Panel Discussion: The Future of State and Local Government Finance

Is the Sales Tax Becoming Obsolete?

Robert Tannenwald

Obsolescence” is an extreme condition. According to the online Merriam-Webster Dictionary, something becomes obsolete when it is “no longer in use or no longer useful.”1 By this definition, if the sales tax is becoming obsolete, it is on its way out. New taxes with much broader bases, at least in their theoretically pure form, are the wave of the future. Old taxes such as the sales tax, designed for a twentieth-century economy, will become “extinct” well before the twenty-first century ends.

Such a conclusion is way too premature. Granted, economic change has complicated the task of taxation at all levels of government. State and local policymakers have faced particular difficulty maintaining the revenue productivity of their traditional sources of taxation, including the sales tax. The sales tax is not well designed to capture rapidly growing classes of transactions, such as purchases of services and electronic commerce. However, as discussed further below, countervailing economic forces may be broadening the sales tax base, not narrowing it. Furthermore, policymakers can redesign the sales tax to overcome political, administrative, and legal obstacles to the

expansion of its base. Reviews of new state taxes, such as those recently embraced by Ohio, Texas, and Michigan and considered by California, have been mixed. (See, for example, Fox, Luna, and Murray, 2007; McLure, 2005; Pomp, 2009; Mikesell, 2009; and Hamilton, 2010). Since a clearly superior alternative to the sales tax has yet to emerge, it should not be relegated (nor, for that matter, should other traditional state and local taxes) to the fate of inexorable obsolescence.

My remarks focus solely on two trends noted above that allegedly are undermining the revenue productivity of the sales tax: the growing importance of (i) services and (ii) electronic commerce in the nation’s flows of economic activity. (For discussions of the potential obsolescence of other components of the traditional twentieth-century state and local tax system, see Tannenwald, 2004, and Brunori, 1998, 2001.)

HOW IMPORTANT IS THE SALES TAX IN THE CURRENT SYSTEM?

The sales tax accounted for 23 percent of the nation’s state and local taxes in state fiscal year (FY) 2007. The personal income tax accounted for the same percentage, while property tax receipts represented 30 percent of the total pie. The corporate income tax, considered the fourth principal component of the traditional system, accounted for only 5 percent (Figure 1). Since the property tax is largely a local tax, the sales tax is one of the two most important taxes in the states’ tax mix.

1 www.merriam-webster.com/dictionary/obsolete.

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HOW THE TWO TRENDS HAVE ERODED THE SALES TAX BASE

The Growing Importance of Services

Architects of the first state and local sales taxes considered services too difficult to tax. Small firms with little record-keeping capacity delivered the bulk of services. Professional service providers wielded (and still wield) a considerable amount of political clout, shielding them from taxation. Since purchases of goods accounted for the majority of sales, all in all, tax policymakers in most states concluded that extending the sales tax base to services was not worth the bother (Tannenwald, 2004).

However, over the past 50 years, the percentage of consumption accounted for by services has grown dramatically, from just over 41 percent in 1960 to 68 percent in 2009. Largely as a result, some have alleged that growth in taxable sales has failed to keep up with state and local fiscal needs.

Policymakers have been forced to raise statutory sales tax rates to maintain an adequate flow of sales tax revenues (Bruce and Fox, 2000). At some point, it has been argued, policymakers will hit the limit on statutory rates as they drive consumers to neighboring states or create other severe distortions in economic behavior. Other forms of taxation, such as gross receipts or value-added taxes, will be superior in generating revenue for state coffers.

The expanding importance of services in the consumption mix seems at odds with the growing array of electronic “gadgets” found in households across much of the income spectrum: flat-screen TVs, “smart” cell phones, iPods, laptops, printers, fax machines, and CD players, just to name a few. In fact, Americans spend a growing fraction of their income on services because their prices have risen much more rapidly than those of goods. We spend more of each dollar on services largely because goods have become so cheap. In inflation-adjusted terms, in 1970 the ratio of services to goods in consumption was about 2 to 1, roughly the same as it is today.

