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How to Tackle Government Labor Costs

Pay freezes, two-tier wages, pension reform—nothing should be off the table.

By A. GARY SHILLING

Life is tough and getting tougher for state and local governments. Revenues from personal and corporate income and sales taxes are down and property taxes are weakening. Budget deficits are jumping, and states now issue debt to fund routine expenditures. Meanwhile, pension obligations are underfunded to the tune of $1 trillion, according to the Pew Center on the States. States on average have set aside just 7.1% of retiree health care and other nonpension benefits, and 20 states have reserved nothing.

Costs remain stubbornly high, propelled over the last decade by rising municipal employment. Since the Great Recession started in December 2007, private payrolls have dropped 7.4%, but state and local jobs are essentially unchanged, according to the Bureau of Labor Statistics (BLS).

Some governments are making service cuts, but these are wholly inadequate, and voters are fiercely resistant to tax increases. The inescapable conclusion: Labor costs, which at $1.1 trillion in 2008 account for half of state and local spending according to the Cato Institute, simply must come down. And there is plenty of reason why they should. Consider:

Years ago, there was an informal "social contract"—public employees generally received lower wages than private-sector workers, and in return they got earlier retirement and generous pensions, allowing them to catch up. That arrangement has long since gone by the boards. The result is a remarkable trend. State and local government employees for years have received pay increases in excess of inflation, and BLS figures show they now have wages that are 34% higher on average than in the private sector.

Partly responsible for these trends is unionization, which the Department of Labor reports has jumped to 37.4% of the public sector in 2009 from 24.1% in 1973 (unionization in the private sector declined to 7.2% from 25.4% in the same time period). The result is often pay levels higher than needed to attract qualified employees. The average quit rate among state and local employees is a third of that in the private sector.

Public employees also have a 70% advantage in benefits. Health insurance, retirement benefits, life insurance and paid sick leave are not only much more available to them, but much richer. In 2009, BLS figures indicate that the costs of health insurance were 2.18 times as much for state and local employees as for private-sector workers.

In the private sector, defined-benefit pensions have declined over the years in favor of defined-contribution plans such as the 401(k). In 2009, defined-benefit plans were available to only 21% of private-sector workers—but to 84% of municipal employees, according to the Cato Institute. And public-sector defined-benefit plans paid retirees about twice as much as those in the private sector.

Public-sector retirement costs also are high because many can retire at age 55 after 30 years of employment with pensions equal to 60% or more of final salary, which is often jacked up by lots of overtime in final working years. In some states, employees can "double dip" by retiring early and then resuming their previous jobs or taking other government positions. So they get salaries and pensions at the same time.

With slow economic growth, limited income expansion and high unemployment likely in future years, a taxpayer revolt may be brewing. Americans still want basic municipal services like police and fire protection, good schools for their kids, clean streets and garbage collection, but at lower costs and budgets that don't kick the deficit can down the road.

State and local government labor costs can be reduced in an orderly way. Following in the footsteps of bankrupt GM, two-tier wage structures would allow existing employees to continue at current salaries, but pay new hires much lower wages that are nevertheless adequate to attract and retain qualified people. And the new people can be enrolled in defined-contribution pension plans that require employee contributions instead of defined-benefit plans. Retirement ages can be increased.

While waiting for existing employees to retire, their pay can be frozen. Pension formulas can be reformed to avoid the system being gamed by heavy overtime in final years on the job, and double-dipping can be eliminated. Retirees in the public sector can be required, as they are in the private sector, to pay meaningful shares of their health-care costs.

These changes would be profound and shake up the high-paid, secure image of state and local government jobs. But essential services would still be delivered, only much more cost effectively. Push has come to shove.

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