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Fatted Leviathan

The time bomb of runaway benefits for government employees

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The collapse of the housing market has been an object lesson for America. Households and banks borrowed too much on expectations of continuing appreciation in real-estate prices. This extra borrowing inflated a bubble until it burst. By discounting the future too optimistically, we let the good times roll away.

The collapse of Chrysler and GM has been another object lesson. Management and unions pledged too many worker and retiree benefits on expectations of continuing demand for their gas-guzzlers. By discounting the future too optimistically, they let the good times roll away.

The private sector is now rethinking its unrealistic optimism. It has to, since its asset valuations have tumbled. Payrolls are shrinking. Benefits are being cut back. Both management and workers are accepting that they have to work harder for less. Government is upping the pressure by hiking taxes, requiring banks to raise more capital, and demanding more-objective risk reporting.

But the government is not applying these lessons to itself. On the contrary, the public sector’s tendency to discount the future too optimistically is growing. It is pledging ever more payoffs to its employees and wards and concealing more than ever their true costs, even as private-sector incomes fall.

The public sector employs about one-sixth of the U.S. work force. Apart from the expansions and contractions of the military, that share hasn’t changed much since World War II. About one in five public-sector jobs is federal, with civilian government and the military each employing roughly 2 million. Nearly another million work in federally owned enterprises, most of them in the Postal Service.

Average federal pay is distinctly higher than private-sector pay. After adjusting for part-time work and the cash value of payment in kind, the Commerce Department’s Bureau of Economic Analysis (BEA) reports a wage and salary premium in 2008 of 33 percent for the military and 58 percent for civilian government. It wasn’t always that way. All of the military premium and nearly half the civilian premium were created between 2000 and 2005.

These premiums were needed to improve recruitment and retention. In 1997, the Congressional Budget Office concluded that the government paid 22 percent less than the private sector for similar jobs. Bolstering the military after 9/11 was also a priority.

For reasons of efficiency and fairness, the extra pay might have been coupled with reducing the job security and trimming the benefits that federal employees traditionally enjoy. It was not. On the contrary, the federal benefit edge has widened. It is not easy to measure how much, for the government refuses to publish direct comparisons. However, a few months ago, Chris Edwards of the Cato Institute deduced from BEA statistics that from 2000 to 2008, benefits grew a whopping $16,000 per full-time federal civilian employee, versus $3,000 per private employee. Federal benefits are now more than four times private benefits.

What was intended as catch-up, then, is now in overdrive. In 2008, federal employees were relatively well insulated from the financial crisis. Their benefits were guaranteed, they bore little risk of layoff, and the thriving business of government buoyed housing valuations for D.C.-area residents. A sense of shared national burden would have called for public-sector restraint in 2009. Instead, as millions of private workers lost their jobs and real incomes declined, civilian federal salaries were boosted 3.9 percent. Not surprisingly, resignation rates for federal employees have sunk to less than a third of private-sector averages.

Fortunately for taxpayers, about 80 percent of public-sector employees work for state and local governments. The great majority of them are employed in education or public safety. These are middle-tier occupations for the most part. By BEA's accounting, state- and local-employee salaries track private-sector salaries fairly well.

But the data the BEA uses can be crude. The Labor Department's Bureau of Labor Statistics (BLS) provides far more detailed breakdowns, except for federal employees, about whom it has been ordered to keep quiet. In particular, the BLS monitors employer costs per labor hour. From fiscal and productivity standpoints, this measure is far more important than take-home pay.

According to the BLS, state and local governments in September 2009 paid $39.83 in salary and benefits per hour worked. That is 45 percent higher than what private employers paid. The salary component was one-third higher. The benefit component was two-thirds higher.

While state and local employees' salary advantage has been stable for at least a decade, their benefit advantage has widened considerably. In inflation-adjusted terms, private benefits per working hour have risen by nearly a dollar since 2000. The corresponding state- and local-employee benefits have risen by nearly three dollars.

Compounding the disparity, public-sector employees typically receive benefits that are far more secure than those that private-sector employees receive. According to a recent study from the Center for Retirement Research at Boston College, almost 80 percent of state and local workers age 25–64 have pensions from their employers, and 80 percent of these pensions provide strictly defined benefits (i.e., they impose no risk from shortfalls in investment proceeds). In contrast, only 45 percent of private employees of the same age have pensions from their employers, and only 40 percent of these pensions provide strictly defined benefits.

Moreover, public-sector benefits tend to kick in at lower ages, with better cost-of-living adjustments and fewer deductibles for health care than private-sector benefits. Only older, heavily unionized private firms offer comparable perks, to their regret. They have been sinking for years under the load and need another $150 billion–plus from the federal Pension Benefit Guaranty Corporation to meet their commitments. They have become international symbols of how not to regain an edge. Yet our civil service is emulating them.

In the pecking order of socioeconomic sins, overpaying public-sector employees is hardly the worst. Better to overpay, for example, than to grossly underpay, which encourages both bad work and corruption. Paying people well to work well can be win-win.

But these perks aren't. To begin with, they pay for comparatively little work. Full-time federal employees with three years of service or more can take off 43 weekdays a year with full pay: 10 holidays, 20 days vacation, and 13 sick days. Employees with 15 years of service get an additional six days of vacation a year. A program called "time off as an incentive" grants extra paid leave "to recognize excellent employee performance." And those with two to three decades of service qualify for retirement at ages 50 to 60 with full or nearly full benefits.

Some state and local programs reward not working even more. Since 1999, California has allowed state employees to retire at age 50 with as little as five years of service. Each year, pensioners receive a certain percentage of their final salaries for each year they worked. Most employees hired in their twenties can retire by age 55 or earlier with 50 percent or more of their highest salary locked in for life, with full inflation adjustment. The state also pays 100 percent of health-care costs for retirees with at least 20 years of service.

Such pledges are anachronistic. They date from an era in which 25 years of hard manual labor broke workers' health, medical technology was limited, benefits were low, average lifespans were under 65, and the worker-to-retiree ratio was extremely high. They are totally unsuited to the 21st century, in which people can work productively for 40 years or more, expensive medical technology is beating back infirmity, benefits are extensive, and the worker-to-retiree ratio is dropping below two to one.

These programs will have to adjust, be it through the market incentives that the Left abhors or the health-care rationing that the Right abhors. But it is difficult to roll back previously granted benefits, no matter how foolish or exorbitant. Experts at the Center for Retirement Research explain that "many state courts have ruled that the public employer is prohibited from modifying the plan" once an employee has started work. Increased employee contributions can come only from new hires.

While wrapped as public-spiritedness, such benefits are actually assaults on future generations. When education bills get padded with extra retirement benefits for teachers, they guarantee that a larger share of future education budgets will be siphoned off to people who no longer teach. That can't possibly help the next generation to learn. Nor can it help the next generation of teachers, who will have to settle for lower pay and worse benefits to keep their states afloat.

State and local fiscal crises will force these issues to the fore. Wages and benefits account for about half of state- and local-government spending. Medicaid, a benefit awarded without any requirement to work, absorbs much of the rest. Over time, wage and benefit expansion has strained the government's capacity to service debt, even under higher tax rates.

The Great Recession is now pushing some over the brink. State and local operating budgets, which exclude capital expenditures, have traditionally run small surpluses, reflecting legal requirements to stay in the black. Back in 2007, even before the crisis hit in full force, the Government Accountability Office (GAO) warned of breakdown, with deficits increasing from now until doomsday. In January 2009, the GAO was even gloomier, adding about 0.5 percent of GDP a year to projected shortfalls.

If they stay on their current track, state and local governments will within a few decades accumulate higher average debt-to-GDP ratios than the federal government has now. Yet they command far fewer resources with which to repay their debts. They cannot print money, and their residents are free to relocate if they raise taxes too much. The short word for where this leads is "insolvency."

Some of our biggest states and localities are already insolvent. California is so far under water that serious budget-balancing has given way to creative gimmicks for borrowing against the future. New York is racing to beat it to the bottom.

The problem is less the nominal deficit than the gaping holes off the balance sheet. If state pension funds were held to traditional accounting standards for banks, never mind the tighter new standards, most of them would have negative capital. They owe clearly defined benefits, with no right to scale them back, yet don't hold nearly enough assets to guarantee debt servicing out of ordinary dividends. So they invest heavily in risky equities, hope for high returns, and get hammered in downturns.

