

# Fiscal Focus

An Independent Voice for Good Government and Sound Tax Policy Since 1926

January-February 2009 Volume XXXV No. 1

83 YEARS 1926-2009



## In This Issue:

- *Special Report: Public Employee Compensation and the Deficit*
- *Budget Trends Commission Report*

## REMINDER:

Send in your 2009 MTA dues.  
*Thank you for your continued support!*

## Minnesota Taxpayers Association

Todd Rapp

*President*

Mark Haveman

*Executive Director*

Aaron Twait

*Research Director*

Linda Edstrom

*Executive Secretary*

Lori Milanowski

*Intern*

The Minnesota Taxpayers Association is a non-partisan, non-profit corporation founded in 1926 to advance economy and efficiency in government.

Unless otherwise noted, original material in MTA publications is not copyrighted and may be reproduced without obligation. Please credit the Minnesota Taxpayers Association.

Fiscal Focus is published bi-monthly for \$150 per year by the Minnesota Taxpayers Association, 85 East Seventh Place, Suite 250, St. Paul, Minnesota 55101. ISSN # 1042-847X. UPS #519130. Periodical paid at St. Paul, MN 55101.

Postmaster, send address changes to:

Fiscal Focus

c/o Minnesota Taxpayers Association  
85 East Seventh Place, Suite 250  
St. Paul, Minnesota 55101

Phone: (651) 224-7477 or  
(800) 322-8297

Fax: (651) 224-1209

E-mail: [question@mntax.org](mailto:question@mntax.org)

Web Site: [www.mntax.org](http://www.mntax.org)

## Special Report: Public Employee Compensation and the Deficit

The state of Minnesota faces a budget shortfall exceeding \$5 billion and deteriorating economic conditions rivaling anything in modern history. In this context, public employee compensation is almost certainly going to be on the table during state and local budget balancing efforts. When breaking down government budgets by spending categories instead of spending programs, the significance of employee compensation quickly becomes evident. Total employee compensation (primarily salary plus retirement and health care benefits) accounts for nearly 75% of state agency and school district expenses, and a significant amount of city and county spending. The U.S. Bureau of Economic Analysis calculates an inflation measure for government expenditures (the implicit price deflator for state and local government) based on actual reported government purchases. Total employee compensation has constituted 56% to 59% of this index between 2000 and 2007.

In this issue we examine the relationship between public employment issues and the

state budget. We also discuss three strategies which lawmakers and governments may be considering as the economic crisis continues to unfold.

### Salary Freezes – More Complicated Than It Seems

In his recent budget proposal, Governor Pawlenty called for pay freezes for all government employees for the coming biennium. This recommendation will most assuredly be a contentious issue during upcoming negotiations between state and local governments and their unions. The idea of a salary freeze sounds straightforward, but the nature of public sector compensation programs makes this more complicated than it may first seem.

At the core of negotiated agreements between most public employee unions and state and local governments are pay scales for various types of government positions plus an annual cost-of-living adjustment (COLA). Eliminating any COLA for FY 2010-

## From the Director:

**Our topic in this issue is a sensitive one** but very relevant to the budget crisis. Underlying the debate regarding support for education, infrastructure, public safety, and other public services is the fact that government is a very labor intensive business. The cost of providing government services has been and continues to be greatly influenced by the structure and design of public sector compensation plans.

Minnesota's national reputation for good government is well deserved, and we can speak from firsthand experience that the state is blessed with extraordinarily talented and dedicated public sector employees. There is no question they should be compensated well for their work. However, by all indications we are facing a fundamental reset in our nation's economy. In times like these, it may be important to recalibrate public sector compensation structures to reflect what is happening in the private sector and the budget and economic realities other taxpayers are facing.



Mark Haveman

This report is not an attack on public employees or their unions. Rather, it is a call to thoughtfully and carefully examine all options before us – especially when demand for many government programs is increasing and more job losses in both the private and public sectors seem likely. In these truly exceptional circumstances, no potential strategies should be dismissed out of hand.

