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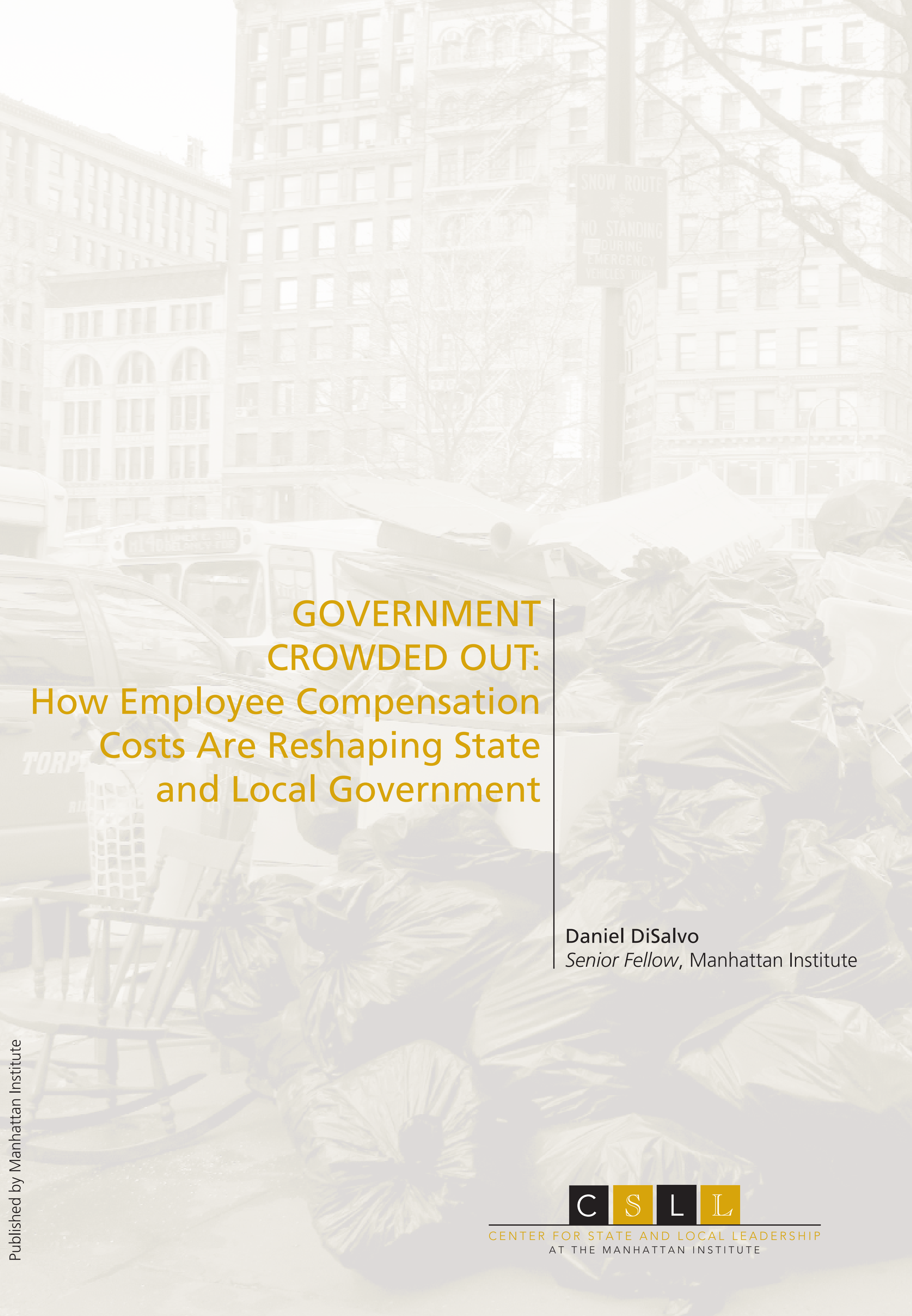

GOVERNMENT CROWDED OUT: How Employee Compensation Costs Are Reshaping State and Local Government

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Throughout the United States, state and local governments face skyrocketing costs for the pensions and health care of their current and retired teachers, firefighters, police, and other employees. Many of these costs are effectively on "autopilot": They are locked in place by law or by union contract, and lawmakers neither control nor review them. In Washington State, for example, 55–60 percent of the budget goes to pay the salaries and benefits of the state's employees, so more than half of the state budget is off limits to policymakers.

As more and more of a government budget is devoted to employee pensions and health care, lawmakers must (a) raise taxes, or (b) engage in dangerous fiscal gimmickry, or (c) take on more debt, or (d) or spend less on schools, roads, public transport, libraries, assistance for the poor, and other functions. Troublingly, many governments are choosing option (d), creating the paradox of government that spends more and more to do less and less.

In this paper, we detail how spending on public-employee pensions and health care is crowding out essential government services in states, cities, and other local-government jurisdictions.

Because of local governments' pension and health-care commitments, we report:

- The cost to local government of employing a worker has soared. For instance, in San Jose the average cost of a full-time worker is $142,000 a year, up 85 percent in ten years. A sanitation worker in New York City now costs $144,000 annually, up from $79,000 a decade ago.

- Governments are spending a rapidly growing percentage of precious revenue on pensions alone. For example, in 2013, according to New York City mayor Michael Bloomberg, "every penny in personal income tax we collect will go to cover our pension bill." Since 2005, the city's spending on pensions rose from 6.1 percent of the budget to 11.7 percent. In Los Angeles, pension costs were 3 percent of the budget only 10 years ago. Today, they are 18 percent.

- The most common response to rising pension and health-care costs is to cut services. Chicago, for example, is in the process of closing 11 percent of its schools. In Des Moines, Iowa, the library is now closed one day a week, trash in the parks is picked up less often and streets are cleaned less frequently, due to a rise in police and fire pension costs of 20 percent. Despite these cuts, Des Moines has instituted a property tax increase.

- Pensions are not the only concern. Most local governments lack any long-term strategy for funding their health-care commitments to employees. As of 2009, the 61 American cities with a population greater than 500,000 collectively had $118 billion in liabilities for employee and retiree health care, and had only set aside enough money to cover 6 percent of this. Meanwhile, U.S. states' health care liabilities increased by $22 billion (4 percent) in just one year (2009–10).

About the Author

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CONTENTS

Government Crowded Out: How Employee Compensation Costs Are Reshaping State and Local Government

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State and local government finances in the United States today are under severe pressure. One cause—increases in Medicaid expenditures—is widely discussed. But an even more important cause receives far less attention: the exploding costs of public employees' compensation, particularly their pensions and health care.

As governments pay more and more for these benefits—usually without choice or review because the expenditures are governed by law or by union contract—policymakers find that governments have less and less to spend on the services that citizens need and expect. Call it the "crowding-out" effect: skyrocketing spending on public employees reduces government's ability to do anything else. As David Crane, a former economic adviser to California governor Arnold Schwarzenegger, has warned about his state, the benefits for California employees now threaten funding "for many programs vital to the overwhelming majority of Californians," including "higher education, transit, and parks."[1]

Many are now aware that the United States federal government faces major constraints on spending because of its retirement programs for all citizens.[2] Far less attention has been paid to the crowding out that menaces state and local government budgets, thanks to their long-standing promises to a much narrower slice of the population: their current and former workers. Yet it is this local and state government crisis that will probably have the most direct negative impact on Americans' lives and on their perception of government.