It's a bit like buying a home beyond one's means and counting on appreciation to service the mortgage. Lenders are rightly castigated for having exacerbated this practice through low standards and deceptive packaging, the so-called liar loans. But liar loans still abound in the public sector, under the guise of "Pension Obligation Bonds." Strapped governments borrow at U.S. Treasury rates plus a premium, pledge to make even more by reinvesting in equities, and treat the wished-for profits as hard assets on their balance sheets. Presto, the budget looks balanced again. And if the equities get nailed, well, distract the public with a new accounting trick.

The Center for Retirement Research estimated in November 2008 that equities held in defined-benefit state and local retirement plans lost $1 trillion from their peak in October 2007. Even at the peak, these plans were only 87 percent funded; a year later, the funding coverage had declined to 65 percent. Due to the growing gap between liabilities and contributions, the Center's most optimistic scenario projected a rebound to only 75 percent funding by 2013.

Recently, the GAO estimated that unfunded retirement benefits for state and local employees exceed $530 billion. Top dishonors go to New York State, whose government, largest city, and largest counties underfund pensions by at least $119 billion. Authorities in California underfund by at least $91 billion. New Jersey underfunds by at least $51 billion. Together these three account for nearly half of all underfunding. Illinois is almost surely fourth, but Cook County refused to report its liabilities. Special mentions go to Detroit and Boston, which despite their moderate size have racked up unfunded liabilities of roughly $6 billion apiece.

Hardly any of the most insolvent state and local authorities can haul themselves back to solvency on their own. Few are even trying. They are simply rolling over their debt as long as they can, and counting on the federal government to bail them out when they can't.

Last year's stimulus staved off a reckoning, but that won't last. Lucy Dadayan and Donald J. Boyd of the Nelson A. Rockefeller Institute of Government report that state tax receipts, adjusted for inflation, have declined an average 12.5 percent over the past four quarters. This is the worst decline on record.

Hopefully, the federal government will not reward irresponsible state and local authorities with bailouts this time around. But if for political reasons it must, there are various ways it can do so. The most transparent is for the federal government to assume their debts. This is also the most embarrassing. It openly taxes residents of other states for debts they did not assume and government services they did not receive. It openly rewards the spendthrift over the frugal. It openly belittles the Obama administration's pledge of enhanced fiscal discipline going forward.

The most efficient and fairest bailout would be a partial one. The Obama administration would disclaim responsibility for state debts, in line with the Constitution and historical precedent. But in recognition of the severe recession, and of the burden previously imposed through unfunded mandates, the federal government would provide bailout funds to the states in proportion to their population. The problem here is political. It would surely offend core Democratic constituencies.

The most politically appealing bailout would come through a health-care bill. Most of the shortfall lies either in future health-care costs for state and local employees or in the current costs of Medicaid. Any transfer of responsibility to the federal government in this area therefore disproportionately helps New York, California, New Jersey, and Illinois. And it will help them even more in legislation that drops the proposed tax on the “Cadillac” health-care plans their employees hold.

If deftly executed, such a policy’s economic impact wouldn’t differ much from that of an open bailout. But its packaging as aid to all state and local governments would conceal the massive transfers from frugal to spendthrift. That is why a modest carve-out from Medicaid financing persuaded Nebraska senator Ben Nelson that his state would come out on top, even though Nebraska reports no underfunded retirement claims at all.

And routing bailout funds through health-care legislation is risky. As Donald Boyd has noted, many people currently eligible for Medicaid don’t enroll. If reform makes the option more familiar and mainstream, costs could spiral out of control. States that trim back care in response will face opposition from advocacy groups, Congress, and courts.

That leads back to the path of least resistance. Promise savings that don’t materialize. Roll over debt that can’t be serviced. Preach responsibility while deferring it. Wait for panic to force your hand.

The generations that will pay the highest price aren’t of voting age yet, and some haven’t been born. Eventually they will rebel against their burdens. When they do, it will make the current tea-party movement look like, well, a tea party.

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