— MH

2011 would be the most visible dimension of any public employment salary freeze. However, a “hard freeze” of public employment compensation would also require addressing contract provisions called “steps” and “lanes.”

Steps are negotiated salary increases provided to employees on the anniversary of his or her hiring date, and so are based on longevity – “each year you are employed in this job, you will get x% more pay.” The percentage increase will vary, and the number of years an increase is allowed is capped,<sup>1</sup> but the key point is that these increases are in addition to any negotiated COLA (See sidebar: The Compounding Math of COLA and Steps). Among state employment contracts, step increases typically have averaged in the 3% range and are relatively uniform within the same union contract (different union groups have historically negotiated different step increases). Teacher contracts reviewed by MTA typically demonstrated greater variation. For example, in the 2008-2009 school year, step increases for teachers in the St. Paul school district ranged from as low as 0.4% to as high as 9.6%.

**Table 1** provides an estimate of the cost savings which could be realized by a step freeze for state and local government employees covered by two of the three major state pension plans – the Minnesota State Retirement system and the Public Employees Retirement Association. In the analysis we assume 50% of all employees are eligible for step increases comprising 40% of the wage base (since those no longer eligible for steps are higher on the pay scale.)<sup>2</sup> The estimated \$350 million in savings includes avoided additional employer contributions for pensions and Social Security. A step freeze affecting all state and local units of government would be substantially higher since many public employees are not included in this analysis—most notably members of the statewide Teachers Retirement Association who are projected to earn roughly \$3.85 billion in salary during FY 2009.<sup>3</sup> A very rough estimate based on similar assumptions used in calculating Table 1 (likely conservative for schools) yields an additional savings in excess of \$100 million over the coming biennium.

Lanes are another mechanism for salary increases. They, too, are negotiated into union contracts and are in addition to both COLAs and steps. However, they are used differently in education than in the remainder of the

**Table 1**

**Estimated Savings From “Step Freeze” in Selected State and Local Government Employee Compensation Plans, FY 2010-11**

Plan	Salary Savings	FICA Savings	Pension Savings	Total Savings
MSRS - General	85,581,000	6,547,000	4,208,000	96,336,000
MSRS - Correctional	7,096,000	543,000	835,000	8,474,000
MSRS - State Patrol	2,294,000	33,000	358,000	2,685,000
PERA - General	178,182,000	13,631,000	12,103,000	203,916,000
PERA - Correctional	5,660,000	433,000	495,000	6,588,000
PERA - Police & Fire	26,865,000	390,000	3,788,000	31,043,000
<b>Total</b>	<b>305,678,000</b>	<b>21,577,000</b>	<b>21,787,000</b>	<b>349,042,000</b>

Notes:

- 1) 50% of workers are eligible for step increases; comprise 40% of wage base
- 2) Average step increases from FY 2001 –FY 2008 used in calculations (MSRS – Correctional and PERA – Correctional have 2.85% average step increase; all others, 2.97%
- 3) Salary savings equals FY 2010 and FY 2011 salary adjusted for step increases less FY 2009 salary
- 4) FICA Savings equals 7.65% times Salary Savings, except for State Patrol and Police & Fire, which do not participate in Social Security and so have 1.45% times Salary Savings
- 5) Pension Savings equals applicable employer contribution rates times applicable salary savings

public sector. For cities, counties, and the state, “lanes” refer to different job classes: a promotion will move an employee into a different lane with a higher salary. It is much easier for these entities to control spending increases related to lanes during times of budget stress, since all they need to do is essentially freeze promotions.

For K-12 education teachers, lanes consist of pay incentives for acquiring additional education credits beyond a bachelor’s degree. Typically, for each 15 additional credits a teacher earns, his or her salary is adjusted upward by a certain percent. For example, in St. Paul’s 2008-2009 teacher contract, a starting teacher with a bachelor’s degree who earns 15 additional college credits gets 1.6% more pay increase than a colleague with only the bachelor’s degree. Like step changes, the percentage of salary increase for the additional education can vary across the pay grid. In St. Paul, someone earning their master’s degree (from BA + 45) between their 6th and 7th year of teaching would see a 6.5% increase in salary due solely to the lane change, while someone earning the same degree between their 11th and 12th years would realize a salary increase of 12.9%. Because lane increases are negotiated on a district by district basis – and lane movement is employer, not employee, controlled – an estimate of savings from a “lane freeze” cannot be determined.

Freezing pay would be an unpopular and politically difficult option for balancing the state’s general fund budget. Moreover, it

will have to extend to local government to show any significant savings. It would have to take into account not just COLAs, common to nearly all jobs public and private, but also the “steps” common to government, and perhaps the “lanes” typical of K-12 education. The potential savings, however, are quite large.

**Pension Contribution Adjustments – A Page from the ‘80s Playbook**

Another compensation-based approach to addressing the budget crisis involves changes to the relative shares of pension contributions between employees and government employers. Such an approach was part of the budget solution during the early 1980’s recession.

Absent a major threat to the integrity of the pension funds and the state’s overall fiscal soundness, the Minnesota Supreme Court has ruled that collectively bargained pension benefits—especially for retirees already relying

<sup>1</sup> Step increases are typically capped between 10-20 years of service, depending on the government entity. Even after an employee has reached the maximum “step,” some employment contracts (common in MNSCU and school district agreements) provide an additional longevity stipend at notable employment milestones – for example, at 20 and 25 years of service.

<sup>2</sup> According to Minnesota Management and Budget, approximately 50% of state employees are eligible for step increases.

<sup>3</sup> Teachers Retirement Association Fund Actuarial Valuation Report as of July 1, 2008, Mercer, December 2008.

on those benefits – cannot be reduced.<sup>4</sup> But contributions to pension funds are explicitly excluded from collective bargaining – that is, they are set by statute. This allows the legislature to change these rules without voiding or changing collective bargaining agreements or other pre-existing employment contracts.

In November 1982 the state faced a \$312.5 million projected deficit for the 1981-1983 biennium. Needing to close the budget gap by June 30th, Governor Al Quie called the third special session of 1982 (and sixth of the biennium). Part of his budget balancing proposal was a temporary takeover by employees of 2.5% of the employer contribution to state pension plans – in essence, requiring employees to pay an additional 2.5% of their salaries into their pension funds. Ultimately a 2% contribution takeover by employees was enacted during the special session for 1983, but was challenged in court. The Minnesota Supreme Court upheld the constitutionality of the law, ruling that there was no express or implied contract that guaranteed fixed levels of employee contributions to the pension funds. The Court also ruled that the claim to a fixed level of employee contributions could not be upheld, because the trial court found that the legislature made no promise, and even if it had, the employees did not establish detrimental reliance on the promise.<sup>5</sup>

**Table 2** estimates the potential biennial savings from a two-year, 50% takeover of government pension contributions by employees. A smaller takeover, like that adopted in the early '80s, would obviously yield less savings. To address concerns of fairness, progressivity

might be built into the takeover structure (for example, lowest paid public employees could be held harmless while the amount of employer takeover would rise as salary rises).

The \$658 million cost reduction estimate is extremely conservative for several reasons. First, the analysis excludes several other major pension funds – which cover several hundred million dollars of payroll. Second, the savings estimates are derived from projected 2009 covered payroll contained in Mercer’s actuarial reports for each fund. Thus, the \$658 million savings estimate assumes a complete freeze (steps, lanes, and COLA) for all employees in these plans for two full years. Any actual increase in salary costs in the next biennium would increase the savings. Finally, the analysis assumes TRA will not need a contribution increase in the next biennium even though TRA representatives have testified before the Legislative Commission on Pensions and Retirement that the TRA board may ask for contribution increases in the near future.