Crafting a budget provides answers to the classic questions of politics as defined by political scientist Harold D. Lasswell: Who gets what, when, and how? It is the heart of policymaking. Indeed, many have remarked that "budgeting is governing." However, the more that budget items are locked in by past decisions, the more that budgeting loses its connection to self-government. Elected officials, constrained by the crowding-out effect, simply have fewer choices in attempting to address society's needs. Boxed in by choices made by earlier generations of long-gone politicians, policymakers struggle to set new priorities. Older, entrenched programs siphon off too much money.

The math of the situation is obvious: if government spends more money on the salaries, pensions, and health care of its employees, it cannot spend more money on public transit, school buildings, park maintenance, relief for the poor, and other programs. Such a government must raise taxes, employ fiscal gimmickry, take on more debt—or shortchange essential civic functions, from bridge repair to public schools. Given the negative political consequences of, and other limits on, the first three options, state and local governments lately have been making extensive cuts to services. This trend will soon accelerate, and the resulting pain will be felt by those who depend the most on public services: people in the middle- and lower-income ranges.

The result in many jurisdictions will be government that pleases no one across the political spectrum. It will spend more (troubling conservatives) even as it does less (vexing liberals). Average citizens will naturally wonder why their government costs more but gives them less. The resulting loss of confidence in government will make it harder for state and local jurisdictions to undertake long-term investments (in infrastructure to enhance economic efficiency and in their workforces to increase productivity), thus compounding citizens' distrust in government's ability to solve problems. Also eroding their trust will be the perception that government serves insiders (in this case, public-employee unions) at the expense of the general population.

According to Elizabeth McNichol of the Center on Budget and Policy Priorities, compensation costs for public-sector workers are, on average, 44 percent of state and local spending.[3] Some states, though, are far above that average. In Washington State, 55–60 percent of the budget goes to pay the salaries and benefits of the state's employees.[4] This means that more than half of the state budget is governed by law or union contract, making it off limits to policymakers.

This is the kind of problem that confronts America's national, state, and local governments today. At the state and local levels of government, large budget items—especially spending on salaries, pensions, and health care for public employees—are effectively on autopilot. With these items as fixed costs (expenditures that must be made regardless of other considerations), governments are budgeting more dollars but deciding less. The resulting picture—governments that spend more public money, do less for the public, and seem to serve public-sector employees at the expense of their fellow citizens—could not be better designed to shake people's faith in their institutions and, indeed, in the very concept of self-government.[5]

THE CAUSES OF CROWDING OUT

The specific past decisions that drive the crowding-out effect are the formulas for how much retirees would receive in pension and health-care benefits. Enacted and expanded when the economy was growing, these choices were not considered for their long-term implications or for their consequences for more difficult economic times. In the few instances when trouble was clearly ahead, the consequences were too far in the future to concern the politicians of the time. Put bluntly, those involved in setting these policies knew that they would not be on hand if and when problems emerged.

The Federal Case

While the focus of this report is on state and local government, the federal government faces a similar problem of past commitments crowding out current needs (though the source of the federal trouble is different from that of other levels of government). Taking a brief look at the federal situation, which is more familiar and has received more press attention, helps illustrate the general problem.

Nicholas Eberstadt, a political economist at the American Enterprise Institute, has recently documented how the federal government's activities have been transformed as it has grown in size since the New Deal. Today, he writes, the federal government "devotes more attention and resources to the public transfers of money, goods, and services to individual citizens than to any other objective."[6] As has been amply documented over the past few years, the principle cause of this change is explosive growth in entitlement spending—the costs of Social Security, Medicare and Medicaid, and other government transfers to individuals. The direction of transfer payments tends to be from young to old, from employed to those out of the labor force, and from workers to retirees. Even when these transfers do receive attention, they have proved politically very hard to reform. And the immense scale of these outlays makes them hard to envision and understand. For all levels of American government, they total more than $2 trillion dollars a year.

Many of the drivers of federal spending are automatic—not decided by current lawmakers or even reviewed because individuals are legally entitled to receive the benefits if they meet the eligibility criteria. The sense of crisis around these entitlements has been spurred by demographic facts: millions in the baby-boom generation (born between 1946 and 1964) are retiring in the near future and will be eligible for benefits.

This type of federal government is quite new. Until the 1960s, the priorities of the federal government, as reflected in its spending, were national security, infrastructure investments (most of which facilitated commerce and helped promote national unity), and limited public services. These priorities were evident in the portions of public spending devoted to defense, criminal justice, the postal service, national highways, and so on. The dramatic change occurred in the wake of the Great Society, when Medicaid and Medicare were created and Social Security expanded. In 2010, almost 66 percent of all federal government spending was on transfers to individuals. All those other national priorities, which once dominated the budget, were relegated to the remaining third.[7]

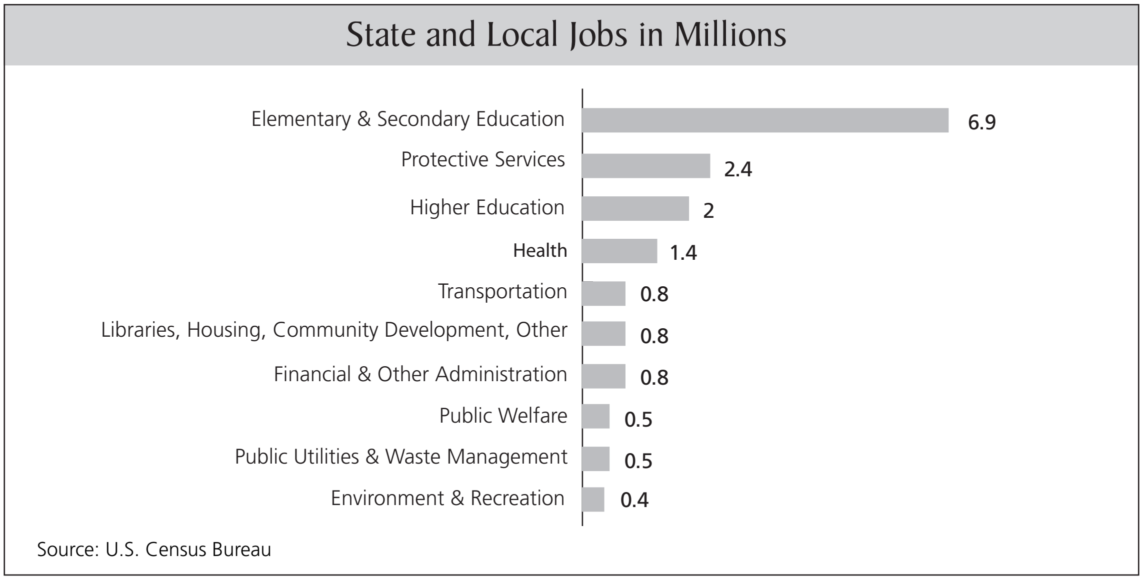
Given the vast numbers of people who will retire in coming decades, entitlement and other transfer spending will continue to squeeze other areas of government expenditures for the foreseeable future. For example, President Barack Obama's 2012 budget proposal, which includes spending and taxing projections for the next decade, avoids cuts to Social Security or Medicare, does not include any increase in middle-class taxes, and therefore reduces nondefense discretionary spending (which covers everything else the government does except defense) to 1.7 percent of economic output by 2022, down from 3.1 percent in 2011.[8] The Senate Democrats recently passed a budget that reduces nondefense discretionary spending from 3.7 percent of GDP today to 2.5 percent in a decade. "One way to think about this pattern," says *Wall Street Journal* columnist Gerald Seib, "is that it leaves wealthy retirees living in gated golf-course communities with benefits that are unscathed, while Head Start programs for kids, or research by scientists in university laboratories, for that matter, take a hit."[9]

The nondefense discretionary spending category includes everything from subsidies for higher education, low-income housing, and job-training programs for the unemployed to financing for the Environmental Protection Agency (EPA), the Food and Drug Administration (FDA), and the Federal Emergency Management Agency (FEMA). As *New York Times* analyst Eduardo Porter has put it, "without such spending, the government becomes little more than a heavily armed pension plan with a health insurer on the side."[10] For states and localities, the squeeze on federal discretionary spending means far less assistance, which totaled $607 billion in 2011, and increased intergovernmental disputes over federal mandates.[11]

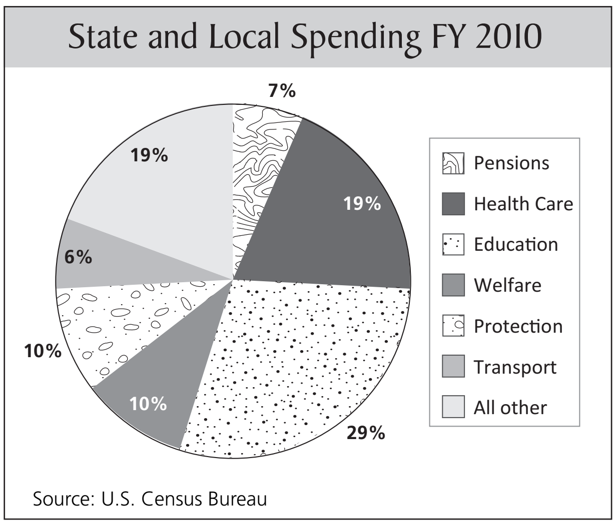
State and Local Governments: Different Drivers, Same Crisis

As the federal government wrestles with the crowding-out problem, the same struggles are evident at the state and local levels. Here, though, the causes of trouble are different.

The U.S. Census Bureau counts 89,527 units of government, of which 50 are states and 39,000 are



general-purpose local governments. There is great diversity in the institutional arrangements of these governments and their modes of financing. Large portions of state and local spending are mandated and partly subsidized by the federal government—most notably, on health (Medicaid), education (schools), and transportation (highways). Those items, especially the expansion of Medicaid, will continue to strain local finances. But they are expenses that the federal government largely pushed onto states and localities, not burdens that states created for themselves.

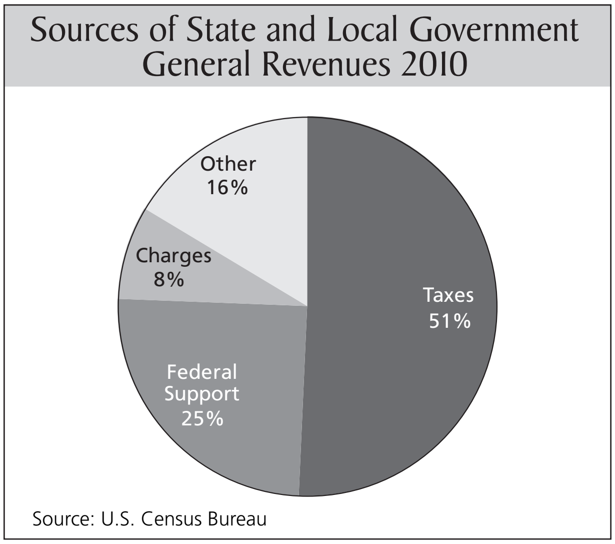


That is not the case, however, for state and local pensions and health-care plans for public employees. In 2010, American state and local governments employed 16.4 million full-time workers. The majority of those workers are teachers, police officers, and firefighters (see charts below). Where the federal government's problems stem from the cost of entitlements for all citizens, state and local governments are at risk because of costs associated with these employees—salaries, pension, health care, and other fringe benefits. Today, worker-compensation costs at governments below the state level consume 70–80 percent of budgets.[12]

The dilemma faced by many American cities illustrates this crowding-out effect. There, thanks to pension and health-care commitments, the costs of employing workers have soared, taking an ever-larger slice of the budget. In San Jose, the average cost of a full-time worker is $142,000 a year, up 85 percent in ten years.[13] A sanitation worker in New York City now costs $144,000 annually, up from $79,000 a decade ago.[14]

How Governments Pay for Crowding Out

Even as rising public-employee health-care and pension costs demand more spending, local government revenues are declining and becoming more volatile. In 2010, state and local government depended primarily



on three sources of revenue: federal transfers (24.9 percent), fees and charges (16.4 percent), and their own taxes (50.7 percent). These units of government took in $1.3 trillion in tax revenue in 2010, down 1 percent from the previous year. At the same time, expenditures increased 4 percent, to $3.1 trillion.[15] In a related development, state and local gov-ernment indebtedness increased 4.6 percent, to $2.8 trillion.

Even with their budgets strapped, state and local governments also find that once-reliable sources of revenue are shrinking. For example, sales taxes, on average, now constitute about one-third of state tax revenue across the 50 states. But sales-tax revenue lately has become more difficult to collect, for two structural reasons: more and more consumer purchases are services, which are taxed more lightly than goods; and consumers by the millions have moved at least some of their shopping online. This has eroded the sales-tax base.[16] Moreover, many sales taxes are reckoned by quantity of goods, rather than by price. This means that inflation has reduced their value as income sources for government. Some states have responded with the unpopular step of increasing sales-tax rates: average rates across the states have increased from 3.5 percent in 1970 to 5.5 percent in 2000.

Meanwhile, other revenue sources, such as specialized taxes on goods such as gasoline, alcohol, and tobacco have also declined. Improved gas mileage has reduced fuel-tax revenue: according to the State Budget Crisis Task Force, "between 1960 and 2010, state and local motor fuel taxes declined relative to the economy by 60 percent." As most states dedicate at least some fuel-tax revenue to transportation, the decline in income from these taxes makes it increasingly hard to fund transportation infrastructure, particularly highways and bridges.[17]

Unsurprisingly, some states have looked to taxes on income to help compensate for falling revenues elsewhere. They have raised income taxes on wealthy residents. (California did so most recently by referendum in 2012.) Unfortunately, the resulting revenue is far less reliable than other forms of tax because wealthy citizens' incomes tend to rely more heavily on the performance of the stock market. When markets take a tumble, so do state revenues.[18] Moreover, such selective taxation raises the prospect that at least some wealthy citizens will move away, while others who might have come to the state go elsewhere. (The size of this effect is a subject of debate, but even the prospect of driving away prosperous investors is not a revenue enhancer.)

