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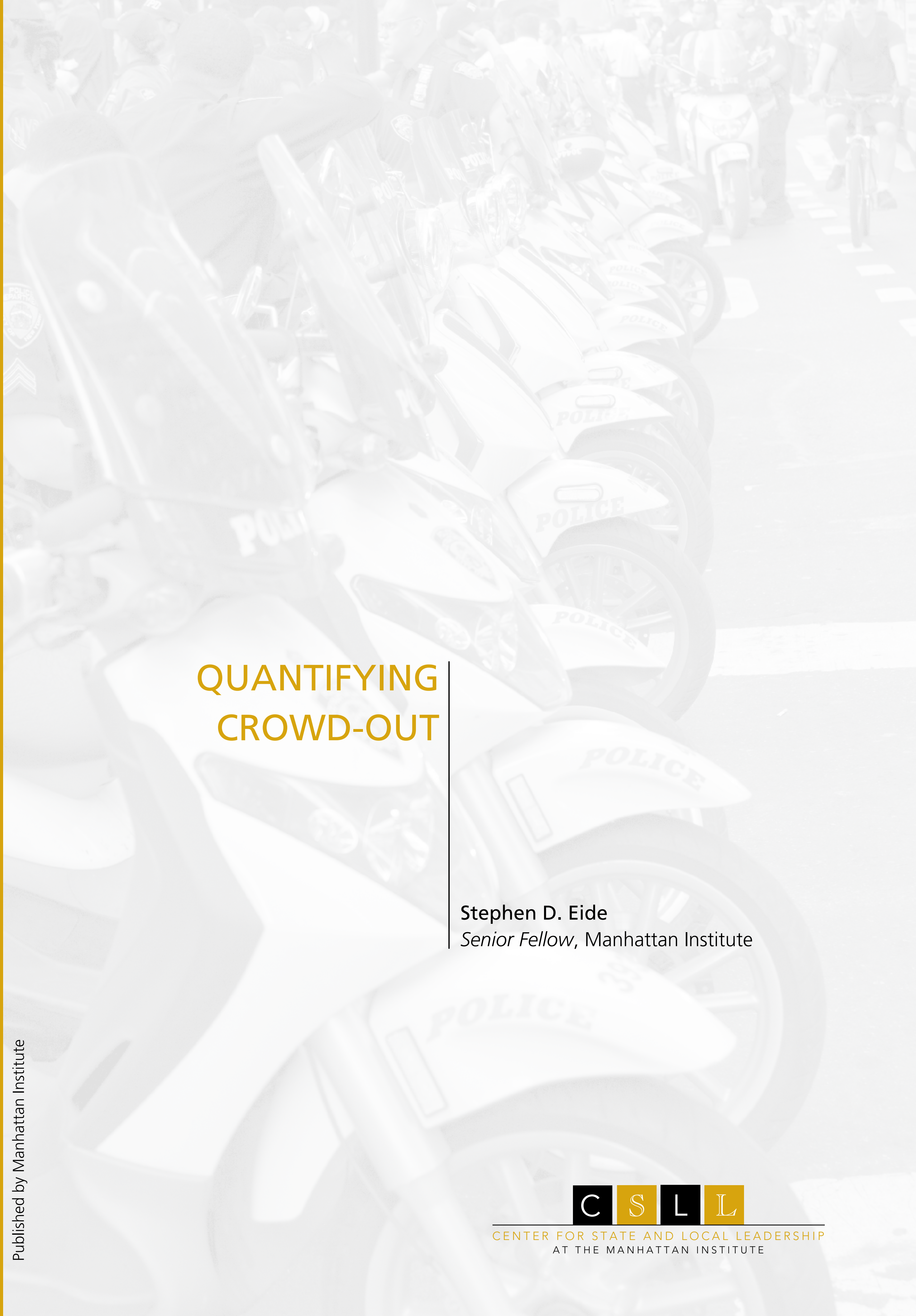

QUANTIFYING CROWD-OUT

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Executive Summary

"The current system is unsustainable. The impact of rising pension costs has meant that San Jose can't hire more firefighters, police officers, librarians, gang intervention workers. These out-of-control costs are why we can't keep all of our libraries, community centers and swimming pools open." San Jose mayor Chuck Reed, 2010

"The pension crisis is no longer around the corner. It has arrived at our schools." Chicago mayor Rahm Emanuel, remarking on Chicago's decision to lay off 2,100 teachers and school support staff this past summer

"I talked to social-services agencies or social workers who, when I started to talk about pensions, would ask, 'Why should I care about pensions?' And I said, 'Because if you don't, your whatever it is—homeless shelter, for example—is going to lose thousands of dollars of funding.' " Rhode Island treasurer Gina Raimondo, 2012

Much recent debate over the health of state and local budgets has been dominated by concerns about how spending on employee benefits is "crowding out" funds for basic services. The economy is growing, and spending is up—but taxpayers are seeing little benefit.

Crowd-out finds its roots in a problem of simple math. Cities can't run deficits, so when growth in revenues fails to keep pace with any major spending category, some other category or categories must be reduced. The effect is most clearly discerned in local workforces, which are still down by over 500,000 employees since the recession, as well as salaries. Local government workers' wages have been flat over the past decade, after adjusting for inflation, and salary spending has been taking up a smaller share of city budgets as benefits' share has grown. Almost unintentionally, increases in benefit costs are reducing funds available to provide for salary increases for a workforce which is shrinking overall.

This paper documents the crowd-out effect at a general level and analyzes budget trends in five major American cities.

Crowd-out is felt in cities in blue states (Los Angeles) and red states (Houston) alike. In Baltimore, unchecked benefits spending threatens the city's nascent renaissance. Some cities have resorted to adjustments that many would describe as gimmicks to respond to crowd-out, particularly the variety associated with pensions. But other, more authentic solutions are available. For instance, Boston's record on managing health-care crowd-out offers valuable lessons for other states and cities. Detroit illustrates the thin line between crowd-out and insolvency.

The best thing for cities to do to combat crowd-out is to keep government small. Benefit costs' growth *rates*—the root of the problem—are significantly determined by factors out of city officials' ability to control. But by employing fewer workers, governments will at least reduce the principal, if not the interest, of what they owe for benefits.

Governments should also concentrate more of their compensation costs in salaries instead of benefits. In addition to being more manageable than pension and health care, take-home pay likely matters more than benefits in cities' ability to attract and retain a qualified workforce, and thus serve taxpayers.

About the Author

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CONTENTS

QUANTIFYING CROWD-OUT

Stephen D. Eide

INTRODUCTION

The recession ended over four years ago, but local governments have gained back few of the nearly 600,000 jobs that they lost.

This record stands in contrast not only to the private sector, which has been steadily adding jobs since early 2010, but the experience of past recessions, during which the government workforce expanded.[1]

These divergent labor-market trends cannot simply be accounted for by the historical severity of the recent recession. Spending has been somewhat flat in recent years, but it remains up overall (see Chart 1, next page).

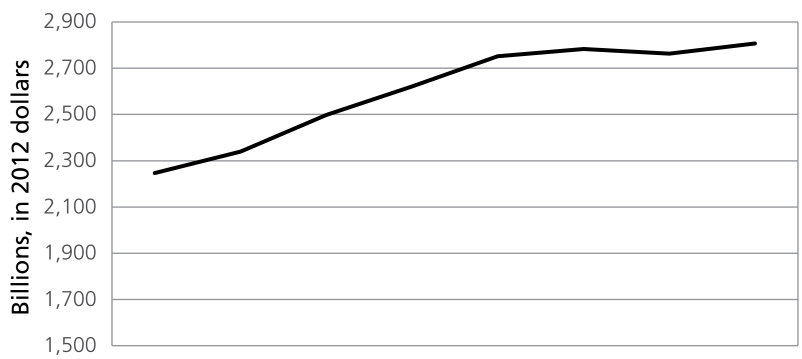
According to the most recent data from the Census Bureau, local governments in 2011 spent $150 billion more, on an inflation-adjusted basis, than they did in 2005, when the local workforce was the same size as at present (14.1 million). The most plausible reason why greater spending has not caused workforce numbers to increase, or at least to remain stable,

Table I: Recession-Era Job Recovery Trends, Private Sector and Local Government

	Pre-recession peak	Trough	% change, trough to present	Change, trough to present
Local government	Jul-08	Oct-12	0.4%	54,700
Private employers	Jan-08	Feb-10	7.0%	7,452,000

Source: Bureau of Labor Statistics (BLS)

Chart 1: State and Local Spending, 2005–2012



Source: Bureau of Economic Analysis (BEA)

Table 2: Historical Growth Rates Among Local Government Revenues, GDP, and Pension and Health Care Spending

	Annual Change		
	Median (1993—2011)	Median (2001—2011)	Median (2008—2011)
General local revenue	5.4%	4.4%	1.7%
Intergovernmental grants to local governments	5.1%	4.5%	1.9%
Own source local revenues	5.1%	4.4%	1.5%
Property taxes	5.3%	6.2%	3.6%
U.S. GDP	2.7%	1.8%	0.8%
Local government employer pension contributions	5.4%	8.2%	8.9%
Total health insurance costs (for nation as a whole)	7.0%	7.2%	5.0%

Source: Census Bureau, BEA, Centers for Medicare and Medicaid Services

is that spending on benefits has continued to rise more rapidly than revenues. Table 2 contrasts the median rates at which local governments' revenues have grown in recent decades and the rates at which their pension costs and national health-care spending have grown.

Public managers can easily manage rapid increases for trivially small line items. But benefits costs are major expenses. As Table 3 shows, spending on pensions and retiree health care (known as "OPEB," or "other post-employment benefits") now constitutes about 12 percent of a typical city's budget.

The data represent averages of 20 cities' benefits spending, as reported in their annual financial statements. (Spending on active employees' health care is not included because cities are not required to report it.) The 2012 figure is greater than that in 2008, and has likely increased over the last year.

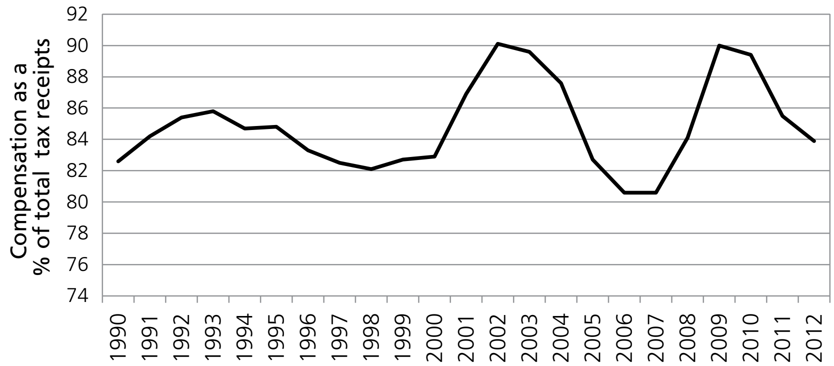
Table 3 understates the scope of the problem. The figures reflect only what governments have been spending, not what they should have been spending, according to their actuaries and principles of sound fiscal management. The Center for Retirement Research at Boston College's most recent survey of the 126 largest public pension systems' fiscal health

Table 3: Retirement Benefit (OPEB and Pension) Costs as % of Total Expenditures, 2008 and 2012

	2008	2012
Median among 20 major U.S. cities	9.1%	11.7%

Source: Cities' financial reports

Chart 2: Employee Compensation Relative to Overall State and Local Tax Receipts



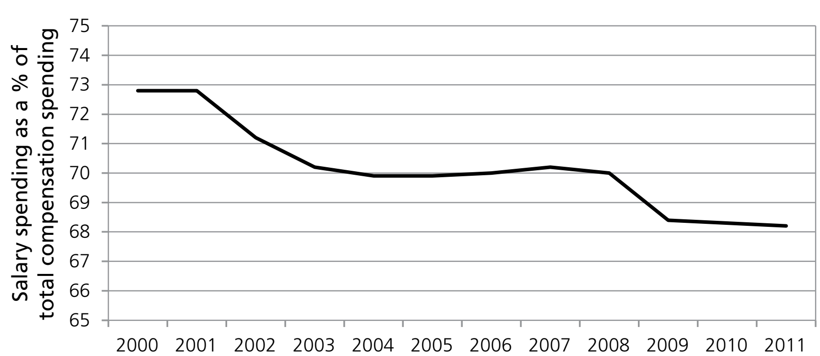
Source: BEA

found that, in 2012, sponsors made only 80 percent of their annual required contributions (ARC).[2] Moreover, many policy experts believe that even those governments that make their full ARC are, in effect, underfunding the systems because the contribution level is determined by overly optimistic assumptions about investment return.[3] The figures also do not reflect any pension obligation bonds cities may have issued. Through this practice, by which cities borrow funds from credit markets to bolster their pension systems, pension debt is transformed into bonded debt, and pension contributions become a matter of annual debt service.

Official figures on retiree health-care spending are even more misleading about the benefits' cost. Most cities fund only the current year's benefits. But the only responsible way to manage retirement benefits is through pre-funding them—that is, setting aside funds for future costs. Pre-funding allows investment returns to fund a significant portion of the benefit (perhaps 60 percent, in the case of pensions, according to the National Association of State Retirement Administrators) and ensures intergenerational equity, in that a given generation of taxpayers is responsible for funding only the services that it receives.

Benefits spending seems to be crowding out overall spending on salaries. Governments have not been devoting a greater share of their budgets to overall compensation (Chart 2).

Chart 3: Salary spending by state and local governments as a share of total compensation, 2000–2011



Source: BEA

Chart 4: Median Local Government Salary, 2002–2012

Source: BLS

Table 4: Change in Total Local Government Jobs v. Median Salary, 2003–2012

	2003–2008	2008–2012	2003–2012
Change in total local government jobs	5.5%	-3.6%	0.4%
Change in median local government salary	-1.3%	0.8%	-0.6%

Source: BLS

In 2012, relative to overall state and local revenues, aggregate compensation spending hovered around 83 percent, close to where it was in the early 1990s and 2000s. (The two peaks around 2002–03 and 2009 illustrate that personnel spending remains elevated even when revenues decline.) But less of governments' total compensation spending is going to salaries (Chart 3).

It is generally accepted among economists that the increased cost of employer-sponsored health benefits has exerted downward pressure on wages in recent years.[4] Reflecting this dynamic, local government wages have slightly declined in recent years, and have been flat over the last decade. After adjusting for inflation, the median local government salary is almost exactly what it was a decade ago (Chart 4).

Table 4 shows that local governments have been hiring (and firing) workers, and increasing (and, in nominal terms, decreasing) salaries, at different rates. While, over the long term, crowd out restrains both salary spending and workforce levels, in the more recent recession-era years, governments have been cutting jobs more than they have been cutting salaries. The introduction above has attempted to map out

Table 5: Five Cities

	Population (city)	Population change, 2000-2010	Moody's bond rating	Median annual metro GDP growth, 2001-2012	Metro unemployment	Change in city workforce, 2003-2012
Baltimore	620,961	-4.6%	Aa2	4.5%	7.5%	-3.0%
Boston	617,594	4.8%	Aaa	4.0%	6.6%	-11.6%
Detroit	713,777	-25.0%	B3	3.0%	9.6%	-40.8%
Houston	2,100,263	7.5%	Aa2	7.9%	6.5%	-0.1%
Los Angeles	3,792,621	2.6%	Aa2	3.9%	9.8%	-5.8%

Source: BEA, BLS, cities' financial reports

Table 6: Crowd-Out in Los Angeles, FY06-FY13			
	FY07	FY14	Total increase (adjusted for inflation), FY07-14
Pensions and retirement	$763,738,073	$1,084,948,687	25.9%
Health benefits	$293,889,368	$400,590,000	20.8%
Total spending	$6,673,214,507	$7,688,492,460	2.1%
Benefits as a share of total spending	15.8%	19.3%	
Source: Los Angeles mayor's office			

the general contours of the crowd-out problem. To gain a better understanding, it is necessary to turn to the local level, where data are more precise and the effects clearer.

FIVE CITIES

Los Angeles: One Mayor's Experience with Crowd-Out

In Los Angeles's FY07 budget, the first over which Mayor Antonio Villaraigosa had responsibility, health and retirement costs constituted 16 percent of all spending. In FY14, Villaraigosa's final budget, they will take up 19 percent. Adjusted for inflation, overall spending increased 2 percent, but both health and retirement spending increased by over ten times that amount.

Los Angeles has also seen the total amount of the budget devoted to salary spending decline over Villaraigosa's tenure, from 42 percent in FY07 to 38 percent in FY14.

Under pressure from a 400 percent increase in pension costs, New York City under Mayor Michael Bloomberg has been forced to reduce the New York Police Department by 2,300 officers.[5] Los Angeles has had a different experience, increasing its force by more than 700 officers since Villaraigosa took office. But that has simply meant that cuts have been all that much more severe within other employee cohorts. All told, Los Angeles has lost almost 5,000 employees since FY06. Public works has lost more than 1,000 employees, and the fire department has lost more than 300 uniformed personnel.

Houston: Crowd-Out in Boomtown

Since the bottom of the recession, the Houston metro area has added more than 300,000 jobs, more than twice as many jobs as it lost during the recession. Houston has outperformed every other major U.S. metro area on this front; only New York, which has three times Houston's population, has added more total jobs since the recession ended.[6] The strength of the city's export- and energy-based economy, along with its having avoided the worst of the real-estate and banking collapses, caused the last recession to be for Houston a normal recession, not the historical downturn from which most states and cities have yet to fully recover. Houston has already gained 61,000 in population in this decade.

Table 7: Houston Salaries, Pension and Health Benefits as a Share of Total General Fund Spending, 1991–2031 (projected)									
	1991	1996	2001	2006	2011	2016	2021	2026	2031
Salary	51.1%	53.4%	48.9%	41.5%	43.0%	37.3%	32.9%	29.4%	27.3%
Pension	5.3%	6.9%	6.1%	8.7%	10.3%	11.7%	12.4%	12.7%	12.6%
Health benefits (active and retired)	5.0%	5.0%	5.4%	8.2%	8.4%	9.2%	10.5%	12.1%	13.9%
Total personnel spending as share of General Fund	61.4%	65.3%	60.3%	58.4%	61.6%	58.2%	55.7%	54.2%	53.8%
Source: City of Houston's Long Range Financial Management Task Force									

But whether this growth will benefit city residents in terms of services depends on how well Houston manages its crowd-out problem. Benefits spending as a share of total budget has grown substantially since the early 1990s, and is set to grow even more over the coming decades.

In Houston, benefits spending is clearly crowding out salary spending. Houston now devotes almost exactly the same amount of its budget to personnel as it did in the early 1990s, but the share devoted to salaries has declined. Over the last five years, Houston's total General Fund workforce has declined by 2,100 employees.

In contrast to its enviable record on economic policy, Houston has failed to confront directly its growing pension-funding challenges. Finding itself unable to pay for benefits increases granted during the late 1990s stock-market boom, Houston has consistently underfunded its ARC and borrowed $600 million from credit markets to shore up its pension funds.[7]

Boston: The Promise of Health-Care Reform

Boston may be the fiscally strongest of America's old, former industrial cities—not only because of its respectable record of economic growth over the past few decades but owing to sound management on the part of the outgoing administration of Mayor Thomas Menino.

Boston has distinguished itself in the area of managing health-care costs. In addition to establishing a trust fund for OPEB, the city has negotiated premium-sharing arrangements comparable with private-sector norms and has shifted costs from premiums to out-of-pocket expenses (co-pays and deductibles).

In 2011, Massachusetts passed a law granting municipalities "plan design" authority—the ability to alter co-pays and deductibles outside of collective bargaining. (Cities must still bargain over premium cost-sharing.) Massachusetts's cities and towns realized $178 million in savings on health care in the law's first year of implementation.[8] The law has given municipal mangers significant leverage over unions and a way to at least reduce *total* health-insurance spending. Though technically enacted outside of the new collective bargaining framework, Boston's concessions were nonetheless "assisted by" the enhanced leverage newly made available to it.[9] As Table 8 shows, in more than one recent year, Boston's annual health-care spending has declined as a share of the total budget.

In future years, the city expects health-care costs to rise at a rate above revenues, as has been the historical trend. But the strain on the budget will be less pronounced because of lower overall spending levels.

Baltimore: The Inflection Point

In February, Baltimore published the results of a ten-year financial forecast, an ambitious effort at multiyear planning, rare among American cities, which generally don't project revenues and expenditures more than a year or two into the future.[10] The forecast projects a total $750 million deficit over the next decade, caused by an 0.8 percent gap between projected revenue growth (1.9 percent annually) and expenditures (2.7 percent). Within the latter figure, benefits costs loom large. According to PFM Group, the consultant commissioned by Mayor Stephanie Rawlings-Blake to perform the study, pensions will increase by a compound annual growth rate of 3.2 percent, and health benefits for active employees will increase by 4.6 percent per year.

Table 8: Pension and Health Care Spending in Boston as a Share of Recurring Revenues, FY07—FY14

	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Pensions	5.3%	5.1%	4.6%	4.8%	4.6%	5.2%	5.5%	6.0%
Health benefits	14.2%	14.5%	14.2%	15.3%	17.6%	18.1%	16.6%	15.8%
Total benefits	19.5%	19.6%	18.8%	20.1%	22.2%	23.3%	22.1%	21.8%

Source: City of Boston; "health benefits" figure includes health insurance for Boston Public Schools and contributions to city's OPEB Trust

Table 9: Salaries and Benefits as a Share of Projected Available Revenues, Baltimore, FY13-22				
	FY13	As a share of available FY13 revenues	FY22	As a share of available FY22 revenues
Salaries	$579.5	36.9%	$731.0	39.1%
Total active employee benefits	$126.8	8.1%	$184.7	9.9%
Total pension cost	$162.3	10.3%	$217.8	11.7%
Total retiree health-care	$103.30	6.6%	$121.90	6.5%
Available revenues	$1,571.1		$1,868.2	
Surplus/Deficit	$166.0		-$578.8	
Source: "City of Baltimore Ten-Year Financial Plan"				

Baltimore's struggles with employee benefits spending have been apparent for some time. Despite a decline in the total workforce, FY07 to FY12, personnel costs rose 20 percent while revenues rose only 3 percent. Health-care benefits for active employees grew 39 percent and pension costs grew 90 percent. As a share of total compensation spending, benefits increased from 34 percent of total personnel costs to 41 percent, thus restricting the city's ability to increase take-home pay.

As a consequence, many services have been scaled back in recent years: rotating company closures for the fire department; closure of recreation centers; less frequent trash pickup; reduced funding for arts programs, street lighting, and library hours; and, most problematic of all, curtailed capital investment.

PFM's projections look at the cost of "carrying forward" current levels of services under "reasonably expected [fiscal and economic] conditions." That means no cuts but also not addressing underfunding issues related to OPEB and capital investment. City departments estimate that $100 million more annually is needed "to prevent further erosion of current, sub-optimal asset conditions while beginning to make slow incremental progress toward improved conditions." In other words, "carry forward" would not meet all of Baltimore's fiscal needs. Should the economy weaken and should revenue growth slow or decline, and if Baltimore's pension funds fail to hit their target, then the gap between benefit costs and revenues will widen.

PFM describes Baltimore as a city facing an "inflection point." Baltimore has lost over a third of its population since 1950, and 110,000 jobs, a quarter of the total, since 1990. Elevated crime and poverty levels, 16,000 vacant and abandoned properties, and the highest taxes in Maryland are among the city's other obstacles to rebirth.

Baltimore hasn't gained population in any decade since the 1940s, but more recently, the decline seems to have slowed, counterbalanced perhaps by downtown redevelopment, growth in the education and health sectors, and competent fiscal management.[11]

It is possible to see in the Baltimore of 2013 shades of either the Detroit of 1980 (which, by that point, had seen three decades of decline, but the worst was yet to come), or the Boston of that same year, which reversed its decline and is now stronger than it has been since World War II.

Whither Baltimore? City government could play a pivotal role in a renaissance, but its ability to do so remains constrained by the high and rising cost of employee benefits.

Detroit: The Thin Line Between Crowd-Out and Insolvency

A month before filing for bankruptcy in July, Detroit's emergency manager, Kevyn Orr, laid out a comprehensive proposal to creditors, detailing what concessions were necessary to stabilize the city's finances. Orr's report claimed that, absent a radical debt restructuring, Detroit would be devoting two-thirds of its annual revenues on legacy costs in less than five years.

Table 10: Spending on Salaries and Benefits in Detroit, FY08–17 (Projected)

	FY08	As a share of available FY08 revenues	FY17	As a share of available FY17 revenues
Salaries	$509.9	36.5%	$352.5	33.8%
Health benefits-active	$49.9	3.6%	$61.0	5.9%
		Legacy Costs		
Pension obligation bonds	$29.8	2.1%	$67.6	6.5%
Pension-related "swaps" debt	$45.3	3.2%	$50.6	4.9%
Pension contributions	$76.3	5.5%	$285.9	27.5%
Retiree health	$129.3	9.3%	$172.0	16.5%
Other legacy	$133.8	9.6%	$96.1	9.2%
Total legacy costs	$414.5	29.7%	$672.2	64.5%
Revenues	$1,397.7		$1,041.4	
Projected deficit	$219.2		$1,348.0	

Source: "City of Detroit Proposal for Creditors, June 14, 2013"

Detroit is an extreme, set apart from other cities by its levels of crime, poverty, and population loss. But it's worth considering where Detroit would be if not for its pension and health-care problems. The hundreds of millions that the city has devoted to such legacy costs in recent years could have been of tremendous assistance in bolstering city services. If, instead of spending $150 million annually on retiree health care, Detroit devoted that sum to hiring more police at a rate of $45,000 each, it could more than double the number of uniformed officers in the Detroit Police Department.

Detroit city government is corrupt, dysfunctional, and deeply in need of reform, not just revenue; but it does need revenue. The city's fiscal and administrative crises have reinforced each other in numerous ways. Cuts to the police department have caused crime to rise. Deep staffing cuts in the city's finance department have exacerbated inefficiency; the tax delinquency rate in Detroit is above 50 percent, partly because, when they seem to be receiving so little back in the way of services, many taxpayers don't see the point of paying their taxes.[12]

Simply stated, if not for its pension and retiree health-care debt, Detroit would not be on the verge of bankruptcy. The vast majority of American cities will not face insolvency. But as Detroit makes clear, rigid benefits commitments restrict public officials' ability to respond to economic headwinds.

CONCLUSION AND RECOMMENDATIONS

New York City's resurgence after its near-bankruptcy experience in the 1970s demonstrates that it is possible for a city to grow its way out of any fiscal trouble, however severe. But the low-growth trends of recent years may be with us for some time. In April, a Government Accountability Office report predicted that property-tax revenues, on which local governments rely for almost half of all own-source revenues, will not return to their 2009 levels, as a share of GDP, until *2060*.[13] Reform on the spending side of local budgets is critical.

Public officials sometimes describe benefits costs as "fixed"[14] or "uncontrollable,"[15] but that's truer with respect to costs' rate of growth (determined significantly by the stock market and global medical inflation) than it is to total spending.

In attempting to manage crowd-out, governments are likely to meet with more success, especially in the near-term, by trying to reduce the principal instead of the interest, so to speak.

- **Keep city government small:** Local governments are now down 500,000 jobs since 2009. Before hiring back workers, cities should perform rigorous services assessments to determine where they genuinely need more staff. *Not* hiring back workers could prove the most practical remedy to fighting crowd-out. It certainly will be easier than trying to rein in health- and retirement-cost growths for employees after they have been hired back.

- **State governments should grant local officials more authority over personnel spending:** State mandates, especially over personnel spending issues, often restrict local officials from taking necessary actions to shore up budgets. Pensions are defined and rigidly protected by state law; and collective bargaining mandates in many states force cities to negotiate all aspects of compensation with unions. Boston's success in reining in health-care spending, with the assistance of state government, demonstrates the benefit of exempting at least some portions of compensation from collective bargaining.

- **Increase premium cost-sharing and move costs toward higher deductibles and co-pays:** Unsustainable health-care growth rates are by no means unique to municipal employers. But because cities offer more generous health-care packages than private industry does,[16] elevated growth rates have resulted in greater overall costs. One way many employers have succeeded in reining in growth in insurance premiums is to shift more costs to co-pays and deductibles.

- **Governments should adopt defined contribution retirement plans.** In a 401(k)-style retirement plan, an employer's annual contribution is "defined," or fixed, often at 6 percent of an employee's salary. The cost is expensed up front, and there is no unfunded liability. Crowd-out is impossible in a defined contribution plan, but it is inherent to defined benefits plans, through which employers promise specific benefits that they must fund, regardless of the condition of the economy. During and after a recession, revenues drop, but pension contributions must increase to compensate for stock-market losses—hence crowd-out.

- **Governments should consider using the Affordable Care Act to eliminate retiree health care.** The federally mandated state-based exchanges are the essential mechanism by which the Affordable Care Act, or Obamacare, intends to provide universal coverage to the previously uninsured. Detroit and Chicago have already announced plans to transfer their retirees to the exchanges, through which they may purchase subsidized care. In principle, governments that pursue this option will be increasing the burden on federal taxpayers, but it should be emphasized that the burden of funding OPEB now rests with state and local taxpayers. Moreover, the federal subsidies are means-tested: retired couples subsisting on more than $62,000 a year will not qualify for a subsidy. Though the exchanges were criticized by some as a "bailout" following the Detroit and Chicago announcements, it is likely that transferring the OPEB burden from state and local governments to the federal government will result in a net gain for the taxpayer.

- **Governments should shift more compensation to salaries.** In addition to being more attractive to many prospective employees than retirement benefits especially,[17] salaries are inherently more manageable than health and pension benefits, even in a unionized context. Salary spending is not nearly as "fixed" as benefits spending, and its growth rate is almost totally predictable.

Endnotes

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[15] Stephanie Miner, "Syracuse Mayor Stephanie Miner Says city's day of reckoning is here," Syracuse Post-Standard, April 10, 2011; "The City of New York Executive Budget Fiscal Year 2014; Message of the Mayor," New York City Office of Management and Budget, May 2, 2013, p. 4.

[16] Josh Barro, *Cadillac Coverage: The High Cost of Public Employee Health Benefits*, Manhattan Institute Civic Report No. 65, July 2011.

[17] For example, over 70 percent of American public school teachers leave the profession before reaching 20 years of service even though, with respect to how their retirement benefits are structured, it is plainly in their interest to stay in until at least 30 years. Marcus Winters and Josh McGee, *Better Pay, Fairer Pensions: Reforming Teacher Compensation*, Manhattan Institute Civic Report No. 79, 2013.

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