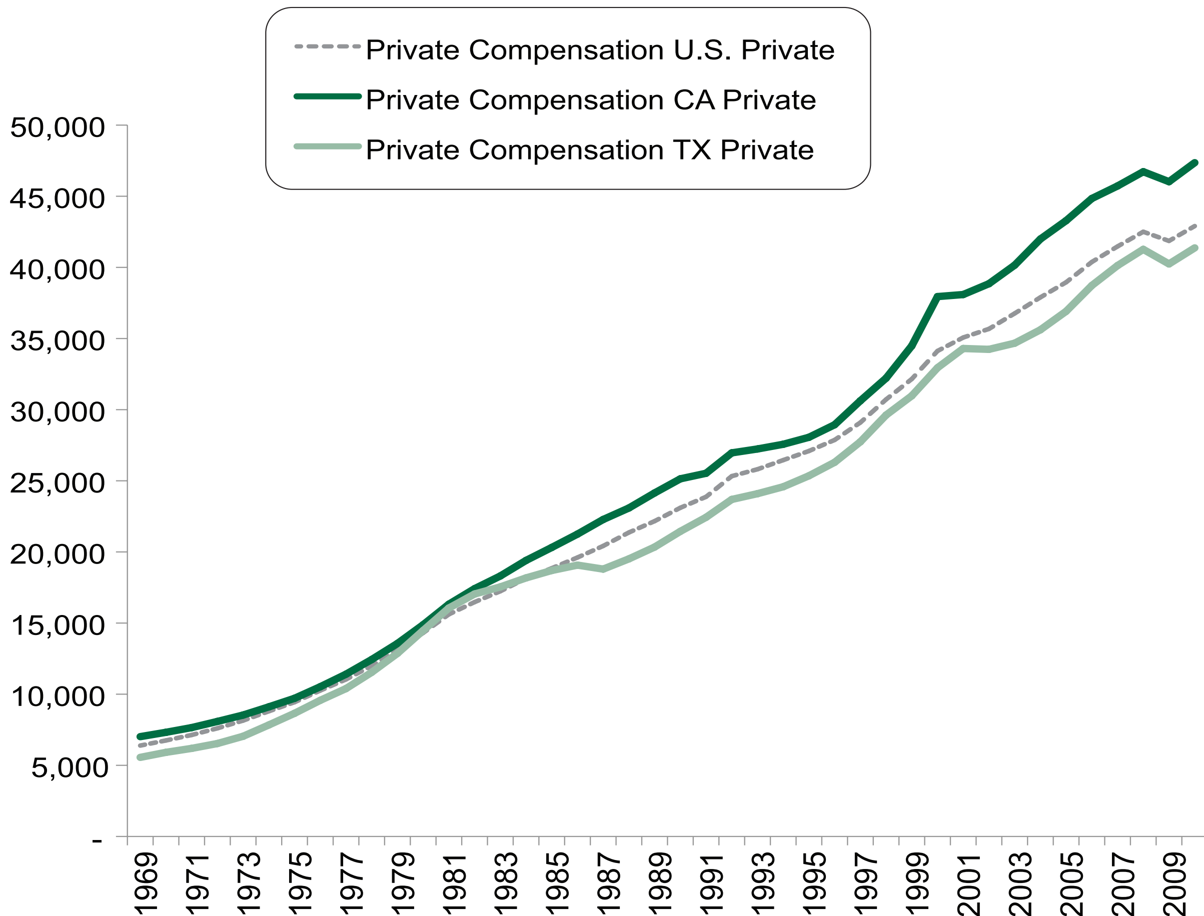
Figure 2
California's Total State and Local (S&L) Compensation per Worker Premium Relative to Texas and the U.S. Average | 1969 – 2010



Author calculations based on U.S. Bureau of Economic Analysis, Regional Data, Personal Income and Employment Tables: SA06N Compensation of employees by NAICS industry

One explanation for the California state and local compensation premium could be higher incomes in California; but, the data do not support this hypothesis. Figure 3 compares the same data – total compensation divided by total employment (including full-time and part-time employees) – only for the private sectors in California, Texas, and the U.S. California workers in private industry earn more than their Texas or U.S. counterparts; however, the California private sector compensation premium is significantly smaller than the California state and local government compensation premium.

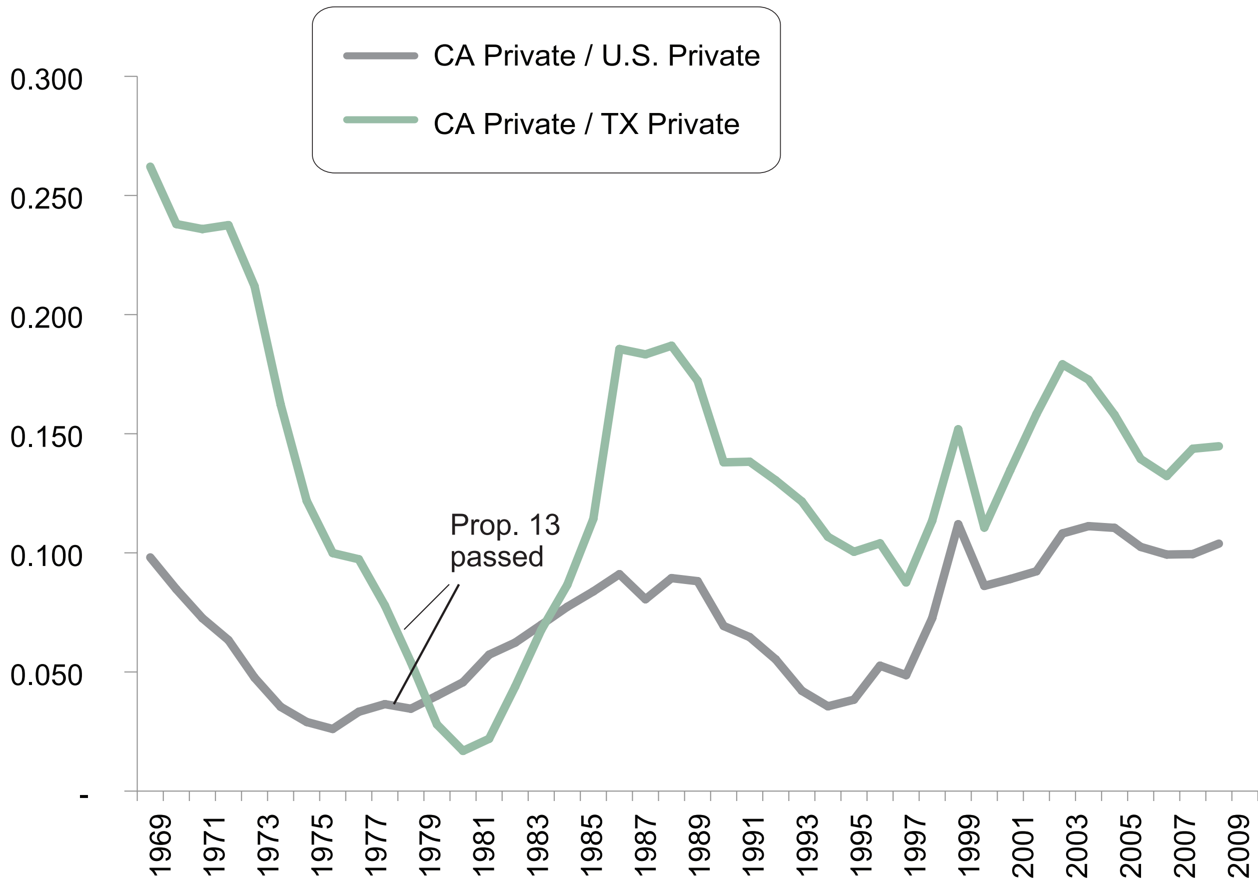
Figure 3
Total Private Compensation per Worker
U.S., California, and Texas | 1969 – 2010
(Total Private Compensation Divided by Total Private Employment)



Author calculations based on U.S. Bureau of Economic Analysis, Regional Data, Personal Income and Employment Tables: SA06N Compensation of employees by NAICS industry

Figure 4 reproduces the calculation contained in Figure 2 using private compensation data. Figure 4 confirms that there is a private compensation per worker premium in California compared to the U.S. overall as well as for Texas. However, as is also evident in Figure 4, the private compensation premium in California is significantly smaller than the state and local government compensation premium. In 2010, California's private compensation premium was 10.4 percent higher than the average for the U.S. and 14.5 percent higher than the average in Texas.

Figure 4
Ratio of California Total Private Compensation per Worker Compared to the U.S. and Texas | 1983 – 2010
(Total Private Compensation Divided by Total Private Employment)



Author calculations based on U.S. Bureau of Economic Analysis, Regional Data, Personal Income and Employment Tables: SA06N Compensation of employees by NAICS industry

The lower private compensation premium for California dispels the notion that the compensation premium for California state and local workers is primarily driven by the higher costs and wages in California. If California's higher costs and wages were the primary driver of the state and local government compensation premium, then the size of the government compensation premium would be similar to California's private compensation premium. Figures 2 and 4, coupled with Table 1 illustrate the vast differences between these relative government and private compensation trends.

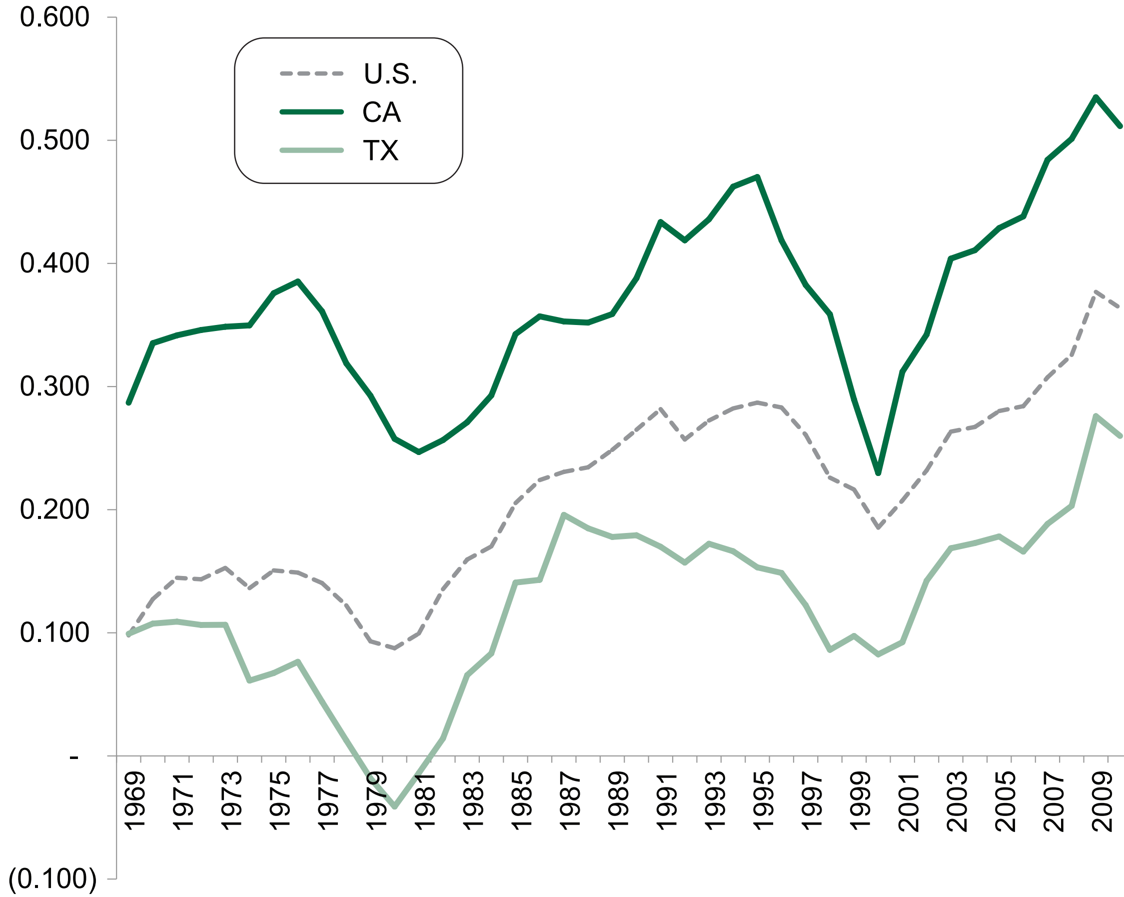
Table 1
Descriptive Statistics: Average, Minimum, Maximum and Standard Deviation
California State & Local and Private Sector Compensation Premium
Relative to U.S. Average and Texas | 1969 - 2010

	U.S.		Texas	
	State & Local	Private	State & Local	Private
Average	20.7%	7.0%	38.3%	13.3%
Min	13.7%	2.6%	24.5%	1.7%
Max	28.7%	11.2%	50.6%	26.2%
Standard Deviation	3.6%	2.7%	6.5%	5.9%

Author calculations based on U.S. Bureau of Economic Analysis, Regional Data, Personal Income and Employment Tables: SA06N Compensation of employees by NAICS industry

One further observation is warranted. Comparing Figure 3 to Figure 1, whether it is for California, Texas, or the U.S. overall, average state and local government compensation levels have consistently been significantly higher than the average private compensation levels, see Figure 5. Figure 5 also illustrates that California's premium, while very volatile, has been increasing over the 1969 through 2010 period and was at its widest ever level in 2009 for California, Texas, and the U.S. overall – however, California's premium was the largest by a very wide margin. Figure 5 raises an important question that supporters of current state and local compensation policies must address: If current state and local government compensation levels are appropriate, then what factors justify maintaining one of the historically widest state and local government compensation premiums compared to the private sector. And, while most pressing in California, this question is just as relevant in Texas and for the U.S. overall.

Figure 5
Premium of Total State and Local (S&L) Compensation per Worker Relative to Total Private Compensation per Worker U.S., California, and Texas | 1969 – 2010 (Total Compensation Divided by Total Employment)



Author calculations based on U.S. Bureau of Economic Analysis, Regional Data, Personal Income and Employment Tables: SA06N Compensation of employees by NAICS industry

Summing up, over the past 40-plus years:

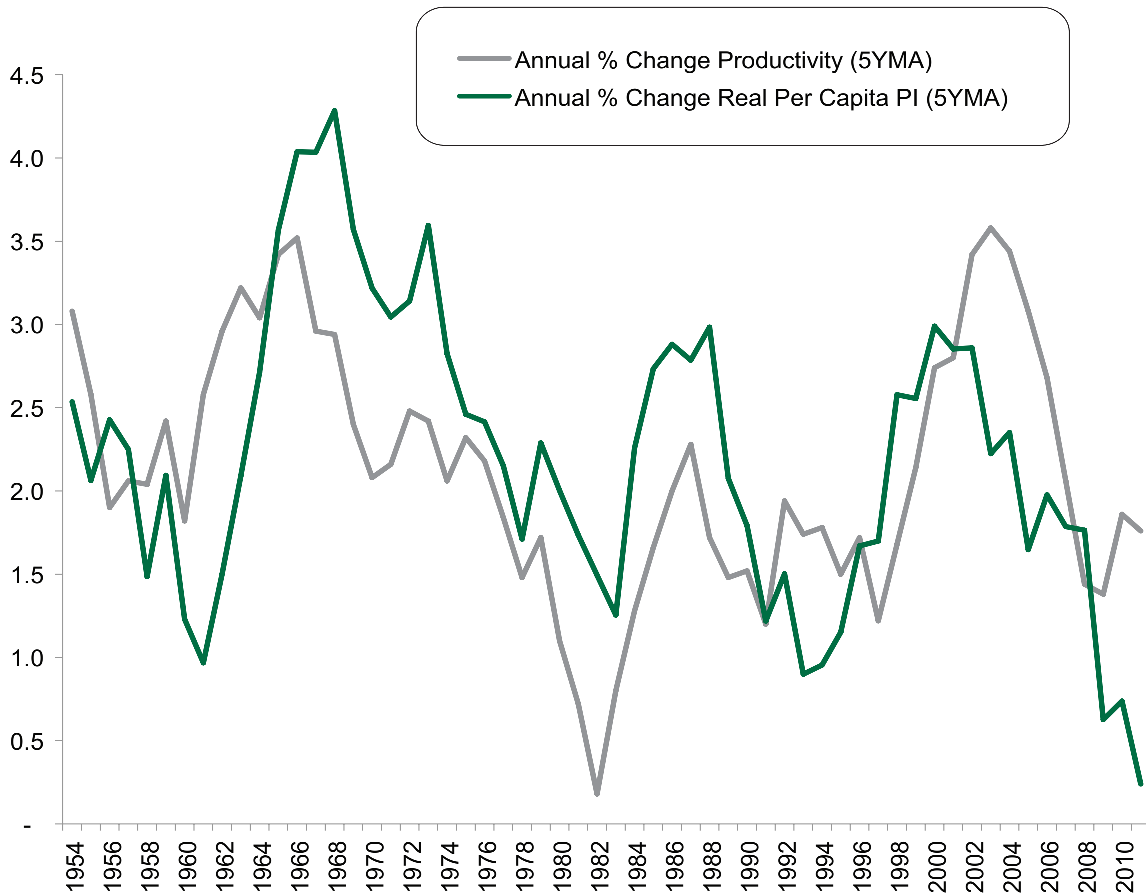
- California's government compensation premium relative to California's private sector compensation levels has been significantly more generous than Texas and the U.S. average.
- While very volatile, the compensation premium of government workers in California relative to private workers in California is growing and is currently near historic highs.
- While California also has a private compensation premium relative to Texas and the U.S. average, California's state and local government compensation premium has been much greater than California's private compensation premium.

These compensation data together paint a disconcerting trend for California. California's government compensation costs are high, growing, and cannot be justified based on California's relatively higher incomes and cost of living. One possible driver for California's higher compensation costs could theoretically be growing worker productivity. As we demonstrate below, this explanation is not supported by the data either.

Compensation Based on the Value of Output

In the private sector, total employee compensation is based on the value that the employees bring to the business. Businesses that pay compensation packages that are too little will lose employees as competing businesses steal their best employees. Businesses that pay compensation packages that are too generous will become unprofitable and, in the extreme, risk survival. It is this process of checks and balances that maintains a stable long-term relationship between private sector worker productivity and private sector worker pay.[33] And, the relationship between pay and income is not simply theory – the empirical data illustrate a tight relationship between worker productivity and rising real incomes from a longer-term perspective. To avoid the noise created by year-to-year volatility, Figure 6 compares the 5-year moving average (5YMA) of the growth in labor productivity – measured as the annual percentage change in non-farm output per hour from the Bureau of Labor Statistics (BLS) – to the 5YMA of real per capita personal income from the Bureau of Economic Analysis (BEA). As Figure 6 illustrates, while there are some divergences, over time these two series follow one another very closely.

Figure 6
Annual Percentage Change in Non-farm Output per Hour (Productivity) Compared to Annual Percentage Change in Real per Capita Personal Income
Five Year Moving Averages | 1954 – 2011



Author calculations based on U.S. Bureau of Labor Statistics, Nonfarm Business Labor Productivity, (Output per Hour) and U.S. Bureau of Economic Analysis, National Income and Product Accounts, Table 2.1 (Personal Income measured in 2005 chained dollars)

Figure 6 illustrates the essential connection between the growth in income and the growth in worker efficiency at producing output. In the private sector there is also a strong connection between the output from workers and the desire for that output from consumers. If the output from workers in the private sector does not reflect consumers' desires, then there are no productivity gains – no producer will continue to produce goods and services that consumers do not purchase, regardless of how effectively those goods and services can be produced.

Public goods do not have a market price, by definition. It is due to this disconnect between the goods and services produced from public sector workers and a market valuation of those goods and services that researchers rely upon a comparative approach to evaluating the appropriateness of government wages. However, as mentioned above, such an approach ignores the value of the public sector output.

Before examining the issue of the opportunity cost (or next best job alternative) for public sector workers, a central question for taxpayers, given the strong link between productivity and pay, is: What is the value that California's taxpayers are receiving for the relatively high and rising cost of California's public sector workers? There is evidence that over the same period of time that public sector wages in California accelerated relative to the private sector – especially between 2000 and 2010 – the quality of services provided by the state of California has worsened.

Declining Quality of Public Services in California

California's state and local compensation premium compared to the private sector is currently around its widest levels. Consequently, if the quality of public services received by Californians reflected the extra costs paid, then the quality of public services received in California around this time should warrant such a high premium. The data illustrate that this was not the case; instead California is failing to provide quality core public services taxpayers expect to receive.

It should be noted upfront that, just like in the private sector, government workers may be (or may not be) responsible for the low quality of California public services. However, in the private sector even if problems are due to the failure of senior management not the average employee, the salaries and bonuses throughout the organization suffer because the value of everyone's output suffers. Despite the fact that the same economic forces hold for the public sector, the expectation that salaries and bonuses should be tied to the success of the services provided is not applied to the government sector. It should be.

For brevity's sake, below California's sub-optimal performance is reviewed in only three key public service areas for taxpayers: state infrastructure, education, and justice. In each one of the key areas examined here, the quality of the public goods provided by the state has declined while the labor costs have been rising.

The quality of California's infrastructure –roads, bridges, highways, airports, ports, water facilities and other modern infrastructure requirements – has declined significantly. Many years ago California was an exceptional provider of these services. According to the American Society of Civil Engineers (ASCE) in California:

> *In the past five decades, our [California's] capital investment has plummeted precipitously. In the 1950s and 60s, California spent 20 cents of every dollar on capital projects. By the 1980s, that figure dropped to less than five cents on the dollar. Current estimates put infrastructure investment at around a penny on the dollar. This is despite ever-increasing demands presented by population growth and economic development. Much of the state's public infrastructure was designed and built to serve a population half the size of California's 38 million residents today, and we face an ever growing population in years to come.*
>
> *It is the old adage of "Pay me now or pay me later." The needed infrastructure investment in California has increased from $37 billion annually in the 2006 Infrastructure Report Card to $65 billion annually in this year's Infrastructure Report Card in just six years.*[34]

It should be noted that the 2012 ASCE report scored California better than average – although daily commuters may find such a grade difficult to believe in the midst of enduring their daily rush hour gridlock. However, as noted in the report California's current relative outperformance is due to its past investments, "California's grades are slightly better than the nation as a whole. The 2009 national grade is a "D." California received an overall grade of "C." This grade is understandable since up until 36 years ago infrastructure investment made up 20 percent of the state's annual budget. Even so, we see elements of our infrastructure in the older parts of the state that are operating well past the design life and need upgrading or replacement. In other parts of the state, infrastructure is 46 plus years old and will soon need significant upgrading. It is essential that we respond now to prevent a California infrastructure meltdown."[35] Additionally, from a taxpayer perspective, while a relative score may be high, California's infrastructure is clearly in need of significant investments – $65 billion worth according to the ASCE report.

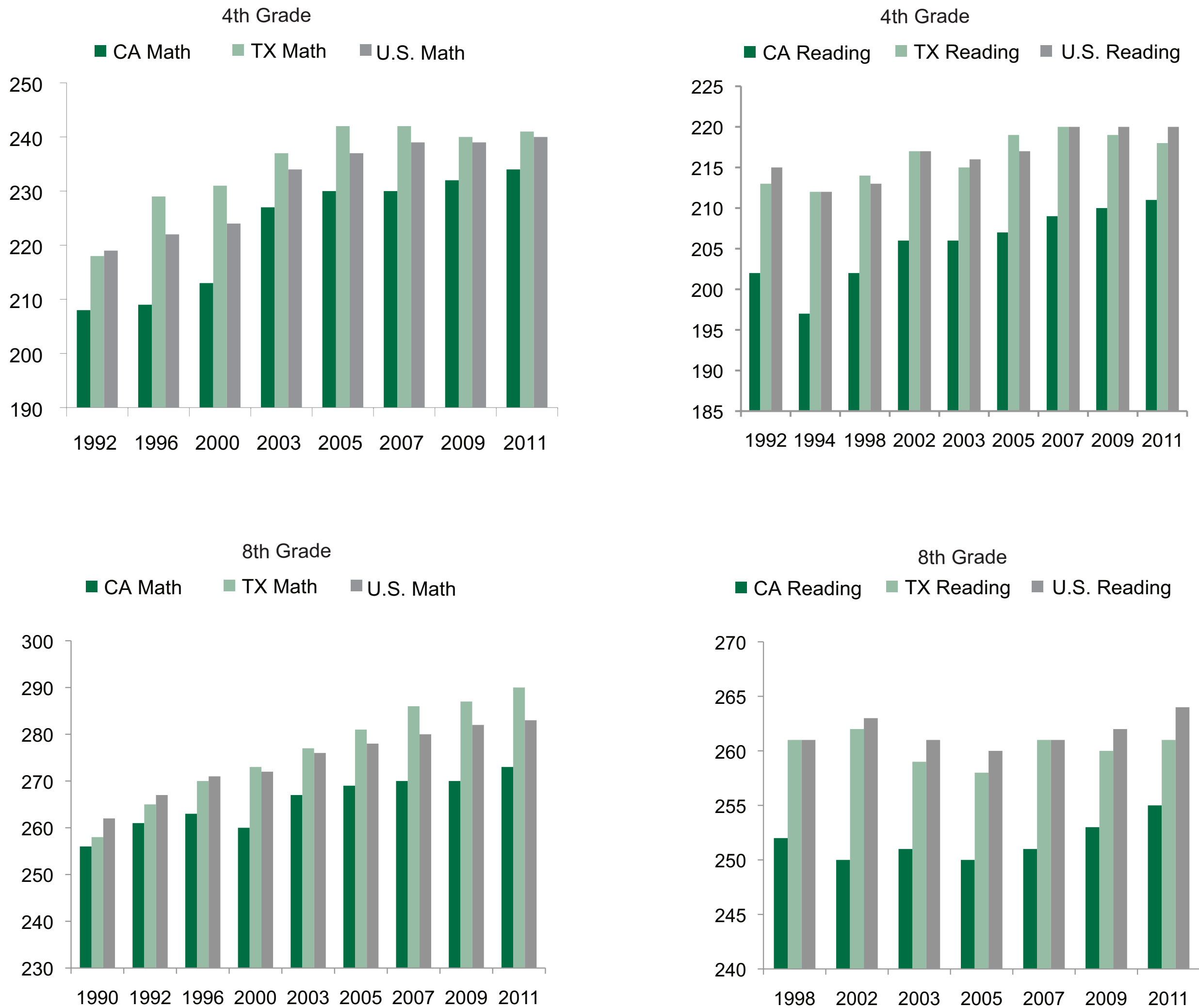
Californian's pay taxes, in part, to ensure that the state's public infrastructure is receiving the necessary investment and maintenance. The growing investment need in a core economic good, coupled with the apparent unwillingness to address this need (ideally through privatization or public-private-partnerships) sets up a situation where the "California infrastructure meltdown" feared by the ASCE may become a reality sooner rather than later. From a public service perspective, Californians are clearly not receiving the services they are paying to receive.

A similar pattern holds for both California's education system, see Figure 7. Figure 7 illustrates that California's primary and secondary education system has been a perennial under-performer compared to the average U.S. state and Texas. There are many ways to measure the quality of public education system. Figure 7 relies upon the Institute of Education Sciences (IES), National Assessment of Educational Progress (NAEP) results in 4th and 8th grade reading and math.[36]

California's test scores have consistently lagged both the national average as well as Texas since 1992. Furthermore, there has been no consistent progress in closing California's under-performance gap over time. While not shown above because the time series available is much shorter, California's scores also fall well below average for science. Primary and secondary school education has been designated as a core state and local government service. The consistent inability of California to perform as well as either Texas or the U.S. average – not to mention the performance of students from most other OECD countries that consistently outperform the U.S. average – is an unmitigated failure of California's state and local governments.

The growing investment need in a core economic good, coupled with the apparent unwillingness to address this need sets up a situation where the "California infrastructure meltdown" feared by the ASCE may become a reality sooner rather than later.

Figure 7
National Assessment of Educational Progress (NAEP)
4th Grade and 8th Grade
Reading and Math Scores
California, Texas, and U.S. Average | Select Years



Source: National Center for Education Statistics, National Assessment of Educational Progress (NAEP); http://nces.ed.gov/nationsreportcard/states/.

As for California's justice system, the problems here are well documented. In fact, nowhere is the dichotomy between employee compensation and the quality of public goods provided as stark. Allysia Finley (2011) describes the excessive compensation for California prison guards by comparing their financial returns to the financial returns Harvard graduates can expect:

> *Roughly 2,000 students have to decide by Sunday whether to accept a spot at Harvard. Here's some advice: Forget Harvard. If you want to earn big bucks and retire young, you're better off becoming a California prison guard.*
>
> *The job might not sound glamorous, but a brochure from the California Department of Corrections and Rehabilitations boasts that it "has been called 'the greatest entry-level job in California'—and for good reason. Our officers earn a great salary, and a retirement package you just can't find in private industry. We even pay you to attend our academy." That's right—instead of paying more than $200,000 to attend Harvard, you could earn $3,050 a month at cadet academy.*

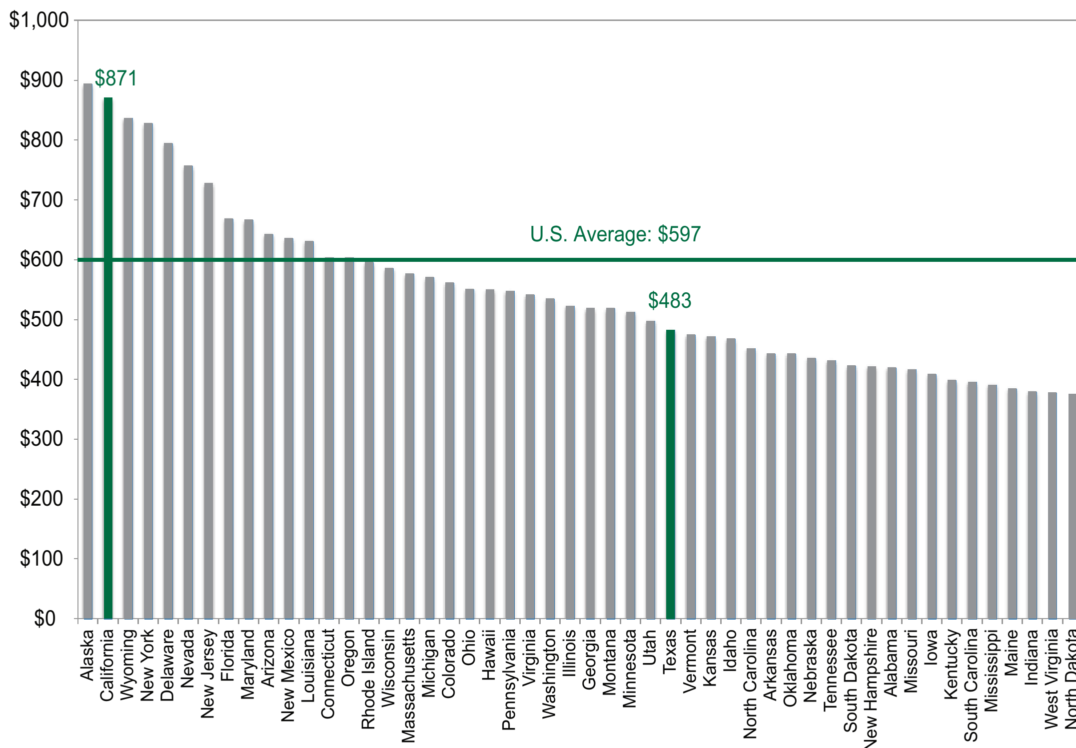
It gets better.

Training only takes four months, and upon graduating you can look forward to a job with great health, dental and vision benefits and a starting base salary between $45,288 and $65,364. By comparison, Harvard grads can expect to earn $49,897 fresh out of college and $124,759 after 20 years.

As a California prison guard, you can make six figures in overtime and bonuses alone. While Harvard-educated lawyers and consultants often have to work long hours with little recompense besides Chinese take-out, prison guards receive time-and-a-half whenever they work more than 40 hours a week. One sergeant with a base salary of $81,683 collected $114,334 in overtime and $8,648 in bonuses last year, and he's not even the highest paid.[37]

These excessive compensation benefits are clearly evident in California's overall Justice costs. On a per capita basis, California spends $871 on total Justice Expenditures, or the second highest of any state, see Figure 8.

Figure 8
Per Capita Justice Expenditures
All 50 States | 2006



Source: Bureau of Justice Statistics Table 8, "Per capita justice expenditure (fiscal 2006) and full-time equivalent justice employment per 10,000 population (March 2006) of State and local governments by activity and State" Justice Expenditure and Employment Statistical Extracts 2006, NCJ 224394, Criminal Justice Expenditure and Employment Extracts Program (CJEE)

Despite these extravagant costs, there are countless problems with California's justice system. For example, in the U.S. Supreme Court's decision requiring California to lower its prison population, Justice Kennedy "…emphasized that the state's prison ills had been well-documented and that officials had faced court orders to fix the problems for more than 10 years." Clearly, the quality of justice services provided to taxpayers does not warrant rising compensation costs either.

From a taxpayer perspective, the quality of the infrastructure provided by the California state government is declining, the quality of California's primary and secondary schools lags the nation, and the state fails to provide

an adequate criminal justice system. These problems of stagnant quality are inconsistent with the rise in overall compensation levels in California that taxpayers are supporting.

Overall, despite the growth in the state and local compensation premium over the past 40 years, there is no indication that the value of the public services provided have improved – and ample evidence that it has worsened. The data reviewed above illustrate that even if the compensation levels of state and local government workers were equal to their private sector "opportunity costs", the declining quality of public services argues that the marginal value to California's taxpayers from those services may be insufficient to justify covering the workers' opportunity costs. The Biggs and Richwine (2011) study illustrates that actual compensation levels for state and local employees far exceed their private sector opportunity costs. Consequently, while the marginal value of public sector services likely fail to justify even the private sector opportunity costs for government workers, the facts show that the actual compensation levels of California's public workers vastly exceed these benchmarks.

The Biggs-Richwine Findings

Compared to private workers, state-local workers tend to earn less in wages but more in benefits.

Biggs and Richwine (2011) rely on what is called a "human capital" approach to comparing wages, which follows the standard practice of the research that compares state and local public sector wages to private sector wages. Smith (1976) is a pioneering study in this field.[38] The human capital model assumes that workers marginal value, and therefore their compensation, can be ascertained based on their skills and personal characteristics.

Biggs and Richwine relied on government data on salaries, benefits, and other forms of compensation (e.g. job stability, pensions, and retirement healthcare) to compare the value of the total compensation package of state and local government workers compared to private sector workers. Ensuring that the total compensation package is incorporated into the analysis turns out to be crucial with respect to the results. As Richwine and Biggs (2011) note:

> *Compared to private workers, state-local workers tend to earn less in wages but more in benefits. The net impact on overall pay is controversial.*
>
> *The Center on State and Local Government Excellence, the Center for Economic and Policy Research, the Economic Policy Institute, and the Center on Wage and Employment Dynamics (CWED) have all released similar studies arguing that the wage penalty and benefit premium for state-local workers either cancel out or tilt in favor of private workers.*
>
> *While these studies more or less properly measure wage differences, none of them considers the full benefit premium enjoyed by state-local workers.*[39]

Clearly, as Biggs and Richwine argue, the value of the full compensation of workers that accounts for all benefits and perks is the economically correct measure to use. To see why, imagine two workers that earn a salary of $50,000 a year. It would be incorrect to claim that both workers have the same total compensation if one worker had health insurance provided by her employer and the other worker did not. Similarly, a worker who only needed to work 20 hours per week to earn $50,000 a year is better off than another worker who also earned $50,000 a year but had to work 80 hours per week. A similar argument holds with respect to job secu-

rity, pension stability, pension generosity, and a whole host of non-wage compensation associated with employment. Because people value all of wage and **non-wage** compensation components, it is incorrect to exclude any non-wage compensation components when comparing the total compensation package offered by alternative employment opportunities. Doing so ignores the fact that employers have many compensation methods available to them and use different combinations of compensation in order to attract, and properly incent, the right types of people.

Biggs and Richwine (2011) valuing each component of employee compensation, adjusting for the skills and personal characteristics, illustrate that once the full value of benefits is properly measured and included in the analysis, California's state and local government employees earn a significant premium compared to the private sector. According to Biggs and Richwine (2011):

> *In the case of California public employees, wages are slightly lower in the public sector. Initially, benefits appear only slightly higher, implying rough parity in compensation between the public and private sectors. However, properly accounting for retiree health benefits and defined benefit pension plans generates a public compensation premium of around 15 percent. The additional job security granted to public-sector employees is equivalent to an approximately 15 percent increase in public compensation, meaning that the total public-sector pay premium in California may be as high as 30 percent.*[40]

These results strengthen the previous historical review of total compensation per worker. The historical data illustrated that the average government compensation was higher than the higher private sector compensation. The Biggs and Richwine findings illustrate that the higher total compensation packages cannot be justified based on the government worker's opportunity cost – government workers in California earn a total compensation package that is *higher* than their own specific market opportunity cost. In simple terms, the compensation package of government workers in California is excessive compared to the salary a worker with the same characteristics currently earns in the private sector.

If California state and local governments were subject to competitive forces, then these excessive wage costs would be driving down the profits of the company signaling to senior management that their labor costs are too high. As a government entity, these signals have been muted – but not silenced all together. The high compensation costs are making California's government unaffordable, and negatively impacts the viability of the state and local governments. The next section illustrates that the Biggs and Richwine findings are consistent with studies that link specific policies to higher government compensation costs – California implements policies that are associated with excessive government pay, whereas other states such as Texas do not implement these policies. Consequently, addressing the trend of excessive total compensation in California requires addressing these policies.

Creating an Efficient Government Workforce

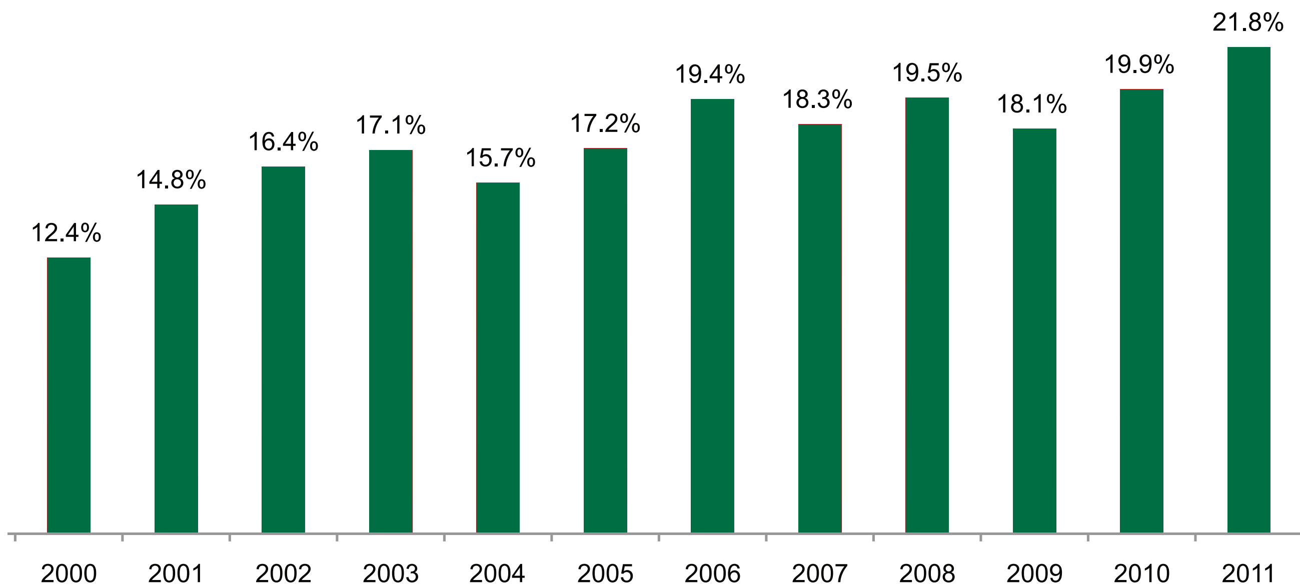
Policies implemented by the state government can create rigid compensation rules that ultimately create a separation between the marginal value of workers and their total compensation packages. These policies are "slowly boiling the frog" by locking in policies that do not impose any immediate cost on the government the day they are implemented, but ultimately drive up total state and local government compensation to their current uncompetitive levels. California's excessive compensation levels directly results from these policies. Rightsizing California's compensation expenses, consequently, requires that these policies be reformed. Below we review

these policies. The policy conclusion for controlling California's current and future compensation costs is, consequently, the repeal or reform of these policies.

Unionization

Ignoring the issue of whether unions have value in the private sector, the data clearly illustrate that unions are helping to drive public employee compensation to excessive levels. In fact, according to the Bureau of Labor Statistics, since 2000 not only do unionized state wage and salary workers earn a premium over their non-union counterparts, this premium has grown significantly, see Figure 9.

Figure 9
National Premium for Union State Wage and Salary Government Employees Compared to Non-union State Wage and Salary Government Employees | 2000 – 2011



Source: Bureau of Labor Statistics, Union Affiliation Data, Current Population Survey: Employed Wage and Salary Workers, Members of Unions and Not Members of Unions

As noted by James Sherk at the Center for Data Analysis at the Heritage Foundation, the fact that unions are incompatible with public sector work was once widely understood – including by President Franklin Delano Roosevelt and the labor movement itself:

> *"It is impossible to bargain collectively with the government."*
>
> *That wasn't Newt Gingrich, or Ron Paul, or Ronald Reagan talking. That was George Meany -- the former president of the A.F.L.-C.I.O -- in 1955. Government unions are unremarkable today, but the labor movement once thought the idea absurd.*
>
> *Public sector unions insist on laws that serve their interests -- at the expense of the common good.*
>
> *The founders of the labor movement viewed unions as a vehicle to get workers more of the profits they help create. Government workers, however, don't generate profits. They merely negotiate for more tax money. When government unions strike, they strike against taxpayers. F.D.R. considered this "unthinkable and intolerable."*

Government collective bargaining means voters do not have the final say on public policy. Instead their elected representatives must negotiate spending and policy decisions with unions. That is not exactly democratic – a fact that unions once recognized.[41]

Citing Franklin Roosevelt directly on the issue of collective bargaining and the right for public workers (in this case federal workers) to strike he wrote the following to Luther C. Steward, President of the National Federation of Federal Employees:

All Government employees should realize that the process of collective bargaining, as usually understood, cannot be transplanted into the public service. It has its distinct and insurmountable limitations when applied to public personnel management. The very nature and purposes of Government make it impossible for administrative officials to represent fully or to bind the employer in mutual discussions with Government employee organizations. The employer is the whole people, who speak by means of laws enacted by their representatives in Congress. Accordingly, administrative officials and employees alike are governed and guided, and in many instances restricted, by laws which establish policies, procedures, or rules in personnel matters.

Particularly, I want to emphasize my conviction that militant tactics have no place in the functions of any organization of Government employees. Upon employees in the Federal service rests the obligation to serve the whole people, whose interests and welfare require orderliness and continuity in the conduct of Government activities. This obligation is paramount. Since their own services have to do with the functioning of the Government, a strike of public employees manifests nothing less than an intent on their part to prevent or obstruct the operations of Government until their demands are satisfied. Such action, looking toward the paralysis of Government by those who have sworn to support it, ***is unthinkable and intolerable****. It is, therefore, with a feeling of gratification that I have noted in the constitution of the National Federation of Federal Employees the provision that "under no circumstances shall this Federation engage in or support strikes against the United States Government."*[42]

The adverse impact from public sector unions is a logical consequence of individual incentives – an insight that a branch of economics known as Public Choice has warned about for years. State and local governments have monopolistic elements – especially in the short term. While in the medium- to long-term, relocation decisions of people and businesses create very important and powerful competitive pressures for states and localities, within a shorter time-frame (especially when compensation decisions are made) these competitive pressures are not binding. Public sector unions, consequently, are generally free from the discipline of competitive pressures (e.g., going out of business due to excessive compensation packages) while entering into salary negotiations with management.[43]

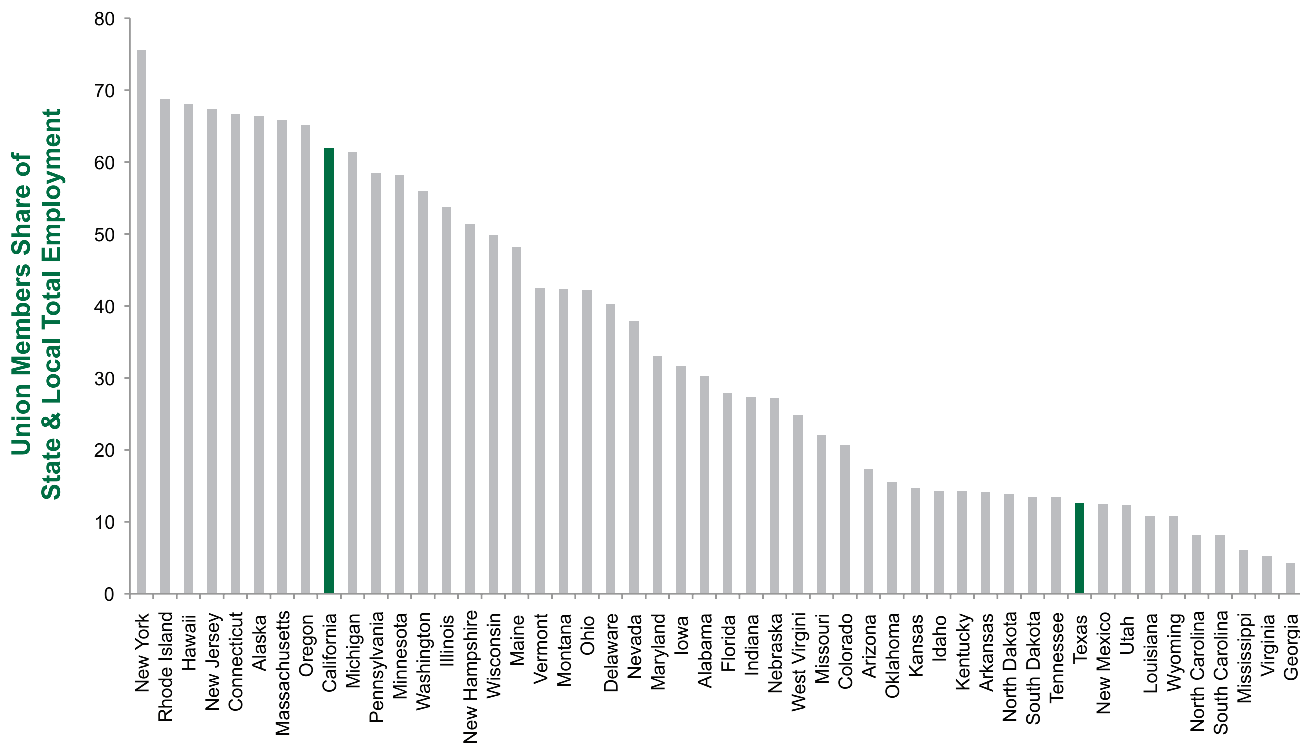
Not only are public sector unions free from competitive pressures, by influencing the re-election prospects of the very people who are deciding their compensation policies, public unions directly influence whether *management* – in this case the politicians – have a job themselves. Consequently, in the face of public sector unions, public sector managers are no longer unbiased agents for the taxpayers (or principals) of the state or locality. Longer-term compensation benefits (e.g. retirement benefits) are particularly susceptible to these adverse incentives because long-term costs impact taxpayers' years after the compensation decisions have been made.