It is important to remember, then, that the growing demands of public-employee compensation are coming at a time when states are having trouble even maintaining current revenues.

What Expenditures Cause Crowding Out?

As we have mentioned, the skyrocketing costs of public-employee compensation are not primarily due to salary increases—although some localities have gone too far in this area; the trouble is rooted in pensions and health-care expenses.

Let us begin with the best known of the major cost drivers: public-employee pensions. Their costs are rising across the nation. Depending on the accounting methods used, estimates of American states' total pension liabilities range from $600 million to $3 trillion. In 2009, New Jersey's unfunded liability was $130 billion, which was more than four times the state's 2008 fiscal-year budget. California, which

NEW YORK CITY'S BUDGET SQUEEZE

Nicole Gelinas

Over the past 11 years—the years during which Michael Bloomberg has been mayor—New York City's budget has risen from $26.3 billion ($33.9 billion in today's dollars) to $50.7 billion. At the same time, however, the number of employees in key services—police, fire, sanitation—has fallen. The key reason: employee-benefit costs, both for current employees and retirees, are crowding out current services.

The squeeze is apparent from the city's budget figures. In fiscal year 2002, which began in July 2001, six months before Bloomberg took office, city-funded spending was $26.3 billion, or $33.9 billion in today's dollars when adjusted for inflation. In fiscal year 2014, the last budget Bloomberg will sign into law, the mayor projects city spending to be $50.7 billion.

This nearly 50 percent increase in inflation-adjusted spending has not funded basic city services. Rather, it has largely funded what the mayor calls "uncontrollable expenses"—pensions, health, and other "fringe" benefits for workers and retirees. Under the mayor's final budget, these "uncontrollable expenses," at $23.1 billion, will exceed controllable expenses, at $22.7 billion, for the first time in New York City's history.[2]

Two big-ticket items—pensions and health care— have defined budget growth.[2] In 2002, for example, the city spent $2.4 billion on health and other "fringe" benefits such as workers' compensation for city employees ($3.1 billion in today's dollars). In 2014, the cost will be $8.8 billion. In 2002, the city spent $1.6 billion on pension contributions ($2 billion in today's dollars). In 2014, the figure will be $8.2 billion. Together, these two costs alone comprise $17 billion, or nearly three-fourths of "uncontrollable expenses." Now nearly 34 percent of the city-funded budget, these costs comprised 15.2 percent of the city-funded budget when the mayor took office.[4]

This benefits spending has taken a toll on the number of people the city currently employs to provide services, especially in the uniformed services, where benefits costs are higher. In 2002, for example, the police department had 36,790 uniformed employees. Next year, the figure will be 34,483. In 2002, the city had 11,321 uniformed fire-department employees. Next year, the figure will be 10,282. In 2002, the city had 7,821 uniformed sanitation workers. Next year, it will have 7,271 sanitation workers.

Higher worker-benefit costs are crowding out capital spending as well. To be sure, capital spending has kept up with inflation since the mayor took office; at $6.3 billion annually then, or $8.1 billion in today's dollars, it was $8.4 billion in 2012 (the last year for which full data is available).

But capital spending has kept pace only because the city has been able to increase its outstanding debt. Since 2002, New York's capital debt has grown from $42.7 billion ($55.1 billion in today's dollars) to $77.3 billion. Debt service costs have grown from approximately $2 billion ($2.6 billion in today's dollars) when the mayor took office to $6 billion next year. The city has benefited from record-low interest rates. But if rates rise, New York will have difficulty maintaining its capital spending and its employee-benefits costs.

Another challenge for city residents and regional commuters into the city, if not a direct challenge for the city budget, is that the independent public authorities that state and city agencies once created to relieve pressure on the city budget are experiencing their own crowding-out problems.

To wit: the state-run Metropolitan Transportation Authority (MTA), the successor to the city-state transit agency that New York created in 1953 to relieve the city's budget, has doubled in size during the 12-year Bloomberg administration, from \$16.7 billion (\$21.6 billion in today's dollars) to \$32 billion. That growth came in part because the MTA must devote so much of its operating budget to similarly rising benefits costs. Therefore, it cannot pay to keep its assets in a state of good repair without borrowing long-term debt.

New York, then, like much of the rest of the country, as DiSalvo describes, faces a serious problem: the employee pension and health benefits that once seemed to be cheap add-ons to the cost of providing city services and investing in city infrastructure are now crowding out spending and investment respectively on those very services and infrastructure.

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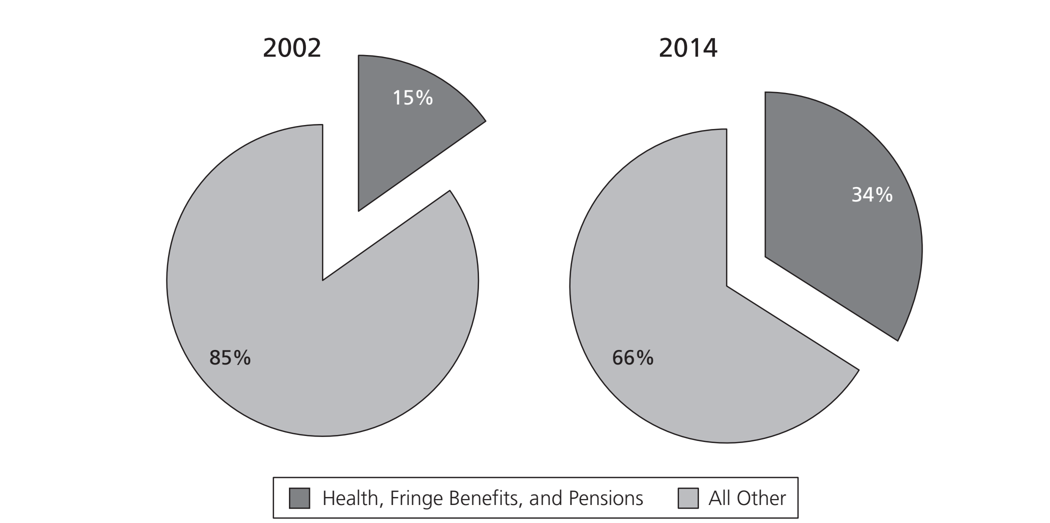
[1] Author's calculations based Five-Year Financial Plan Revenues and Expenditures, June 2002, and Financial Plan Summary, January 2013, New York City Office of Management and Budget, as well as Bureau of Labor Statistics inflation data.

[2] Controllable / Non-Controllable Spending Analysis, New York City Office of Management and Budget, January 2013.

[3] The city has also doubled education spending, but education costs, too, include big-ticket spending on pension and healthcare benefits. The other biggest "uncontrollable expense" is Medicaid, but as the state took on responsibility in Medicaid growth in the mid-2000s, it has not grown as quickly as pension and healthcare spending for public workers.

[4] Spending and debt figures in the preceding paragraph as well as in the paragraphs below derive from author's calculations based on the Comptroller's Reports for 2011 and 2012 as well as the above-cited city budget documents.

Under Bloomberg, Benefit Costs Crowd Out Spending on Vital Services



faced a $25.4 billion budget gap in 2011, paid pensions greater than $100,000 per year to more than 12,000 state and municipal retirees that year. Of course, some of these outlays are supported by investments, but many pension plans are not adequately funded. And investments, of course, vary with market performance. When investments fail to cover fixed pension obligations, government must make up the shortfall.

As more workers retire and investment returns continue to be lackluster, pensions will soon begin to consume a bigger share of state and local budgets. Today, pensions make up, on average, 4.6 percent of state and local revenues. However, if governments earn only 4 percent return on their investments over the next decade, pension contributions will rise in ten years to 14.5 percent of revenue, becoming the third-largest slice of many state budgets, after schools and health care. Consider how pension commitments are a growing part of state budgets in the charts on page 9-10. Again, governments can meet their growing obligations only by raising taxes, issuing more debt, engaging in accounting gimmicks, or cutting services. We expect that many states will engage in some unappetizing combination of all those coping strategies.

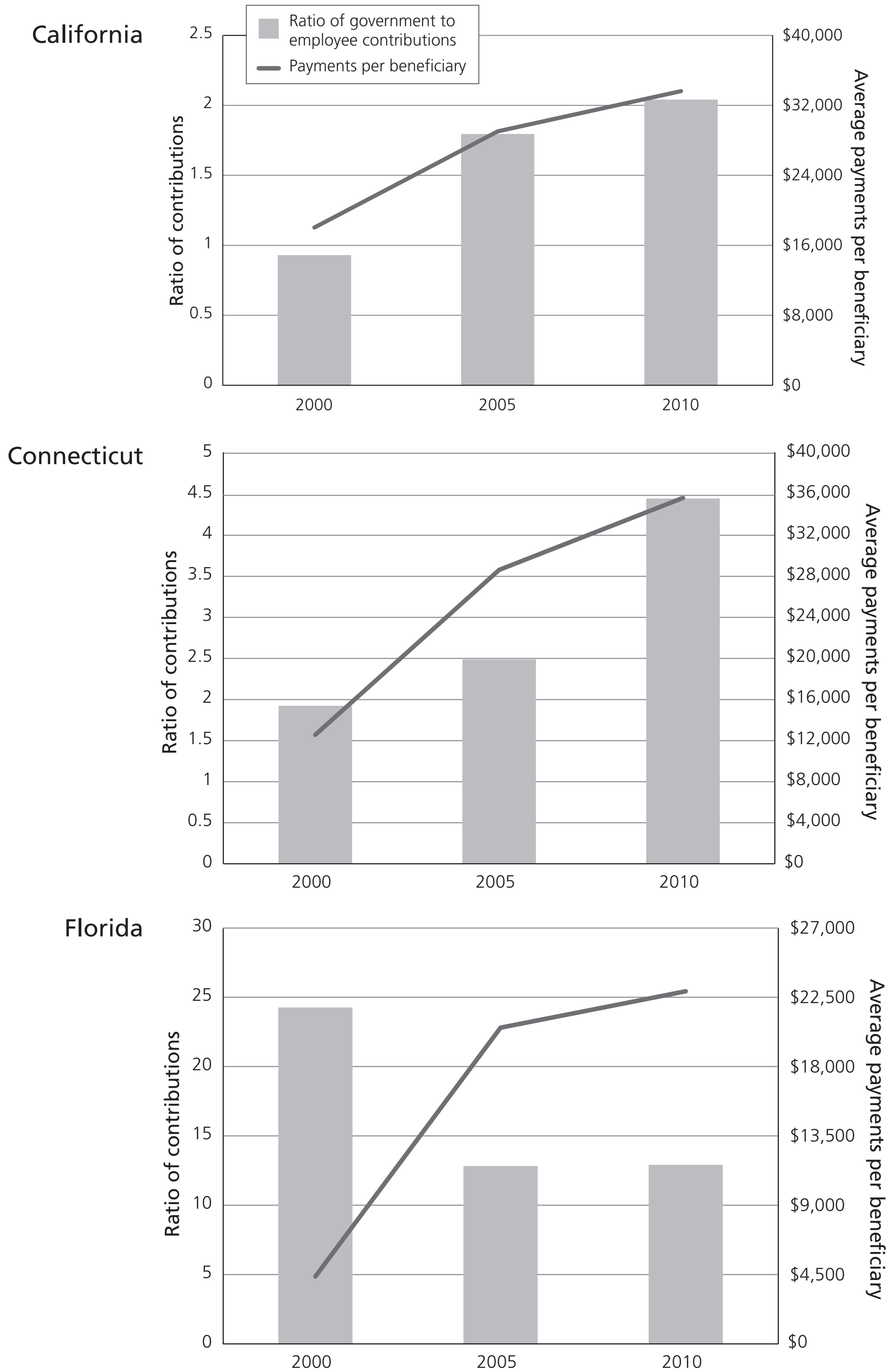
Union contracts create pressure for more outlays because they, too, define benefits that must be paid, regardless of investment performance. But such contracts also contain less direct drivers of cost—such as early retirement incentives. In the first decade of the twenty-first century, the number of people in the United States receiving government-sponsored pensions shot up by 38 percent, to 8.25 million, while the number of workers on the job contributing to public pension funds increased only 5 percent. As the ratio of workers to beneficiaries fell, nonfederal government-employee pension costs exploded, doubling from $100 billion to $200 billion.

Even as awareness of the public-employee pension problem has spread, far less attention has been paid to the budget pressure caused by public-employee health benefits. These have the potential to pose an even greater problem for governments because, unlike pensions, health benefits are most commonly paid out of each year's operating funds. In other words, retirees, who served yesterday's taxpayers when active, are being supported by today's taxpayers. A fairer and more fiscally sound approach, of course, would be to "pre-fund" such obligations: set aside money and invest it to pay for future retiree health care, just as pension funds are invested to pay for those obligations in the future. Fewer than ten states have undertaken any sort of pre-funding, and very few governments have adequate assets to cover the health benefits that they will pay. Meanwhile, most of the rest of the states lack *any* long-term strategy for funding these liabilities, and the same goes for America's big cities. As of 2009, the 61 cities with a population greater than 500,000 collectively had a $118 billion employee health-care liability and had set aside enough money to cover only 6 percent of it.

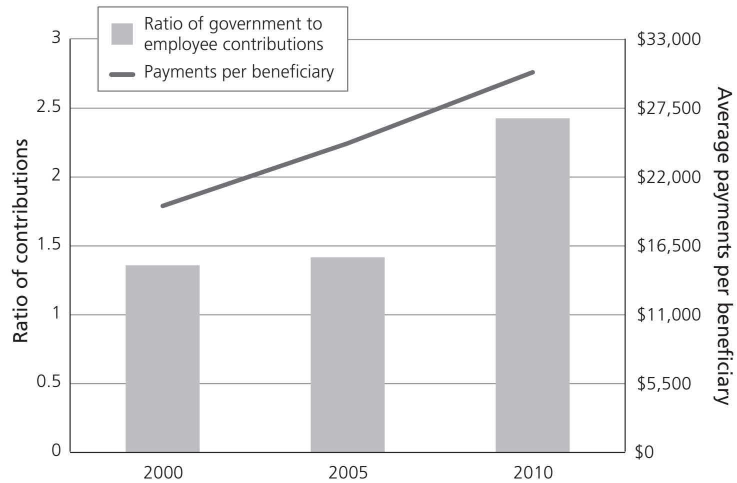
One reason that health benefits receive less attention is that estimates of governments' liabilities vary widely and good data are hard to come by. Looking at 75 public-sector health plans, Alicia Munnell, of Boston College's Carroll School of Management, estimated that total liability of nonfederal governments for health care was $588 billion in 2012. The Pew Center on the States estimates the total unfunded liability to be $627 billion. Total liabilities are, however, likely to be much higher because many health plans are locally administered and not on any state's books. Yet local governments are legal creations of the states, so those state governments could become liable if and when those local units of government require a bailout. This is why other studies have found governments' total liability for employee health care to be as much as $1.6 trillion.[19] And these liabilities have been increasing, as health-care costs rise. Pew found that states' liabilities increased by $22 billion (4 percent) in just one year (2009–10).

A major source of cost increases in these plans is the care of retirees. A number of different types of retiree health-care plans are offered by states and municipalities. Some plans cover workers who retire before they are eligible for Medicare at age 65.[20] Other plans supplement Medicare coverage for the rest of a worker's life. Some government sponsors contribute

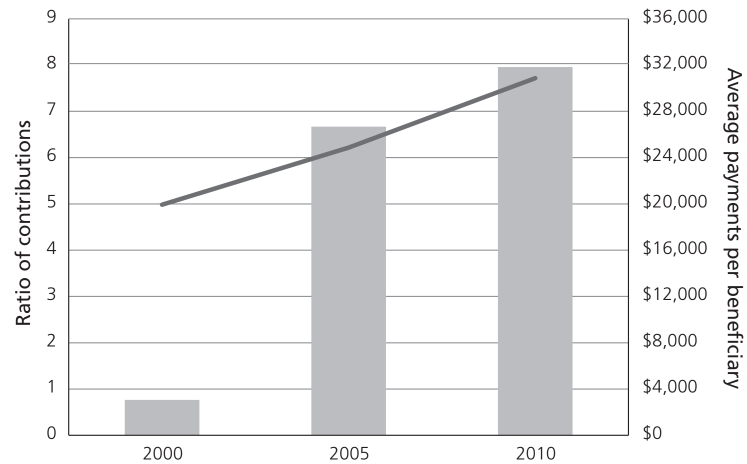
Government Bears the Brunt of Rising Pension Costs



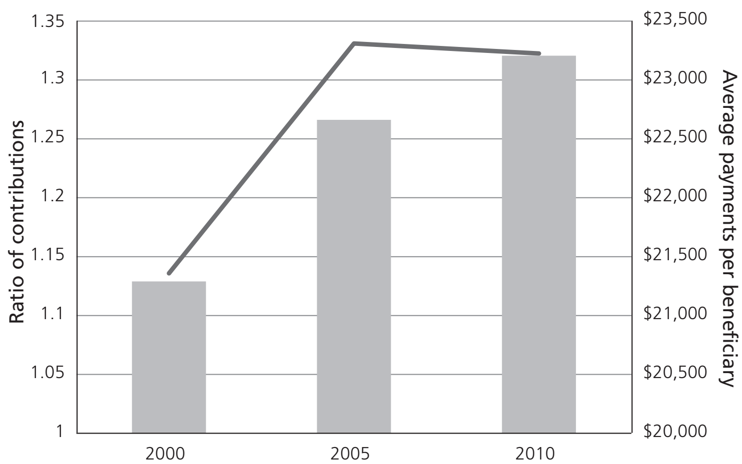
Illinois



New York



Texas



almost nothing to these plans; in other cases, they make fairly generous contributions.

Hence, the degree of trouble that health plans pose for state governments varies, depending on how much of the insurance premium is paid by a state. Some state governments, including New Jersey, Rhode Island, California, Pennsylvania, and Illinois have immediate problems because they pay 100 percent of the premium. At the other extreme, Idaho, Montana, Wisconsin, and Minnesota do not face fiscal pressure from this source: they pay no portion of the premium. It is safe to say, though, that most other states face at least some pressure from this source because a majority of them pay 50 percent or more of their employees' health-care premium.

THE CONSEQUENCES FOR GOVERNMENT SPENDING AND SERVICES

Since 2009, state government payrolls have declined by 161,000, and local payrolls by 560,000. Yet from 2008 through 2010, spending by the 50 state governments rose by $200 billion, to $1.9 trillion. State and local governments are now spending more but doing less.

As we have discussed, these employee-related costs will demand more of governments' revenue, thereby reducing spending on road maintenance, libraries, parks, public transport, and other crucial services that citizens expect from their government. Unable to alter commitments that are locked in by law or contract, lawmakers—who know that revenue is scarce and taxes are hard to raise—must take money from other government functions. Already, in Massachusetts, hundreds of millions of dollars in school funding never reached a classroom because the funds were used to pay for the health care of education workers. These practices are certainly among the reasons that major increases in spending on education over the last 30 years have had so little effect on student performance.

Massachusetts—where employee health-care costs jumped about 85 percent from 2001 to 2006, according to the *Boston Globe*—furnishes other examples of crowded-out governance: jurisdictions doing less for their citizens even as they spend more on their current and retired employees. The town of Stoneham, for example, was forced to cut a dozen jobs in the police and fire departments and reduce other services by reducing the hours of town employees.[21] Other cities have had to take even more dramatic action: last year, Scranton, Pennsylvania, temporarily cut the pay of all city workers to the minimum wage of $7.25 an hour. Among the huge bills that necessitated this cut, the city manager explained, was the one for workers' health insurance.[22]

Last year, the National Conference on State Legislatures forecast that for ten states, employee retirement and benefit costs would be their fastest-growing budget items.[23] Illinois governor Pat Quinn was blunt in his most recent State of the State Address: pension costs, he said, are "squeezing out education, public safety and other vital services to the tune of $17 million a day."[24] His budget director, David Vaught, has added what is now a familiar refrain among officials: "Our revenue growth is not enough to keep up with pensions and Medicaid. It creates a squeeze for everything else."[25]

Attempts at Reform

The aforementioned facts make change an urgent priority. Indeed, governments are attempting to head off disaster. Since 2009, some 40 states have undertaken some sort of "reform." Unfortunately, many of these changes have been largely cosmetic; they have not really addressed the underfunding problem. One common strategy, for example, is to offer new workers a different deal from what their seniors received—less generous pensions, a higher retirement age, or greater health-care contributions. The damage that this does is immediate, in that it reduces the attractiveness of government service. Yet the savings will appear only when these newly hired employees retire, many years from now. In the meantime, today's crowding out of government services remains largely unaffected by the "reform."

Moreover, while they rather ineffectually address pensions, few state and local governments have even

Examples of Retiree Health-Benefits Changes Made by Selected Governments since 2004

Government	Type of benefit change	Description of retiree health-benefit change
Gainesville, FL	Government contribution	In 2009, the city began determining the amount of government contribution as a fixed dollar amount based on the retiree's years of service and age at the time of benefit commencement. Before the change, the contribution was a specified percentage of a retiree's health-insurance premium, which meant that the amount of contribution changed with changes in premium costs.
Harris County, TX	Government contribution; Eligibility	In 2007, the county increased the number of years of service needed for an individual to receive a government contribution for the cost of his or her retiree health benefits and reduced the amount of that contribution. As a result of the changes, the county now has the following three-tiered system: individuals employed by the county as of March 1, 2007, and eligible to retire by February 2011 are eligible to receive retiree health benefits if the sum of their age and years of service equals 75 and they have a minimum of ten years of service. The county provides a 100 percent contribution for these individuals.
New Jersey	Government contribution	In 2007, the state began requiring some retirees to contribute toward the cost of their health-insurance premiums, thus reducing the amount of government contribution. Specifically, employees who reach 25 years of state government service, the length of service required to be eligible for retiree health benefits, on or after July 1, 2007, must contribute an amount equal to 1.5 percent of their pension benefit toward the cost of their health-insurance premiums. The retiree's contribution is waived for individuals who participate in a government-sponsored wellness program.
Oakland County, MI	Benefit design; Government contribution	In 2005, in response to a large increase in the county's costs for retiree health benefits, the county adopted a new defined-contribution retiree health-benefit plan for eligible individuals hired on or after January 1, 2006. The defined-contribution plan replaced the county's defined-benefit plan, under which the county paid for 60–100 percent of the premium for eligible individuals hired before 2006. Under the defined-contribution plan, the county contributes $1,300 per year to a retirement health savings plan for each eligible employee. Upon retirement, employees with 15 years of county service can access 60 percent of the funds that the county contributed to their health savings plans for eligible medical expenses. With each additional year of service, the employee has access to another 4 percent of the contributed amount. As such, employees with 25 or more years of service have access to the full amount of funds in their health savings plans when they retire.
South Carolina	Government contribution	The state reduced the level of government contribution for employees hired after May 1, 2008, who become eligible for retiree health benefits. Employees hired before that date who become eligible for retiree health benefits qualified for the full amount of government contribution (which officials said was approximately 71 percent of the premium) if they retired with at least ten years of service. Under the new requirements, in order to qualify for the full government contribution, such employees hired on or after May 1, 2008, must have 25 years of service. Individuals with 15–25 years of service qualify for half of the government contribution, while no contribution is provided to employees with less than 15 years of service.

Source: General Accounting Office

begun to address the cost of health care (for some exceptions, see the table below). While the federal Affordable Care and Patient Protection Act takes small steps toward reining in costs, it is far from clear how much the new law will be able to accomplish on this front. What is certain is that many state workforces are older and many baby boomers are approaching retirement. This creates a one-two punch: costs per public-sector retiree are rising, and the number of retirees is also growing. The resulting pinch on government budgets could well be more severe than that of pensions.

Instead of finding ways to pay for these health benefits, governments have tried to reduce costs by instituting wellness programs, restricting coverage, and requiring workers to pay more for their plans. The last is the main strategy, implemented by increasing the percentage of the premium paid by the employee and increasing co-payments and deductibles. Yet such steps are unlikely to be enough. In fact, one reform that offers more reliable savings is not technically a health-care policy change. When governments increase the retirement age for public employees, they reduce their exposure to their most expensive health-insurance expense: coverage for people under 65. Those who are over 65, being eligible for Medicare, are far less expensive to insure because supplementary benefits to Medicare cost less.

Where the Worst Crowding Out Will Occur

As state governments face trouble on both the pension and health fronts, cities and towns may have even worse problems. Crowding out is especially tough on cities that have experienced big declines in property values (because property taxes are a mainstay of their income) and on those that are in states such as California that limit municipalities' power to raise revenues or to address labor costs. (Nearly a third of the Golden State's cities require collective bargaining and prohibit the outsourcing of public services to private contractors.)[26]

The Pew Research Center reports that the most populous cities across America have a gap of more than $217 billion between what they had promised their workers in pensions and retiree health care and what they have saved to make good on that promise.[27] Consider Pittsburgh, which has one of the worst-funded city pensions in the country. In 2011, actuaries estimated that it had set aside only 30 percent of the funds needed to cover future promises to city workers. (To be considered well funded, a plan should have a funding ratio of at least 75 percent.) In its desperation for new revenue, the city has now sued to remove the tax-exempt nonprofit status of the University of Pittsburgh Medical Center, one of the city's largest employers.[28]

More generally, unfunded urban pension liabilities grew 15 percent in just one year, from 2009 to 2010. Such figures indicate that other things that city governments want to do must be put on the back burner or forced off the stove entirely.

Consider New York City, where pension, health care, and fringe benefits now consume nearly 34 percent of the city-funded budget (see Nicole Gelinas's side bar, page 6-7). Mayor Michael Bloomberg described the problem: "We now spend more on pensions than we do on the operating budget of the NYPD, the Fire Department and the Sanitation Department—combined." "Next year," Bloomberg said in 2012, "every penny in personal income tax we collect will go to cover our pension bill." According to the mayor, pension costs prevent the city from spending on social programs: "Because as pensions consume an ever larger portion of our annual budget, that leaves less and less for everything else. The $6.5 billion more that we are spending on pensions is money that we're not using to fund child care, housing for the homeless, libraries, summer jobs for teens, senior centers and parks and environmental protection."[29]

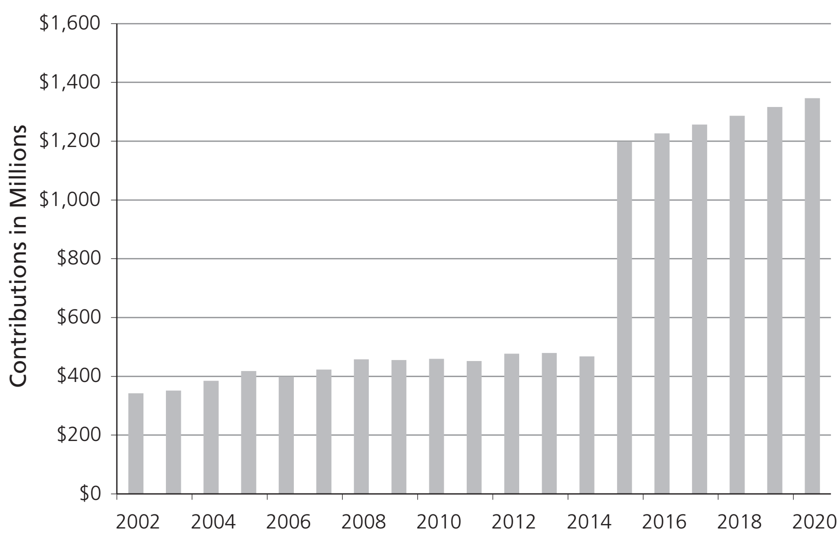
Such talk has become a common refrain from other mayors, such as Los Angeles's Antonio Villaraigosa. In L.A., pension costs have risen over the past decade from 3 percent to 18 percent of the city's budget, and the state's independent oversight agency, the Little Hoover Commission, predicts that pensions could rise to 37 percent of the budget by the year after next. Because of this, some now warn that the city verges on insolvency.[30] Today, 91 percent of Los Angeles's general fund revenues are dedicated to employee salaries and benefits.[31] Atlanta, the *Journal-Constitution* reports, "has had to shovel tens of millions of dollars more into worker pensions, even as the city's revenues have declined and officials have laid off hundreds of workers. And residents have paid ever larger chunks of their property taxes to city worker retirement plans."[32] Over the past two years in Des Moines, Iowa, police and fire pension costs have increased by 20 percent at a time when its property-tax revenue has been shrinking. In response, the city has raised property taxes and cut services by closing the library one day a week, picking up trash collection in parks less often, and reducing street cleaning.[33]

In Chicago, Mayor Rahm Emanuel is moving to shut down 11 percent of the city's elementary schools, possibly the largest number of schools shuttered at one time, to close a $1 billion budget deficit—further straining his relationship with the city's teachers' union.[34] Why was this dramatic cutback necessary? Many factors are involved, but certainly relevant is a new state law, which mandates that, starting in 2015, the city must contribute more to its $17 billion pension liability. This will likely mean an increase of $550 million in its annual required contribution in the first year that the law takes effect (see chart below). On top of the increased pension cost, the city comptroller reports that the Windy City's subsidies for retiree health care are projected to increase from $109 million today to $500 million over the next decade—largely thanks to an increasing number of retirees and to rising health-care costs.[35] These budget woes formed the backdrop of the strike called in autumn 2012 by the Chicago Teachers Union. All told, these costs create a steep fiscal cliff for the city.

CONCLUSION: THE CONSEQUENCES FOR GOVERNING AND PUBLIC TRUST

A great deal is known about the behavior of policymakers when the budget pie is growing. Indeed, we have had much time to observe them, over the decades of sustained effort that it took to build activist government. However, less is known about what they will do when the pie is not getting any bigger—or when big slices of it have already been served. As UC Berkeley political scientist Paul Pierson has observed, we cannot expect the politics of retrenchment to mirror the politics of programmatic expansion.[36] It is obvious that sacrificing education, health, and relief for the poor in order to pay for the benefits of a small group of people (those who once

Chicago Pension Contribution (historical and projected)



Source: City of Chicago, Annual Financial Analysis, 2012 worked for government) is hardly a wise allocation of scarce resources. Yet, as we have observed, in many cases these programs are on autopilot, and the hands of politicians are tied. Ironically, the generosity of activist government has narrowed the scope of government decision making.

Historically, budgeting at all levels of American government received little attention from the press. It was a low-key horse-trading affair that occurred in the relative obscurity of legislative committees. Now, state and local budget battles are front-page news. Paradoxically, media attention has increased at the moment when policymakers' margin of maneuver has shrunk. This has changed the tenor of public debate about budgets. Where earlier political wrangling focused on policy and paid little notice to budget details, now all policy is discussed in terms of its impact on spending.

Referring to the national budget, political scientist Eric Patashnik of the University of Virginia has described this change as the "fiscalization of the policy debate," wherein "[programs are debated] not according to their particular merits but according to their impact on the government's overall fiscal condition."[37] This shift has significant consequences for the workings of politics. Details of policy can be negotiated by experts. But a fiscalized debate subsumes those details to an ideological war about the appropriate size and role of government. Budget battles become both more intense and less amenable to compromise, as partisan polarization prevails over pragmatism.

For politicians, managing the great "crowding out" is likely to be an exercise in what Georgetown University political scientist R. Kent Weaver has called "blame avoidance."[38] Instead of chasing credit for bringing home the bacon in government spending, elected officials will strive to make clear that they were not responsible for the bacon being taken away. (Perhaps this shift is responsible for the growth of business transacted in the U.S. Senate after midnight.) Under conditions of austerity budgeting, then, politicians are inclined to hide the causal chains linking their actions to unpopular outcomes. We expect to see an increase in the use of obscure parliamentary procedures and abstract rhetoric — especially when politicians are trying to raise income and sales taxes. We also think it likely that some states and cities will be tempted by fiscal gimmickry—New York governor Andrew Cuomo's accounting proposals to address his state's local pension problems are indicative. Furthermore, U.S. states and cities over the last 25 years have already racked up $60 billion in "pension obligation bonds"—essentially, high-interest loans that are used to add money to pension plans (and which, if markets falter, can leave a city stuck with large interest payments for money that it lost in the downturn).

Such tactics help policymakers cover their tracks—and make it more difficult for average citizens to assess what their government is doing. Raising taxes, for example, requires open legislative debate and sometimes approval at the ballot box; "pension obligation bonds," on the other hand, can be issued without discussion and, under federal law, do not require voter approval. While that may help officeholders keep their jobs in times of austerity, it is hardly a recipe for encouraging a vigorous and healthy public debate about the alternatives facing various levels of American government. Nor is it a means for winning citizens' trust as governments take difficult decisions.

The new politics of retirement benefits are also driven by significant political asymmetries in mobilization and attention to the issues. Powerful public-employee unions are engaged and vigilant about protecting state and local workers' salaries, pensions, and health-care benefits. But the consumers of public services—users of roads, schools, libraries, and parks—are not an "interest group" and so are largely disorganized. The costs to taxpayers of pension and health benefits are diffuse and often indirect. The benefits for public-sector employees, though, are concentrated and direct. Any significant effort to reduce crowding out in government budgets will no doubt be met with a mobilized and motivated opposition.

However, all is not lost. Some politicians have proved capable of defying the perverse incentives of crowding out, and they have found promising solutions to the problem. The most prominent example is Rhode Island state treasurer Gina Raimondo, who engineered a major reform of her state's failing pension system, which was only 48 percent funded in 2010 (far below the 75 percent funding that is considered the minimum threshold for a healthy fund). In 2011, Raimondo, who ran a hedge fund before winning her office, managed to persuade her state's legislature to pass a package of reforms that delay retirement, suspend cost-of-living increases in pensions, and offer retirement programs more like 401(k) plans than traditional public-sector pensions. Her plan has saved the state some $3 billion in pension costs. Interestingly, it was learning of the crowding-out effect—which was forcing cuts to Providence's library and bus service—that motivated Raimondo to leave the private sector and seek office.[39]

To raise public awareness, Raimondo launched a "Truth in Numbers" campaign, where, she would often say, "This is math, not politics." She was then able to broker a deal with Democrats in the legislature, who were allied with the state's public-employee unions. The Rhode Island Retirement Security Act (RIRSA) was enacted by the state legislature in autumn 2011, with bipartisan support in both chambers. Raimondo's example provides hope that it is possible to achieve significant reform by being frank with key stakeholders and the American public.

We can only hope that more reformers of this type—truth-tellers who recognize that the mathematics of crowding out cannot be evaded with gimmicks, new debt, or endless tax increases—will emerge in the coming political battles over state and local government budgets. Until crowding out is effectively addressed, Americans will increasingly live in a paradoxical world of government that spends more and more to do less and less. If we are to keep our schools, libraries, bridges, and parks—to say nothing of our national faith in democratic self-government—this paradox cannot continue.

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