



The Free Enterprise Nation

The Hidden Costs of Government

POSITION PAPER

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SUMMARY

There are 88,000 institutions in the United States that make up the "public sector." Collectively, these institutions employ approximately 21,000,000 people. About one-half are employed in public education and the other one-half by various local and state entities and by our federal government. The cost of maintaining the pay and benefits of these "public servants" represents one of the largest claims on taxpayer dollars of all kinds in the United States.

While public sector workers do pay sales, property and income taxes, they are themselves paid with tax dollars. Private sector employers and workers actually generate the new tax dollars with which public sector workers are paid in the first place. Simply put, public sector employees are tax dollar "recyclers," while private sector businesses and their employees are tax dollar "creators."

In addition to the actual pay and benefits for public sector employees, many of these institutions, including the federal government and state governments, provide programs in the form of welfare payments or subsidies, medical care, or other entitlement programs such as Medicare and Social Security. In most cases, the tax dollars necessary to fund these entitlement programs consist of a redistribution of dollars, taken from a taxpayer and provided to someone else, who may or may not also be a taxpayer.

The confusing flow of tax dollars, taken by government and public education entities from private sector companies and their employees and put to a "better use" by the public sector, results in a mind-numbing array of budgets, debts, bond issues, and deficits that become completely incomprehensible when buried in an array of budget types, separate sets of books, and nearly indefensible and often intentionally misleading accounting and reporting practices.

Public sector entities are not held to the same standards of accounting and reporting that are required of businesses in the private sector. The result is that many, if not most, public-sector entities maintain several "sets of books" that make it impossible for taxpayers to determine exactly where their tax dollars are going or the long-term liabilities that exist in connection with these compensation, benefits, and entitlement programs.

Most public sector entities provide defined benefit pension plans for their employees, allowing them to retire from 10 to 25 years earlier than is provided under Social Security. Additionally, many of these public-sector entities provide free or highly subsidized health insurance plans to their employees during the term of their employment that continue after their "early" retirement at ages as young as 40. Recent studies have shown that the average public sector employee also receives compensation that is significantly higher than that received by workers in the private sector.

The compensation, benefits, and unfunded liabilities associated with these early retirement and entitlement programs is generally either not disclosed to taxpayers or is presented by using accounting practices and actuarial assumptions that would not be allowed in the private sector. Simply put, they are often either hidden or intentionally misleading, or both.

The result of the failure to fairly and fully disclose the true elements of the cost of government and public education has been to create a generally unseen, and definitely unsustainable, financial burden on the employers and employees in the private sector. Each year, as a bit more of the emerging iceberg of hidden costs becomes visible, there are budget shortfalls and the need for even more deficit spending and/or the creation of more debt.

The “surprise” emergence each year of ever-increasing and ongoing costs for pay, benefits and entitlement programs has created an inexorable and growing need for more and more tax dollars from those that create all of the new tax dollars in the first place ... the private sector. The result is high unemployment in the private sector as employers break under the burden of increasing taxation and fewer new small businesses are created or survive. A downward spiral has ensued, resulting in a greater demand for government to provide unemployment benefits and an even greater demand for taxes on the fewer and fewer remaining businesses and employees in the private sector. In fact, the private sector employs one million fewer people than it did a decade ago, resulting in the longest stretch with no net increase in employment since the Labor Department began tracking the numbers in 1939.

There can be only one solution: Taxpayers must be fully informed of the true cost of government, including the cost of compensation and retirement benefits of all public sector workers and of the current unfunded liabilities for benefits and entitlement programs already promised but not yet delivered. Only then will American citizens be able to make informed decisions as to their willingness to continue to support the current public sector infrastructure as it is or to vote to effect changes in current public policy. The Free Enterprise Nation has identified The Hidden Costs of Government as one of the top five economic threats to America in 2010.

FEDERAL VS. PRIVATE SECTOR PAY/BENEFITS DISPARITY

“That’s extraordinary ... the American taxpayer is paying for exorbitant benefits, compensation, and pay scale that are double their own average salaries. That is utterly mad. That’s the stuff of revolutions, I believe.” – Lou Dobbs, CNN

Lou Dobbs was reacting to the report by the Cato Institute’s Chris Edwards who had recently done a study of Bureau of Economic Analysis data which showed that, as of 2008, the average federal worker received \$119,982 in compensation and benefits as compared with the private sector average of \$59,909. Most striking was the “benefits”

component of compensation. The federal worker “won” with \$40,785 for benefits as compared with the private sector worker’s \$9,881.

The difference in the total compensation between public and private sector workers was \$60,073 per year in 2008. With a total of 1.9 million federal workers, the difference in annual compensation was a healthy \$114 BILLION a year, taken from the private sector businesses and their employees to pay federal workers. Was the difference due to government largesse, or to the private sector’s unwillingness to pay its workers fairly? In order for private sector employers to match the largesse of the federal government and pay their workers the same as federal workers, their payrolls would have to increase by an impossible \$7 trillion a year, or about one-half the GDP of the United States.

In spite of the devastating impact of near-record unemployment levels in the private sector, government actually grew in 2009. To “rub salt in the wound” the federal workers were rewarded on 1-1-09 with a 3.9% “cost of living raise” (an average of \$3,000 each); in March with an increase in paid time off for child care; and in October their benefits were further improved when they began being allowed to save unused sick days and be paid for them in their final year before retirement, thus getting a “two-fer:” being paid for unused days at a much higher rate of pay than when they were earned, as well as increasing their final earnings and therefore their pension benefits.

The economic impact of the current record-setting recession and high-unemployment has not affected federal workers. Nearly 20% of federal workers now have salaries of \$100,000 or more, and pay above \$100,000 is becoming commonplace. According to Dennis Cauchon in a *USA Today* article on December 11, 2009, “Defense Department civilian employees earning \$150,000 or more increased from 1,868 in December 2007 to 10,100 in June, 2009.”

NON-FEDERAL VS. PRIVATE SECTOR PAY/BENEFITS DISPARITY

Significant disparity in pay and benefits is not confined to federal-level employees vs private sector employees. According to 2008 Bureau of Economic Analysis data, many states also have average total compensation per job figures that are higher for government jobs than for private sector jobs. In most states, it is the value of the rich state benefits programs that leads to this disparity. For example, in Montana, the total compensation per job averaged \$53,568.27 for government jobs and \$39,362.95 for private sector jobs. These total compensation figures include wage/salary disbursements and supplements such as employer contributions for employee pensions and various insurances. When looking at wages/salaries only, private sector jobs averaged \$32,290.42, making the value of employer-provided benefits an average of \$7,072.53. For government jobs, wages/salaries averaged \$37,378.90, making the value of government-provided benefits an average of \$16,189.37, or 129% higher than that of the average private sector job. In Rhode Island, the value of government-provided

benefits averages to be 146% higher than that of average private sector jobs, and in West Virginia, the value of such benefits is a whopping 212% higher for government jobs than for private sector jobs¹.

HIDDEN LIABILITIES OF SOCIAL SECURITY AND MEDICARE

When it comes to Social Security and Medicare, our nation’s promises exceed its collections by more than \$106 trillion, according to a 2009 National Center for Policy Analysis (NCPA) brief. Using data from 2009 Social Security and Medicare Trustees Reports, the NCPA places the unfunded liability for Social Security at nearly \$18 trillion for 2009. In addition, the combined unfunded liability for Medicare is estimated at \$89.3 trillion. The following depicts the status of these programs’ unfunded liabilities for 2008 and 2009:²

	2008	2009
Social Security	\$15.8 trillion	\$17.5 trillion
Medicare Part A	\$34.7 trillion	\$36.7 trillion
Medicare Part B	\$34.0 trillion	\$37.0 trillion
Medicare Part D	\$17.2 trillion	\$15.6 trillion
Total	\$101.7 trillion	\$106.8 trillion

UNDERFUNDED PUBLIC SECTOR PENSION PLANS

As of the end of 2008, the stated debt of non-federal public sector institutions was an estimated \$2.2 trillion, representing the total of all outstanding non-federal bonds. In addition, “off the balance sheet” unfunded liabilities of non-federal pension plans were stated to be \$400 billion. Public sector pension plans have long used actuarial valuation methods that would not be allowed in the private sector, and are considered by most economists and actuaries to be imprudent, resulting in significant understatements of the actual liabilities that exist.

There are 2,433 non-federal pension plans that cover a variety of employee types, including teachers, police, firefighters, and general government employees. Approximately 86% of these employees have a defined benefits pension.³

What’s more, public sector pension plans are often abused. Many of these plans provide for pension benefits that are a fixed percentage of pay with built in escalations after retirement. The definition of “pay” is sometimes an average of the final 3 years pay, or

¹ Bureau of Economic Analysis. (2009, October). Regional economic accounts. Tables SA06N, SA07N and SA27N.

² Villarreal, P. (2009, June 11). Social Security and Medicare Projections: 2009, National Center for Policy Analysis.

³ Free Enterprise Nation, Biggs, Andrew G., “Truth in Accounting: Calculating the Market Value of Unfunded Obligations in State and Local Government Pensions.”

simply the final years pay. Many plans allow the lifetime accumulation of unused vacation and/or “sick days” to be paid in a lump sum at the final rate of pay prior to retirement. These lump sum payments are often included in “compensation” for the purpose of calculating lifetime retirement benefits. Many plans, particularly those covering law enforcement and firefighters also include overtime earned in the last year before retirement. This practice, known as “spiking,” can allow those covered under these plans to retire (well before the attainment of age 65) at pensions that exceed their salary in their last year of employment. Provisions sometimes allow the designation of children or grandchildren as “beneficiaries” who will continue to receive ever-escalating pension benefits after the retiree dies. Other abuses include the questionable designation of many retirees as “disabled” or “partially disabled,” entitling them to increased and/or tax-free pensions. In some plans, more than half of all retirees are designated as “disabled” in spite of the fact that hundreds of overtime hours were earned in the last year of employment and that many of these retirees return to active employment elsewhere, often with another public sector employer. (See “OH, MY!” category on The Free Enterprise Nation Web site at www.TheFreeEnterpriseNation.org). Unfortunately, the actuarial valuations performed in accordance with acceptable standards in the public sector, usually fail to incorporate these abuses into the calculations of “unfunded liabilities,” thus hiding the true cost of these plans from taxpayers.

While corporate pension funds are required by law to use low, risk-adjusted discount rates to calculate the market value of their liabilities, public pension plans are not. There is consensus among financial economists that the accounting methods used by public pension plans significantly underestimate the plans’ true level of underfunding. They believe that market-based techniques for valuing private sector investments should also be applied to public pensions.⁴

The most glaring weakness in public plan calculations is the use of interest rate assumptions that are more appropriate for use by riverboat gamblers than by taxpayer-funded and guaranteed entitlement programs. The Free Enterprise Nation asked Andrew Biggs of the American Enterprise Institute to estimate what the actual unfunded liabilities of these plans would be if appropriate interest rate assumptions were utilized. His report estimates that total public sector pension plan underfunding total is not the \$400 billion stated by these plans, but is actually more than \$3.5 trillion. (See The Free Enterprise Nation Web site at www.TheFreeEnterpriseNation.org for Biggs’ report, “Truth in Accounting: Calculating the Market Value of Unfunded Obligations in State and Local Government Pensions.”)

⁴ *Wall Street Journal*, Biggs, Andrew, July 6, 2009, “Public Pensions Cook the Books”, <http://online.wsj.com/article/SB124683573382697889.html>

The underfunding of public pension plans is not only due to their unique style of “cooking the books.” Politics also play a role. As Thomas Firey from the Cato Institute explains:

“New York Times reporter Mary Williams Walsh nicely summarizes the dynamic that creates this liability: ‘[Public pension plans] are governed by boards that often include municipal labor leaders, whose duty to represent their workers’ interests can easily conflict with their fiduciary duty to represent the plan itself. And even the most exemplary pension boards can be overruled, in many cases, by politicians whose priorities may be incompatible with sound financial management.’

In other words, politicians and labor leaders who need political help today make grand promises of future benefits to special interests. But the politicians don’t want to anger taxpayers with the cost of those benefits, so they underfund the promises — after all, the bill won’t come due for years or decades. Between then and now, I suppose we’ll hide under some coats and hope that somehow everything will work out.”⁵

Who is on the hook for this? If city, state and local pension benefit promises are to be kept, it will be up to taxpayers to come up with the money -- either through higher taxes or lower service levels”.

Unlike Social Security benefits, which are not guaranteed by law and which can be reduced, benefits in state and local pension plans are usually guaranteed by the state and local governments.

As Andrew Biggs points out:

“Given this legal protection, and the political clout of government employee unions, it seems highly unlikely that governments could successfully renege on accrued pension benefits. For that reason, taxpayers and other stakeholders of state and local budgets must be prepared to make significant sacrifices as these pension benefits come due.

However, while accrued benefits are virtually sacrosanct, governments do have the ability to alter the terms of which future benefits are earned. Employee contributions can be increased, and the benefit formula made less generous going forward. While government employees will understandably be upset, it is worth noting that state and local pension benefits are generally significantly more generous than pensions paid by Social Security and private sector defined

⁵ Cato Institute, Firey, Thomas, August 8, 2006, “What’s Another Taxpayer Liability?”, <http://www.cato-at-liberty.org/2006/08/08/whats-another-taxpayer-liability/>

benefit or defined contribution retirement programs. As the costs of an aging population come to bear, these costs should be shared proportionately between taxpayers and beneficiaries.”¹

The Free Enterprise Nation has developed a recommended standard of best practices that should be followed by all those who account and report on public sector pension plans. (See The Free Enterprise Nation Web site at www.TheFreeEnterpriseNation.org for FEN-recommended “Best Practices for Public Sector Pension Plan Accounting.”)

TAXPAYER DISCLOSURE ACT

Taxpayer Disclosure Acts are needed at federal, state, and local levels. The Free Enterprise Nation believes that the taxpayer is entitled to know the pay and benefits, and the costs of the benefits that are being provided, for all employees of taxpayer-supported entities. They should also be provided with an accurate portrayal of all of the long-term liabilities associated with these benefits. Every taxpayer supported entity at every level should be required to provide complete, fair, and accurate information to taxpayers using accounting, actuarial, reporting, and disclosure standards that are the same as are required in the private sector. Additionally, a combined “balance sheet” should be provided by every taxpayer-supported entity that fully and accurately discloses the total debt and long-term liabilities that exist. “Taxpayer Disclosure Acts” should be implemented at federal, state, and local levels.



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