The evidence substantiates the insights from Public Choice theory as well as Roosevelt's concerns. Lewis (1988) performed "a survey of micro, ordinary least squares, cross-section studies of the union/nonunion wage gap in the public sector with the aim of providing mean gap estimates for that sector that are more or less comparable to those for the economy as a whole.' The survey covers seventy-five studies…"[44] In his review of the academic studies on the subject, Lewis found that between 1973 and 1984, the wage gap between public union workers and non-union workers was between 8 percent and 12 percent.

Schmitt (2010) argues for increased unionization precisely because it is associated with increased public sector compensation: "Across all the states…unionization is strongly associated with increases in overall compensation, measured here by hourly wages and health and pension benefit coverage. In the typical state, unionization is associated with about a 15 percent increase in hourly wages (roughly $2.50 per hour), a 19-percentage-point increase in the likelihood of having employer-provided health insurance, and a 24-percentage-point increase in the likelihood of having employer-sponsored retirement plans."[45]

Edwards (2010) also confirms the strong relationship between unionized public sector workers and higher compensation levels: "Unionized public sector workers have far higher wages and benefits, on average, than nonunionized public sector workers. Their wages are 31 percent higher, on average, and their benefits are 68 percent higher. Overall, the union compensation advantage in the public sector is 42 percent."[46] California's rate of public sector unionization is among the highest in the country. Figure 10 reproduces data from Edwards (2010) that estimates the share of state and local government employees who are members of a union. California, which ranks 9th, is clustered among the high unionized states. Texas, which ranks 41st, is clustered among the low unionized states. Based on the data presented above, widespread unionization appears to be associated with higher government costs. And, a more formal analysis provides further support.

Figure 10
Estimated Union Members Share of State & Local Total Employment
2008



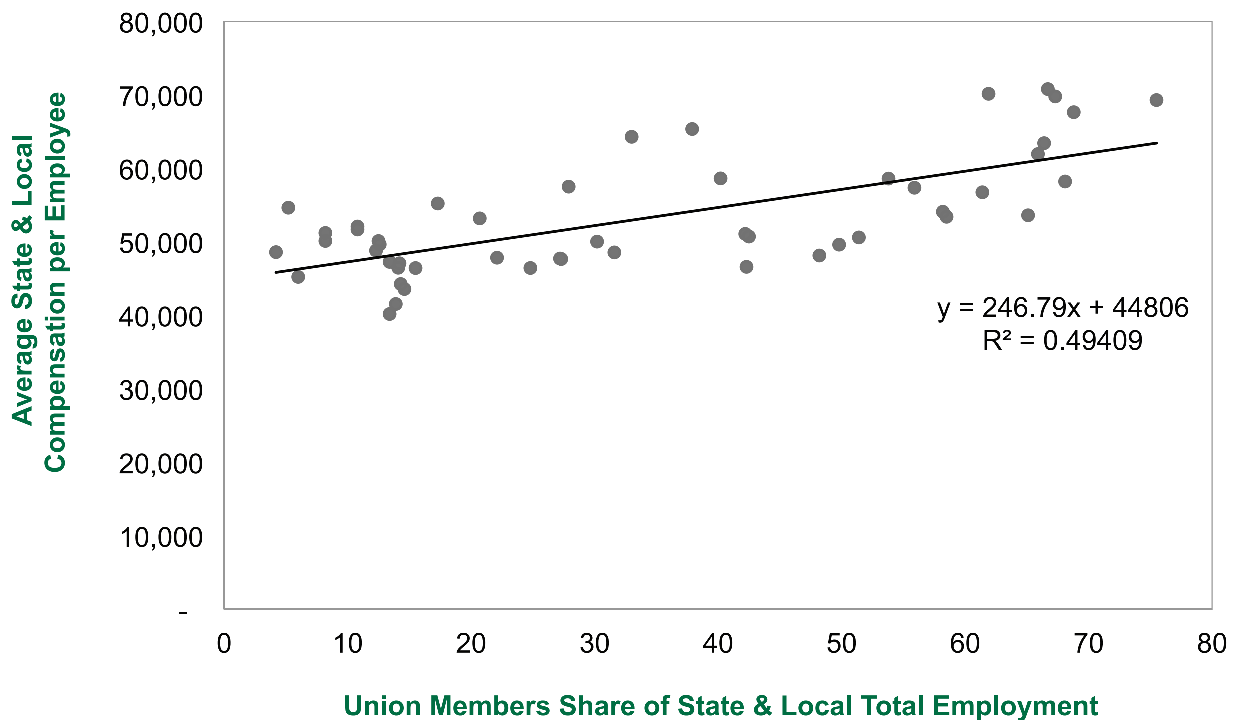
Source: Edwards (2010) estimates based on BLS data compiled by www.unionstats.org.

To formally test the impact of unionization on state and local compensation costs, Edwards (2010) performed an OLS regression that estimated the impact on government compensation costs from higher state and local government worker union membership. His results showed that "if the public sector unionization share in a state increased by 10 percentage points, it would lead to higher annual average public sector compensation of

about $1,167." [47] Figure 11 presents the positive relationship between estimated union share of state and local employment and higher state and local government compensation costs.

Due to graphic limitations, Figure 11 only presents the relationship between average state and local compensation costs and union membership. Other factors, especially a state's overall average income levels, also matters. However, as Edwards (2010) illustrated, the results in Figure 11 are robust even when state's average income levels are included.

Figure 11
Estimated Union Members Share of State & Local Total Employment Compared to State & Local Government Compensation Costs 2008



Source: Edwards (2010) estimates based on BLS data compiled by www.unionstats.org; and Bureau of Economic Analysis, Regional Data, Personal Income and Employment Tables: SA06N Compensation of employees by NAICS industry

Strong unionization, consequently, is an enabler of excessive government employee compensation. As Greenhut (2009) explains,

> *...the public's servants have become the public's masters. The people who work for the government and are supposed to serve the overall public have become a privileged elite that has exploited their political power for vast financial gains and special protections and privileges. Because of its political power, this interest group has rigged the game so there are few meaningful checks on its demands. This has manifested itself in higher pay and far higher pension and benefit levels than those received by the vast majority of Americans working in the private sector. This power has protected government employees – even incompetent and abusive ones – from being fired, except after long processes and only for the most grievous offenses. This situation has eroded public services, made it impossible to reform even the poorest performing agencies and school systems and resulted in higher taxes, less*

freedom and unsustainable levels of debt spending that will be borne by future generations. It has also created a two-tier system whereby the rulers are treated better than the ruled. These problems are getting worse, especially with a tough economy.[48]

With respect to California, Edwards (2010) found that "California's 62 percent unionization rate, for example, translates into a statewide boost in public sector compensation costs of more than 10 percent, according to these regression results."[49] Simply put, California has a high rate of unionization, and this high rate of unionization has translated into a larger compensation disparity for government – as expected.

In a positive sign, some of the most egregious excesses of public sector unions are being rolled back. In a recent U.S. Supreme Court case, (Knox vs. SEIU) the U.S. Supreme Court:

sharply criticized public-sector unions for using money from nonmembers to fund special political campaigns, stepping into the intense political debate about such unions and signaling that new constitutional limits may be coming.

The justices ruled Thursday that the Service Employees International Union in California violated the First Amendment rights of its dissident members by taking extra fees from their paychecks in 2005. The money was used to fight two anti-union ballot measures.

"This aggressive use of power by the SEIU to collect fees from nonmembers is indefensible," said Justice Samuel A. Alito Jr., speaking for the court's majority. "When a public-sector union imposes a special assessment or dues increase, the union ... may not exact any funds from nonmembers without their affirmative consent."

While the Supreme Court decision will help reign in such "indefensible" practices of public sector unions, effectively controlling state compensation costs requires further state action.

Collective Bargaining and Binding Arbitration

California's high public sector unionization rate is not a random event. There is evidence that California's legislative environment encourages the formation of public unions, thereby reinforcing the trend toward ever greater compensation excesses. Disalvo (2010) describes both the growth in unions and how growth in collective bargaining rights was a pre-condition:

In 1958, New York City mayor Robert Wagner, Jr., issued Executive Order 49, known as "the little Wagner Act." It gave city employees bargaining rights, and provided their unions with exclusive representation (meaning that the unions alone were legally authorized to speak for city workers, regardless of whether those workers belonged to the unions or supported them). ...