Will this trend continue—cheaper and cheaper goods relative to services? At some point, will those producing these progressively cheaper goods—workers in developing nations—begin to garner higher wages? Already, wages are rising in China (MacLeod, 2010). Chinese workers produce more of the goods consumed in the United States than those of any other foreign nation. Granted, technological change and economies of scale will probably keep tamping down costs, but these forces reduce the cost of delivering services, too.

Moreover, purchases of consumer goods and services account for only 60 percent of the nationwide state and local sales tax base. The other 40 percent consists of business-to-business (intermediate) transactions (Phillips et al., 2010). Shifts in the pattern of this latter group of transactions may have broadened the base, offsetting to some degree the impact of the shrinking share of goods in consumption.

2 U.S. Bureau of Economic Analysis, National Income and Product Accounts, Table 1.1.5 (www.bea.gov/national/nipaweb).

3 Author’s calculations from U.S. Bureau of Economic Analysis, National Income and Product Accounts, Table 2.3.6 (www.bea.gov/national/nipaweb).
A case in point is the shrinking share of total intermediate purchases made by manufacturers. From 1998 to 2008, their share of private sector intermediate transactions fell from 39 percent to 34 percent. In taxing intermediate purchases, state and local policymakers have generally favored manufacturers based on the theory that they are the most powerful engines of economic growth. Consequently, a large percentage of their inputs is tax exempt. As evidence of this “pro-manufacturing” bias, Figure 2 presents the ratio of sales taxes paid on intermediate purchases to the total value of those purchases in calendar year (CY) 2008 for manufacturing and the private sector as a whole. The ratio in manufacturing was only half of that in the whole private sector. Thus, because manufacturing’s share of intermediate sales has shrunk, the economy-wide “effective tax rate” on these sales has risen, contributing to the overall revenue productivity of the sales tax.

The rising effective tax rate on intermediate purchases has not made the sales tax a better tax. Taxing intermediate sales diminishes the tax’s transparency and neutrality (through pyramiding, among other ways). However, every real-world tax departs from the normative principles of taxation. The rising effective tax rate on business-to-business sales, however, enhances the long-run viability of the sales tax by enabling it to generate more revenue. In the future, it might allow policymakers to improve the tax by trading some reduction in the taxation of intermediate sales for extension of the tax base to services consumed by households.

Could this ever happen? Are the political and administrative obstacles to expanding the taxation of services more broadly so great that it is beyond the realm of possibility? Attempts to extend sales tax bases to services over the past 20 years, such as in Florida, Massachusetts, and Maine, have not been

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Panel Discussion

Figure 2
State and Local Taxes as a Percent of Intermediate Purchases (CY 2008, estimated U.S.)

SOURCE: Author’s calculations; U.S. Bureau of Economic Analysis; Phillips et al. (2010); and Phillips, Cline, and Neubig (2009).

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4 Author’s calculations and U.S. Bureau of Economic Analysis, Intermediate Inputs by Industry (May 25, 2010, release). Federal Reserve Banks, credit intermediation, and related activities were subtracted from total private sector intermediate inputs. Data can be found in the Industry Account Tables (www.bea.gov/industry/gpotables). Shrinkage since the 1970s or 1980s would have been much greater. Unfortunately, given the change in the industrial classification system from the Standard Industrial Classification (SIC) to the North American Industry Classification System (NAICS) system and other methodological changes, data before 1998 are not available.

5 For a discussion of several services that would be good candidates for inclusion in state sales tax bases, see Mazerov (2009).
especially successful (Francis, 1988, and Goodman, 2010). However, given the degree to which state and local governments have been compelled to cut badly needed programs (Williams et al., 2010) and the long-standing structural deficits of state and local governments (Lav, McNichol, and Zarahdtk, 2005), the taxation of some services could emerge as one of the more palatable among several unpopular deficit-closing alternatives (Goodman, 2010).

**The Proliferation of Electronic Commerce**

Over the past eight years, the nation’s volume of electronic commerce (e-commerce) has grown at an exponential rate. In 2001, retail e-commerce transactions totaled $34.4 billion dollars, 1.1 percent of all retail sales. By 2009, the volume of e-sales had jumped to $143.4 billion, 3.9 percent of the total. The volume of intermediate-purchase transactions is much higher. In 2006, an estimated 93 percent of all e-commerce consisted of business-to-business purchases (Bruce, Fox, and Luna, 2009).

The rapid proliferation of sales conducted over the Internet threatens to erode state and local sales tax bases because, given the nature of these sales, it is difficult for administrators to detect them and collect the taxes due. A vendor’s lack of a physical presence in the customer’s state lies at the root of this problem. The Supreme Court has ruled that, absent authorizing federal legislation, a state cannot compel vendors lacking a physical presence within its borders to collect sales taxes on its behalf. In legal terms, a vendor lacks “nexus” with a state if it has no physical presence within the state’s boundaries. As an illustration, if a resident of New York buys a computer through the Internet from a company based in California, the state of New York cannot compel that company to collect New York sales tax on the purchase. Without collection at the point of sale, however, the transaction effectively cannot be taxed (use tax laws notwithstanding). According to a study released in mid-2009, the nationwide loss in e-sales tax revenue attributable to failure to tax e-sales from vendors lacking nexus will range between $11.4 billion and $12.7 billion in FY 2012 (Bruce, Fox, and Luna, 2009). Given these estimates, if state and local general sales tax revenue grew at an annualized rate of 3 percent between CY 2009 and CY 2012, the resulting percentage loss in sales tax revenue attributable to nontaxable e-sales would fall between 2.5 percent and 2.8 percent.

Yet, the taxation of interstate e-sales would be much easier (assuming congressional authorization) if sales taxes were simpler and more uniform across state and local governments. Congress has been reluctant to authorize the sales taxation of interstate e-commerce at the point of sale in part because state and local tax regimes were so numerous, varied, and complicated. Under such conditions, requiring a multistate seller to sort out the taxes owed by every one of its customers in every state would be an overwhelming task. In recognition of this problem, in 1999 the National Governors Association and the National Association of State Legislatures agreed to design a simple model sales tax and urge state and local governments to conform to it and to ratify the Streamlined Sales and Use Tax Agreement (SSUTA). The process of formulating the uniform tax and implementing the Agreement is overseen by the Streamlined Sales Tax Governing Board, Inc. To date, 23 states conform to the Agreement. Legislation calling for conformity has been introduced in 10 others.

The development of a variety of sophisticated tax software packages has made the tax collection problem even more manageable. If the nation’s subnational governments all complied with the

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6 Author’s calculations from U.S. Census Bureau (www.census.gov/retail/mrts/www/data/html/10Q1.html), Table 3.
8 In the four quarters comprising state FY 2009 (average of 2008:Q3–2009:Q2), nationwide collections from state and local sales tax revenues equaled $433.4 billion (National Income and Product Accounts, Table 3.3; us.bea.gov/national/nipanet). At an annualized growth rate of 3 percent, state and local sales tax revenues would equal $460.0 by state FY 2012: $11.4/$460.0 = 0.025; $12.7/$460.0 = 0.028.
9 See the website of the Streamlined Sales Tax Governing Board, Inc. (www.streamlinedsaletax.org).
10 Mainstreet Fairness Act. H.R. 5660. 111th Congress, 2D.
SSUTA, this software would give every vendor the capability of determining the state sales taxes due on the sale of any good or service regardless of the customer’s location.11

In short, given evolving conditions, Congress should give state and local governments the necessary authority to tax electronic purchases at the point of sale. If it did so, both the revenue productivity and fairness of the sales tax would be enhanced.

CONCLUSION

During the past few years, a few states, such as Ohio, Michigan, and Texas, have adopted a gross receipts tax or something similar. Some consider such a tax or a value-added tax as an important new component of future state and local taxation, possibly as a partial or full replacement of the corporate income tax, sales tax, or property tax. Yet, as pointed out above, none of these taxes has garnered rave reviews from either tax experts or tax policymakers. As Mikesell (2009) notes, many states imposed gross receipts taxes between the early 1900s and mid-1960s. