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Public and Private Sector Compensation: What is Affordable in This Recession and Beyond?—A conference summary

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On February 26, 2009, the Federal Reserve Bank of Chicago and The Civic Federation hosted a forum to examine the differences in wages and benefits between the public sector and private sector and to discuss best practices in work force sustainability.

Materials presented at the forum are available at www.civicfed.org/ev090226_pensionforum.html.

For many years, conventional wisdom has held that public sector wages were lower than private sector wages, so generous ancillary benefits were needed in order to attract and retain skilled workers in the public sector. More recently, data from the U.S. Bureau of Labor Statistics (BLS) have suggested to some observers that total compensation averages of the public sector now significantly exceed those of the private sector. Economic pressures and global labor trends have led many private sector firms to eliminate expensive benefits, such as defined benefit pension plans (in favor of defined contribution plans),[1] but most public sector agencies have not followed suit. Such changes have created a greater perceived gap between public sector and private sector employees in terms of both financial security and overall compensation.

The participants at this forum were invited to discuss these compensation differences and the assumptions behind them. The obvious question was the following: Who gets better pay and benefits—public sector or private sector workers? The participants illuminated various issues that make this question difficult to answer. While, at first blush, this might seem like an easy comparison to make, the aggregate wages and benefits data on both types of workers do not tell the whole story on compensation differences. There are also many factors to consider before one can draw any conclusions about how each sector can attract and retain the most effective work force.

Review of the data

Jay Mousa, regional commissioner, U.S. Bureau of Labor Statistics, Chicago Regional Office, along with Greg Philipaitis, assistant regional commissioner, described what kind of data the bureau collects and what that data tell us about differences in wages, health insurance, vacation time, and retirement benefits. Mousa noted that 16.4% of U.S. workers are employed in the public sector. More specifically, federal government employees make up 2.0% of the work force; state government employees, 3.7%; and local government employees (including teachers, police, and firefighters), 10.6%. This distribution has been fairly stable over recent years, with the largest additions to the public sector being teachers.

The BLS's September 2008 *Employer Costs for Employee Compensation* (ECEC) survey shows that average total compensation in the private sector is $27.07 per hour, while the average total compensation in the public sector (state and local governments only[2]) is $39.18 per hour. However, Philipaitis explained

that there are numerous caveats to be considered. Some of them are as follows.

- The employer surveys are voluntary, with 15% to 20% of private sector employers refusing to participate and only 4% to 5% of public sector employers refusing.
- More than 40% of public sector workers are represented by a union, while fewer than 10% of private sector workers are.[3]
- Average employee tenure is twice as long in the public sector.[4]
- The occupational mix of each sector is different: For instance, roughly two-thirds of public sector jobs are professional and administrative, while 51% of private sector jobs are; and retail sales and food service jobs, relatively low-paid and often part-time positions, represent 20% of private sector jobs, but only 2% of public sector jobs.[5]

Philipaitis also compared selected occupations that do exist in both sectors, such as nurses, accountants, lawyers, and civil engineers. He noted that the hourly wages for these highly skilled professions tended to be better in the private sector, but added that when the value of benefits is also considered, the result may favor the public sector. Among union members in both sectors, overall compensation levels are actually quite similar.

Keith A. Bender, associate professor of economics, University of Wisconsin–Milwaukee, expanded on the issue of wage distribution. In low-skill jobs, public sector wages exceed private sector wages, but in high-skill jobs, public sector wages significantly lag private sector wages (benefits are not included in this analysis). This is what some academics call the "double imbalance"—that is, assuming that the private sector represents efficient operation of the labor market, the public sector is overpaying low-skill workers while underpaying high-skill workers.

Bender then discussed the limitations of employer survey data and illustrated the importance of controlling for factors such as education, age, and occupation when comparing wages. Using a simple example with data from the U.S. Census Bureau's March 2008 *Current Population Survey*, he demonstrated that when one controls for none of these characteristics, public sector employees appear to receive an 18.6% wage premium over private sector employees. But when one controls for gender, race, education, union membership, age, occupation, and state of residence, public sector workers have a 4.5% wage discount as compared with private sector workers.

Private sector benefits have gone through significant restructuring over the past several decades, while public sector benefits have largely remained the same.

Jeffrey R. Brown, the William G. Karnes Professor of Finance, University of Illinois at Urbana–Champaign, focused on the cost of benefits. He noted that according to 2008 ECEC data, the employer cost per hour for benefits is $13.41 in the public sector (state and local governments only) and $7.93 in the private sector. This difference arises primarily from health and retirement benefits. Health and retirement programs are more widely available in the public sector, with a higher level of participation in them among its employees. In addition, the public sector provides more generous benefits and greater employer subsidies. For example, 60% of *part-time* state and local government employees receive pension benefits, and two-thirds of public pensions include automatic cost of living increases, which are now rare in the private sector.

Brown also noted that approximately 25% of state and local government employees across the nation do not participate in Social Security, and thus they rely heavily on their employer defined benefit plans in retirement. Although it is typically beneficial for these employees to pay into their public pension plans rather than Social Security, Brown noted that this exemption may not survive future Social Security reforms because of the high costs of public pension plans. He emphasized how valuable public employee pension benefits are, particularly when they are protected from impairment by a state's constitution (as in Illinois), because they transfer investment risk from the employee to the employer. The recent crisis in the financial markets has made the value of protected defined benefit plans all the more obvious to private sector workers with 401(k) retirement accounts, which are unprotected and have seen substantial losses.

Can the current structure of public sector wages and benefits be sustained?

Private sector benefits have gone through significant restructuring over the past several decades, while public sector benefits—usually including a defined benefit plan and some form of retiree health care—have largely remained the same. Given the deteriorating condition of state and local governments' finances, the forum's participants turned their attention to the sustainability of public sector wages and benefits.

Allen T. Steinberg, principal, Hewitt Associates, described the dramatic erosion of the private sector retirement system over the past ten to 20 years. In 1998, 68% of the Fortune 500 firms offered some form of an ongoing pension plan. By 2008, this percentage had fallen to 42%. The drop in retiree health care coverage was even more dramatic for retiree coverage before Medicare eligibility (age 65), having fallen from 88% in 1991 to 33% in 2008. Retiree coverage after Medicare eligibility also dropped from 80% to 27% over the same period.

Steinberg suggested several factors have led to this change in private sector behavior. Some of them are as follows:

- Move from "career" employment to shorter-term "transactional" employment;
- Accounting rule changes requiring increased transparency and accountability for the funded status of a pension plan;
- Asset volatility and equity exposure;

- Increasing life spans and medical cost inflation;
- Regulatory burdens and costs;
- Increasing use and acceptance of defined contribution plans; and
- Need to reduce costs in the face of industry competition.

In contrast, in the public sector roughly 80% of state and local government employees have a defined benefit plan and 75% receive some form of a retiree medical subsidy. While this is a stark difference, Steinberg cautioned against making direct comparisons between public sector and private sector benefits. Some of the drivers affecting private sector benefits are less present in public sector benefits. The key to any benefits program is to accurately and honestly assess the risk across the entire plan. In particular, important elements to examine are the costs of early retirement, the mortality/longevity risk, the extent of survivor coverage, and projections of inflation and asset volatility. Steinberg suggested that the relative stability of public sector benefits over the past few decades reflects key traits of public sector employees. These traits include greater longevity on the job as well as higher union participation, which tends to support these benefits through the collective bargaining process. However, because of substantial funding shortfalls, certain elements will need to be revisited if the benefits are to be sustained for future workers.

Chicago Transit Authority—A case study

In 2007, the Chicago Transit Authority's (CTA) pension fund had a funded ratio of 26%.[6] The fund was teetering on the verge of insolvency. James Franczek, partner, Franczek Radelet and Rose, which represented the CTA, and Jorge Ramirez, secretary-treasurer, Chicago Federation of Labor, described the negotiations that took place that prevented the collapse of the CTA pension fund. Franczek began by explaining that the CTA pension fund was responsible for both pension benefits and health care costs. Given these two liabilities (and chronic underfunding), the decline in the fund was particularly rapid over the past decade. The negotiations between the CTA and its labor union focused on both pension and health care benefits reforms.

With respect to pension reforms, the CTA agreed to boost its contribution from 6% to 12% of payroll, while employee contribution levels also doubled from 3% to 6%. Next, it was agreed to issue a pension obligation bond of $1.1 billion, which boosted the pension funds' funded ratio to 72%. The agreement also required that the funded ratio stay above 60% through 2039 and reach 90% by 2060. Finally, governance reforms and changes to pension benefits for new hires were added.

In regard to benefits reforms, an independent health care trust was established with $528.8 million from the bond sale proceeds. This removed health care costs from the pension fund, Franczek explained. Employees are required to contribute at least 3% of compensation (on a pretax basis) to the retiree health care trust. In addition, the reforms required retiree contributions for health care coverage, as well as an increase in the threshold for retiree eligibility (retirees must now be 55 or older, with ten years of service instead of just three years as before). Also, cost reimbursement for health care services for retirees was reduced from 100% to 90% in network and 70% out of network.