From the mid-1960s through the early '70s, states and cities followed with a plethora of laws providing public-employee unions with collective-bargaining rights. In many cases, the consequences were almost immediate. In New York state, one year after the passage of the so-called Taylor Law in 1967, 360,000 state-and local-government employees became unionized; the New York Times described the law as having an "almost revolutionary effect." Other states and cities experienced similar expansions in the number of public-sector union members. For example, in 1968, California passed the Meyers-Milias-Brown Act — a law granting local-government workers bargaining rights — and then extended those rights to teachers a few years later; in the 1970s and '80s, both membership in public-sector unions and the number of strikes in California skyrocketed. Nationwide, by 1970, the [American Federation of State, County & Municipal Employees] AFSCME had negotiated more than

1,000 collective-bargaining agreements, nearly twice the number in place in 1964. And by 1972, nearly half of the states had public-employee collective-bargaining laws in place at either the state or local level.

Collective-bargaining laws gave government workers powerful incentives to join unions. Between 1960 and 1980, the portion of full-time unionized public employees jumped from 10 percent to 36 percent of the public-sector work force. The AFSCME grew from 99,000 members in 1955 to just under 1 million members in 1980. Over the same period, the American Federation of Teachers [AFT] grew from 40,000 to more than half a million members. Today, its membership stands at more than 1.5 million — which makes the AFT larger than the largest exclusively private-sector union, the United Food and Commercial Workers (1.3 million members). But even the AFT is dwarfed by the largest labor union in the United States: the National Education Association, which claims 3.2 million members.[50]

Empowering public sector workers with strong collective bargaining rights, consequently, has been a historic enabler of public sector unionization. Hardgrave (2010) summarizes the divergence of collective bargaining rights across the states:

Twenty-six states guarantee collective bargaining rights for all public employees, either implicitly or explicitly. Twelve states only guarantee collective bargaining rights for specific groups of public employees. Ten states provide no legal guarantees for collective bargaining, while two states prohibit collective bargaining. Additionally, states differ on whether strikes are allowed and whether disputes should be settled with binding arbitration, voluntary arbitration or neither.[51]

In Table 1, Hardgrave (2010) categorizes the 50 states into four general legal environments for collective bargaining: collective bargaining required for all public employees, collective bargaining required for some groups, no guaranteed collective bargaining, and collective bargaining prohibited. Whereas the average of the state unionization rates is 34.3 percent, those states with required collective bargaining have an average unionization rate of 50.9 percent. Those states that require collective bargaining for some groups have an average unionization rate of 18.4 percent, those states with no guaranteed collective bargaining have an average unionization rate of 15.7 percent; and the two states that prohibit collective bargaining have an average unionization rate of 6.7 percent.

Empowering public sector workers with strong collective bargaining rights, consequently, has been a historic enabler of public sector unionization.

Of course, since 2010 the number of states that allow collective bargaining has changed (e.g. Wisconsin). The contentious debates in Wisconsin, along with the subsequent failed recall election against Governor Scott Walker, exemplify the importance that is placed on the collective bargaining issue. Mandating collective bargaining leads to greater public sector unionization, which leads to excessive compensation costs over time.

California is one of the states where mandated collective bargaining for public employees exists. It also has a unionization rate of 61.9 percent, which is above the average for even the states that require collective bargaining.

It is not simply the amount of unionization that matters. The legislative environment also impacts the bargaining strength of the unions when negotiating total compensation. As is logical, states that impose laws and regulations that provide unions with greater bargaining advantages going into compensation negotiations lead to even greater compensation excesses. A prime case in point is binding arbitration, where "unions

are guaranteed no worse than management's final offer, and often win far better. The potential worse case of an arbiter's ruling makes binding arbitration a powerful threat against governments during union negotiations."[52] California still mandates binding arbitration in 24 cities and counties.[53]

The Outcome: Excessive Compensation

Collective bargaining, unionization, and binding arbitration have stacked the negotiations in the union's favor. It should not be a surprise that compensation levels continue to grow. Additionally, incorporating the generous compensation levels into state benefits also made sense – it provided increased compensation to the government workers without costing the state any upfront money. Unfortunately, the bill for these promises is now coming due. California is facing a pension and benefit tsunami that will drown the state in red ink unless it is addressed.

The biggest hit to the state's future budgets – and city and county budgets as well – is going to be the massive pension and health care payouts for government retirees. This is impacting almost every state and local government in America. But California is going to be among the hardest hit. Beyond the broader reforms to collective bargaining rights and public unionization, there are several specific policies negotiated under these broader arrangements that need to be addressed. According to PensionTsunami.com,[54] these specific policies include:

- *Pension spiking.* In 1999, CA Senate Bill 400 passed, which had the effect of increasing the ability of state and local government workers to "spike" their pensions. California Highway Patrol (CHP) officers formerly could retire at age 50 with the "2 percent at 50" rule, meaning that at age 50, they could retire and get 2 percent of their final year of pay, times the number of years on the job. So a CHP officer who put in 30 years would get a 60 percent pension – of the last, highest year of pay. After SB400, the "3 percent at 50" rule meant the same officer would get 90 percent of pay at retirement. In addition to adding costs to the state pension system, this rule encouraged officers to retire early. Why work any longer for just 10 percentage points more than you could get when retired? And "retirement" often meant getting another job – commonly with another law enforcement agency. The early retirements put stress on the state's general fund, because that meant more officers had to be hired to replace the early retirees.[55]
- SB183, which passed in 2002, extended the "3 percent at 50" rule to other, non-police state and local workers. That means that in 2010, for example, 3,000 teachers received pensions of more than $100,000 a year.[56]
- *Pay spiking.* Government workers have seen their pay boosted, especially for law enforcement and firefighters in the wake of 9/11. Higher pay means, eventually, higher pensions, because retirement is based on the final year of pay.[57]
- *Defined Benefit Plans.* Like most state governments, California offers a generous defined benefit pension plan, while the private sector has transformed into defined contribution plans. Defined benefit plans financial viability can turn quickly. In the face of difficult fiscal conditions these states under-funded their pension systems in order to maintain expenditure levels in other parts of the state budget. The result has been significant deterioration in the health of these pension systems (see below). A defined benefit plan is also less efficient. Public sector defined benefits plans creates large entitlement costs that the state must fund, creates unfair wealth transfers across public sector employees, and is becoming an excessive burden relative to private sector pensions that the taxpayer (generally the recipient of the less generous pension) must fund.

And, then there are the things that are outside of California's control. First, the baby boomers are retiring. The oldest baby boomers are now retiring and by the time the youngest baby boomers retire in about 20 years, the demographics will simply be too large to ignore. When coupled with the stock market crash over the last several

years, the problem is even direr. In July 2009, Calpers reported that its investments for the previous fiscal year, which ended June 30, 2009, had crashed by 23.4 percent, or an incredible $56.2 billion. CalPERS (the California Public Employees' Retirement System) provides "retirement, health, and related financial programs and benefits to more than 1.6 million public employees, retirees, and their families and more than 3,000 public employers," according to its website.[58] The California State Teachers' Retirement System suffered a similar loss: 25 percent, or $43.4 billion. According to the state Constitution, these funds are guaranteed by taxpayers.[59]

The Pew Center's 2011 Report showed that the Great Recession took an even greater toll on California's pension system. California's pensions were nearly below the 80 percent threshold considered to be actuarially funded (as of 2009 it was 81 percent funded) and California's retiree health costs were only 0.1 percent funded![60] In total, California's pension and health system is underfunded by nearly $162.5 billion based on the Pew Center numbers. These pension figures are based on the assumption that the pensions' market value will rise, on average, 7.75 percent a year. Should these lofty return assumptions not pan out, then the pension and health care liabilities of the state are even larger than these figures suggest.

Policy Reforms to Right-size California's Compensation Levels

Biggs & Richwine (2011) found that California's state and local government workers are paid a significant government compensation premium. The evidence presented above illustrates that there are several policies that lead to excessive government compensation, and other policies that help control excessive compensation costs. Not surprising, California implements many of the policies that lead to excessive compensation costs; Texas does not. However, Texas' environment is not perfect and California should not simply aim to replicate Texas environment, which would be a great policy reform for California. Instead, California should implement the optimal policies and, in so doing, fulfill the politicians' fiduciary responsibility to the taxpayer.

Table 2 summarizes the key policy areas that impact government compensation and compares California to Texas in each one of these areas. Texas' system is flawed. For instance, the average retirement age of 60 and the unfunded healthcare liabilities are a concern. However, Texas' policies are solid in many key areas. Texas prohibits collective bargaining for public sector workers, has a lower unionization rate – partly due to the prohibition on collective bargaining, does not impose forced card check (or allowing unions to form without a vote of the potential members via secret ballot), prohibits strikes by public employees, and has protections against pension spiking. California, in comparison, fails in all of these areas. California requires collective bargaining that has increased the power (and scope) of public sector unionization (which is one of the highest in the country), imposes forced card check, allows non-core government workers to strike, and has no protections against pension spiking. California's compensation premium compared to the private sector should come as no surprise given these policies.