<sup>4</sup> “The Minnesota Supreme Court has ruled that public employees have a protectable entitlement to their pension, but that this is subject to legislative modification in the public interest ...The Minnesota Supreme Court has recognized that there is a balance between the need for public employees to be secure in their retirement programs and, on the other hand, the public’s concern with the integrity of the pension fund and the state’s overall fiscal soundness.” House Research memo to Ways and Means Committee, February 13, 2004

<sup>5</sup> “Legal Issues Relating to Employer Modification of Public Pension Plans” House Research memo to Ways and Means Committee, February 13, 2004

One conceptual advantage of this approach is that substantial savings could be realized while holding state and local government program delivery essentially harmless. For local governments and schools, various state aids would need to be cut commensurate with reductions in employer pension contributions. It would not trigger layoffs, and employee pension funds would still receive the required funding support. In its most extreme version, reduction in take home pay would range from 5-7% for employees in these plans – obviously representing real sacrifice by public sector employees. However, some of this would be offset by tax savings since pension contributions are made with pre-tax dollars.

### Alternative Service Delivery and Privatization

Words like “consolidating,” “streamlining,” “avoiding duplication,” and “merging” became very popular among lawmakers in the wake of the November budget forecast. Squeezing out cost savings and efficiency improvements through intergovernmental contracts and cooperation is already common among many Minnesota local governments. Expanding these types of efforts will be a hot topic. Economies of scale, especially in areas of purchasing and procurement, may result in cost savings, but the biggest impact in an expansion of these initiatives would almost certainly revolve around eliminating duplicative job functions. Already some legislators have expressed concern that these consolidation efforts would only exacerbate the current job loss situation in the state.

**Table 2**

#### Potential FY2010-11 Savings From 2-Year, 50% Employee Takeover of Employer Pension Contributions, Selected State Plans

Year	Plan	Employee Cont. Rate	Alt. Employee Cont. Rate (50% employee takeover)	Reduction in Gross Pay	Government Savings
FY '10	MSRS - General	4.75%	7.125%	2.375%	\$56,497,000
	PERA - General	6.00%	9.4375%	3.4375%	\$170,251,000
	TRA	5.50%	8.25%	2.75%	\$99,424,000
FY '11	MSRS - General	5.00%	7.5%	2.5%	\$59,470,000
	PERA - General	6.00%	9.5%	3.5%	\$173,346,000
	TRA	5.50%	8.25%	2.75%	\$99,424,000
	<b>FY 10-11 Total</b>				<b>\$658,412,000</b>

**Notes:**

- 1) A small portion of TRA members (roughly 5.25%) are covered under the former Minneapolis Teacher’s Retirement Fund Basic Plan, and so are not coordinated with Social Security. We have eliminated them from the analysis by reducing the TRA covered salary by 6%.
- 2) With the removal of the Basic Plan members from the TRA analysis, we assume that schools contribute 5.5% of salary for the Coordinated Plan members who remain in the analysis, rather than the 5.69% blended contribution rate presented in TRA’s 2008 actuarial valuation.
- 3) The analysis does not include public employees covered under specialty plans (such as PERA Police & Fire) or smaller retirement plans.
- 4) Based on projected FY 09 salaries in the relevant 2008 actuarial valuations.

## The Compounding Math of COLAs and Steps

To illustrate the cumulative impact of COLAs and steps over a typical two year public employment contract period, we use the experience of former Department of Revenue employee and current MTA research director, Aaron Twait.\* The following is based on his former job classification and start date (November 15, 2006), projected onto the current 2007-2009 labor contract for the Minnesota Association of Professional Employees.

Date	Triggering Event	Salary Increase	Salary
06/30/2007	N/A		\$37,855
07/1/2007	New fiscal year	COLA increase of 3.25%	\$39,087
11/15/2007	Anniversary of hiring date	Step increase of 3.58%	\$40,486
07/1/2008	New Fiscal Year	COLA increase of 3.25%	\$41,802
11/15/2008	Anniversary of hiring date	Step increase of 3.40%	\$43,222

**Two year salary increase** **\$5,367 or 14.2%**

**Two year change in total employer expense** **\$6,208\*\***  
(w/ FICA and pension contribution)

The above example illustrates the power of compounding with respect to employee compensation in government budgets. Of course, education “lanes” introduce an additional compounding factor for K-12 education spending. Their influence is especially relevant to school district budgets since the wage impact is controlled by the teacher, not the district.

\*We would be remiss if we didn't note that had Aaron stayed at the Department, he would have been worth every penny.

\*\*Includes an increase in the MSRS contribution rate from 4.0% on June 30, 2007 to 4.5% on November 15, 2008.

If creating winners and losers among existing public employees contains political peril, privatization would most assuredly be even more controversial. Although privatization is generally perceived as transferring full responsibility for a service or activity from the public to the private sector, it can actually take on many forms, some of which retain a strong public sector role. The primary argument in favor of privatization rests in efficiency and cost savings. Government is often constrained by layers of authority, mandatory civil service regulation, and collective bargaining agreements. In contrast, private organizations have strong incentives to control costs while meeting customer expectations since they must make a profit. The primary arguments against privatization are based in various types of market failures such as a lack of competitive, qualified vendors or equity concerns. Many public services are provided as a social good regardless of ability to pay. Providing them through the private sector may raise concerns over access to and delivery of these goods or services. An ad-

ditional concern cited in various studies of privatization is the need for government to effectively manage contracts, provide oversight and control, and monitor performance; skills sets and capabilities which may need to be supplemented within government.<sup>6</sup>

The potential savings that exists within Minnesota state and local government from alternative service delivery and privatization efforts can only be evaluated on a case-by-case basis. However, since labor costs play such a predominant role in the delivery of public goods, a public and private sector wage comparison offers some potential insights.

**Table 3** presents 2007 data from the U.S. Bureau of Labor Statistics comparing full-time private and public sector wage rates for major job categories. The data covers the Minneapolis-Saint Paul-Saint Cloud Combined Statistical Area which comprises two

<sup>6</sup> General Accountability Office. “Privatization: Lessons Learned by State and Local Governments, March 1997

thirds of the state's population. The reported 28% average public sector premium across all job classes should be interpreted with some caution since comparing private and public sector educator salaries results in a bit of an “apples to oranges” comparison. Nevertheless, data suggests that government cost savings may be available, especially from outsourcing several ancillary services supporting general government operations.

Table 3 also provides some important perspective on long held conventional wisdom regarding public sector compensation. It has long been argued that defined benefit pension plans – increasingly rare in the private sector – and relatively more generous health care plans are required to offset private sector wage premiums and retain high quality government employees. These BLS survey results suggest this remains true for certain employment sectors, especially some professional disciplines. However, it is also evident why seeds of growing public unrest may exist. In many circumstances tax dollars are used to support both wage premiums and benefit programs unavailable for similar private sector jobs.

## What Will Labor Negotiations Bring?

In its January economic update, Minnesota Management and Budget describes a state economy in significant distress. Tax revenues are down 4.55% below forecast. By every indication, the February forecast is likely to cut projected revenues further and increase the state's budget deficit. Real output is expected to decline by 5.4 % in the current quarter, and the agency notes that “even with a stimulus package this recession will be longer than any since World War II.” Minnesota has shed nearly as many jobs in the last three months as the state lost during the entire 2001 recession. Private-sector workers are experiencing layoffs, pay freezes, furloughs, higher health-care premiums and cuts to 401(k) matches.