The agreement between the CTA and its union was dependent on the state legislature passing legislation identifying additional dedicated funding. In return for the pension and health care concessions, CTA union members were given a five-year collective bargaining agreement; it granted annual wage increases of 3% for the next three years and annual wage increases of 3.5% for the subsequent two years.

Ramirez explored possible reasons behind the rapid decline of the CTA pension fund. The first issue he identified was that the trustees of the pension fund had no voice in setting either the benefits or funding levels. This lack of authority among trustees, he argued, led to a pattern where monies intended for the pension fund were used for ongoing operating deficits; in other words, pension contributions were routinely skipped to meet other more immediate needs. Ramirez suggested that a key reform would give the trustees the authority to perform as true fiduciaries; with such powers, they could focus on protecting the assets of the fund for its participants. Also, he said, the solvency of the pension plan should be required. Finally, he stated that the ability to pass on unfunded mandates to the transit system should be prevented—e.g., the recent program allowing senior citizens to ride free on CTA buses and trains, which cost the system $30 million per year in revenues.

Views from state legislature and a public union

Robert S. Molaro, former state representative (D-21st District), Illinois House of Representatives, presented a perspective from the Illinois political trenches. Molaro noted that the fragmented structure of Illinois's pension system (many state and local governments' independent pension funds operate under differing governance rules) makes it difficult to come up with systematic reforms. Further, benefits expansion in Illinois (while frequently criticized) has for the most part been in line with other public sector systems across the United States. The problem has been a culture of borrowing

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against the pension funds for other state obligations; also, there's an unwillingness to make necessary contributions to the pension funds. A simple solution, Molaro suggested, would be to require contributions to match the actuarially required contribution (ARC) every year.[7] However, Illinois has failed to fund at the ARC and has compounded the problem by avoiding making contributions by adopting a multiyear funding structure that requires accelerated payments in the final years of the pension plans. This tends to push the problem into the future.

There have been some reforms, Molaro said. Legislation now requires that a funding source be identified for any future benefits enhancements. Molaro suggested that, in addition to requiring that annual contributions are made at the ARC, reforms could include moving the retirement age out for new hires and reviewing automatic increases in benefits levels. The biggest problem facing Illinois is that closing the pension fund gap will require new revenues. Molaro contended that procuring new revenues to close this gap would be quite challenging for legislators; e.g., raising taxes to pay for state employee pensions would be highly unpopular among their constituents.

Hank Scheff, director of research and employee benefits, AFSCME (American Federation of State, County, and Municipal Employees) Council 31 (in Illinois), stated that wages and benefits reflect contract negotiations and that Illinois's problems stem from underfunding pensions—and not the level of benefits provided. Scheff argued that defined benefit plans are not necessarily more costly than defined contribution plans. Scheff suggested that defined contribution plans are more costly to administer for employers than defined benefit plans. And he noted that studies suggest that individuals receive lower investment returns, on average, from defined contribution plans than from defined benefit plans. In addition, defined benefit plans do a better job at pooling mortality risk, which ensures that the fund has enough assets to cover participants regardless of how long they receive benefits. Scheff concluded that the only solution to Illinois's underfunded pension system is to identify new revenues.

Conclusion

Participants at the forum identified several factors and trends that help explain differences in wages and benefits between the public sector and private sector. It is an open question whether the current structure of public sector benefits is sustainable without either new revenues or reductions in benefits.

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[1] In defined benefit pension plans, retirees are typically provided a monthly annuity that is based on years of service, final average salary, and age at retirement. The employer and/or employee make annual contributions to an employer-owned retirement fund, and the employer bears the investment and mortality risks. In defined contribution plans, such as 401(k) and 403(b) plans, the employer and/or employee make annual contributions to an employee retirement account, but there is no guaranteed benefits level at retirement. The employee bears the investment and mortality risks.

[2] The ECEC survey excludes federal government employers.

[3] U.S. Census Bureau, 2008 *Current Population Survey*. When the data are controlled for union participation, average compensation levels in the public and private sectors are much more similar. Union workers are typically better compensated than nonunion workers. December 2008 ECEC data showed that in the private sector, average total compensation was $36.22 per hour for union workers compared with $26.31 per hour for nonunion workers.

[4] U.S. Census Bureau, 2008 *Current Population Survey*.

[5] U.S. Bureau of Labor Statistics, 2007 *Occupational Employment Statistics* survey and 2007 *National Compensation Survey*.

[6] A funded ratio is the ratio of net assets to actuarially determined liabilities.

[7] Funding at the ARC means that the government is meeting the normal (or service) cost and the amortized unfunded actuarial accrued liability (UAAL). The UAAL is the ratio of the excess of the actuarial accrued liability to the actuarial value of the assets.