Table 2
A Comparison of California and Texas Policies in Key Areas

	CALIFORNIA	TEXAS
Compensation Premium over Private Sector (2010) (unadjusted for skills)[61]	51.2%	26.0%
Percentage of Workers Unionized[62]	61.9%	12.6%
Collective Bargaining Requirements	Required for all public Employees[63]	Prohibited[64]
Retirement Age (system avg., varies by system)	60 [65]	60 [66]
Pension Spiking	No Pension Spiking Protections[67]	Pension Spiking Protections [68]
Right to Strike	Yes[69]	No[70]
Arbitration Rules	No Provision[71]	No Provision[72]
Forced Card Check	Yes[73]	No Provision[74]
Health Care Benefits in Retirement	Offered, but unfunded[75]	Offered, but unfunded[76]

Sustainably addressing California's excessive compensation of government employees requires a reversal of these policies. Structurally, California must also address the root cause of the problem – the excessive power granted to public unions and the collective bargaining system. Like Texas, California should remove the guarantee for collective bargaining, and ideally, as FDR might counsel, prohibit the practice all together. Similarly, the right to strike and to arbitration should similarly be severely limited and ideally removed. These reforms will remove the system's current biases toward excessive compensation levels for state and local government employees. They do not address the current levels, however.

California should also pursue reforms that, over time, bring current government compensation levels into balance with the private sector. Biggs and Richwine (2011) documented that it is the overly-generous benefits driving the excessive compensation levels. Consequently, the reform policies should address current benefit levels – especially the retirement health and pension systems.

Instead of attempting to change the Rube Goldberg that is California's current defined benefit systems, California should consider switching all employees to a defined contribution plan. In lieu of terminating the government plans, an option used by the private sector is to freeze their current retirement plans. When a defined benefit plan is frozen, the plan continues to exist but the growth and operations of the plan are curtailed. The purpose and extent of freezing a defined benefit plan varies. According to the PBGC:

> *Some plans are frozen because the sponsor falls on hard economic times and decides to temporarily freeze its plans to reduce the contributions it is required to pay into them. Other plans are frozen because the sponsor wants to cover its workers under a defined contribution or hybrid plan and does not want to terminate or convert the old plan. Still others are frozen after one company acquires another, and the plans of the two companies cannot easily be merged.*
>
> *… a plan can be frozen in several ways. It can be closed to new entrants so that only those in the plan at a point in time continue to accrue benefits. The plan can be frozen for some, but not all, participants. Such a partial freeze could be based on age, tenure, job classification or plant location. Under a hard freeze, no participant accrues any further benefits based on either job tenure or compensation growth. Under a soft freeze, benefits are generally not increased for additional tenure but are increased for compensation growth.*[77]

Ideally, California would pursue a hard pension freeze. Such a policy would end the unknown "entitlement" nature of the current define benefit plans and put state and local government workers pensions on a similar path to the private sector. Over the past 30 years, the private pension system in the United States has gone through a radical transformation; but as documented above California state and local governments have not followed the private sector's transformation.

Defined benefit plans were once a sizable minority of all benefit plans. In 1975, out of over 311 thousand benefit plans, one-third or 103 thousand were defined benefit plans – although the total number of employees covered by a pension was less.[78] The number of defined benefit plans peaked in the early 1980s and have been declining ever since. As of 2009, there are approximately 47 thousand defined benefit plans (including government sponsored plans) or 6.7 percent of the nearly 707 thousand benefit plans that existed.[79]

The number of people covered by each plan type has followed a similar pattern. Because defined benefit plans tend to cover more people, more people with a pension plan were covered by a defined benefit pension plan in 1975—over 33 million of the 44.5 million covered by a pension plan (over 74 percent) were covered by a defined benefit plan.[80] By 2009, the percentages had reversed themselves—only 32 percent of the 129.3 million people covered by a pension were in a defined benefit plan (including government sponsored plans).[81]

Long-term viability requires California state and local governments to follow the private sector pattern. And, a primary defined contribution benefit system for public sector workers is not an untried phenomenon—Michigan and Alaska have defined contribution plans as their primary retirement plan; and Washington, Oregon, Indiana, and Georgia have hybrid plans that contain elements of both a defined benefit plan (a minimum guaranteed benefit) and a defined contribution plan (an investment component that provides benefits based on the market returns).[82]

All new employees or current unvested employees should be transferred to a defined contribution plan that should meet the average standards for a large private sector defined contribution plan. According to a Watson Wyatt survey of the defined contribution plans of the Fortune 100 companies, these standards could include (i) no minimum length of service requirement for eligibility in the defined contribution pension plan, and participation in the defined contribution plan should be permitted upon hire; (ii) non-matching contributions of up to 6.0 percent of pay should be available to all employees with immediate eligibility, and (iii) employer match up to a set percentage of pay, with immediate eligibility.[83] California should also implement Health Savings Accounts to cover employees and pensioners health costs. All vested public employees should also be transferred to the defined contribution plan subject to the same benefits as all new employees or current employees who were not vested. The defined benefit plan would continue operating with the purpose of paying out current obligations.

While eliminating the defined benefit pension systems is the ideal reform, such a reform may be politically unattainable. However, the need to bring public compensation in line with the private sector remains. Assuming that the defined benefit plans are not going to be eliminated, reforms to the current generosity of the defined benefit system should include: (i) increasing the number of years used as the basis for retiree pension benefits; (ii) raising the retirement age, while accounting for the different needs of different profession; (iii) disallowing retirees to draw both a state salary and a state pension; (iv) create salary increase caps for the purpose of calculating pensions to protect taxpayers against pension spiking; and (v) increasing employee contributions to their own retirement.

Following this reform model will not only help address California's pension funding problem; it will also help level the playing field between public sector compensation and private sector compensation by eliminating a key driver of the excessive state and local government compensation.

Conclusion

State competitiveness matters. Andy Puzder, CEO of CKE Restaurants, noted in the Foreword to *Eureka! How to Fix California*, that his "…company's history is tied directly to the days when California was the land of opportunity, 'The Golden State.' We love California and we would love to grow our California business. Nonetheless, due to the high cost of doing business in California, CKE is not expanding its operations in California and is choosing to place its bets on other states that have lower costs of doing business, such as Texas."[84] As demonstrated above, California's excessive compensation package for government employees is one reason why the cost of doing business in California is uncompetitive.

Comparing compensation packages across different industries is always difficult. Biggs and Richwine (2011) provided an important contribution by illustrating that the government compensation costs in California are significantly more generous than their private counterparts – perhaps over 30 percent more generous. The historical data illustrate that this is not a recent phenomenon and that the government compensation premium has been growing over time. Consequently, the evidence regarding California's state and local government compensation costs are clear: when all benefits are included, these costs are excessive and growing.

The reasons behind California's excessive compensation costs are also clear: California implements policies that encourage excessive compensation. These policies include mandating collective bargaining, empowering public sector unions, and, in some areas, mandating binding arbitrations. These policies have led to practices such as excessive pension spiking, low retirement ages, covering health care services during retirement, generous pension levels, and permitting the practice of receiving both a government pension and a government salary. When coupled with the declining asset values of California's pension system, these trends have created a crisis waiting to happen.

Reversing the Biggs and Richwine findings requires reforms to these policies behind the excessive compensation levels. The reforms must repeal the practices directly driving up costs – the excessively generous public pension benefits. Ideally this would be achieved by freezing the current defined benefits plan and replacing this plan with a combination of a defined contribution pension plan coupled with Health Savings Accounts to help ensure that California's pension liabilities remain financially viable. If a comprehensive pension reform is politically unattainable, then pension reforms should at a bare minimum:

- Increase the number of years used to calculate retiree pensions
- Raise the retirement age, while accounting for the different needs of different professions
- Disallow retirees to draw both a state salary and a state pension.

Whether the pension reform freezes defined benefit plans or simply implements the bare minimum reforms to the defined benefit plans, California should also increase employee contributions to their own retirement.

Regarding the broader public sector union issues, California should follow the path of Wisconsin and return balance to the compensation negotiation process. These reforms should begin by prohibiting collective bargaining in the state and require that all public-sector unions be disbanded. If such actions are not feasible, then at bare minimum any requirements to engage in collective bargaining should be eliminated and no employee should be forced to join a public union or pay union dues. Such reforms will return balance back to the compensation negotiation process and help ensure that future excessive compensation costs are not foisted upon the taxpayers once again.

Endnotes

1 Source: Author calculations based on data from the Bureau of Economic Analysis. Average compensation is calculated as total compensation divided by total workers for private industries compared to state and local governments. The values in the table are the percentage premium of state and local government workers relative to private sector workers. No skill adjustments, such as in Biggs and Richwine (2011) were performed. The average premium of state and local workers in the U.S. compared to private sector workers in the U.S. was 36.4 percent.

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18 Letter on the Resolution of Federation of Federal Employees Against Strikes in Federal Service, August 16, 1937; http://www.presidency.ucsb.edu/ws/index.php?pid=15445#axzz1wT8aDojs; emphasis added.

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About the Author

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Wayne Winegarden has more than 20 years of experience in public policy, economic research, and business. His expertise lies in applying quantitative and macroeconomic analysis to create greater insights for policy leaders, and corporate strategy and planning for decision makers. He has advised Fortune 500 companies, state legislators, political candidates, as well as small business and trade associations. He founded Economic Solutions and Laffer Associates strategy services; managing staff, budget, and corporate development.

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Prior to Arduin, Laffer & Moore Econometrics, Dr. Winegarden was a managing director at Laffer Associates from 2008 to 2012. He was also a manager at Philip Morris International and Philip Morris Management Corporation where he analyzed economic and fiscal issues. His teaching experience includes Marymount University and George Mason University.

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