Against this backdrop state and local governments will be negotiating with their unions for the coming biennium. It will be interesting to witness the reception to the governor's “hard freeze” proposal. If a sense of shared sacrifice prevails in the form of a hard freeze, perhaps combined with some temporary increase in worker responsibility for their retirement plans, state and local governments and schools will be able to keep

**Table 3**

**Public Sector vs. Private Sector Wage Comparisons – Major Employment Categories, 2007  
Minneapolis-St. Paul – St. Cloud Combined Statistical Area**

	Mean		Median		Public Sector Wage Differential	
	State and Local	Private	State and Local	Private	Mean	Median
All Workers	31.26	24.44	26.65	19.71	<b>27.9%</b>	<b>35.2%</b>
Management	45.98	39.77	46.22	38.67	<b>15.6%</b>	<b>19.5%</b>
Business and finance operations	26.91	37.83	26.76	27.57	<b>-28.9%</b>	<b>-2.9%</b>
Computer and mathematical science	31.28	36.62	33.29	36.12	<b>-14.6%</b>	<b>-7.8%</b>
Architecture and engineering	28.17	32.78	25.20	29.46	<b>-14.1%</b>	<b>-14.5%</b>
Life, physical and social science	30.65	33.98	28.86	32.31	<b>-9.8%</b>	<b>-10.7%</b>
Community and social services	24.85	18.90	22.92	17.46	<b>31.5%</b>	<b>31.3%</b>
Education, training, and library	47.27	22.81	40.41	21.34	<b>107.2%</b>	<b>89.4%</b>
Healthcare practitioner and technical	32.92	28.69	33.76	27.60	<b>14.7%</b>	<b>22.3%</b>
Protective service	26.92	NA	27.88	NA	<b>NA</b>	<b>NA</b>
Building and grounds cleaning / maintenance	18.43	13.10	18.31	12.42	<b>40.7%</b>	<b>47.4%</b>
Office and administrative support	18.63	16.99	18.79	16.48	<b>9.7%</b>	<b>14.0%</b>
Installation, maintenance, and repair	24.72	22.63	23.48	22.48	<b>9.2%</b>	<b>4.4%</b>

Source: National Compensation Survey for Minneapolis-St. Paul-St. Cloud Combined Statistical Area, U.S. Bureau of Labor Statistics, July 2007, Tables 12 & 13.

more people employed and levels of services can be better preserved in a time when they are most needed. If cost of living and longevity increases are protected, greater public sector job loss, greater human service reductions, and more-crowded classrooms would appear to be an inevitable outcome. ■

## Budget Trends Study Commission Presents Report

The Budget Trends Study Commission issued its report to the Legislature on January 12th, and has spent considerable time since then presenting its findings to various committees. Commission co-chairs Kevin Goodno and Jay Kiedrowski appeared before a joint meeting of the House Taxes and Finance Committees on January 13th and before the Senate Tax

Committee on January 21st. Their key findings include:

- Minnesota is experiencing a demographic shift toward an older population, greater diversity, and fewer active workers vis-à-vis children and the aged
- Between 2008 and 2033, state expenditures are expected to grow at 5.4% per year and revenues are expected to grow at 3.9% per year, resulting in a structural budget problem
- State health care expenditures are expected to grow at an 8.5% rate annually between 2008 and 2033
- Shifting consumption patterns are reducing Minnesota’s sales tax base
- The general fund tax base has grown more volatile over the past decade, making long term budget instability more difficult to manage

Their recommendations have three central themes:

- Providing decision-makers and citizens with the necessary information to make informed budget and policy decisions
- Achieving a long-term balance of state revenues and expenditures
- Managing state budget volatility

The Commission’s report is available through the Minnesota Management and Budget website at:

<http://www.mmb.state.mn.us/budget-reports-trends/324-budget-trends-reports/3060-report> ■



85 East Seventh Place  
Suite 250  
St. Paul, MN 55101

Periodical  
Paid  
Postage  
St. Paul, MN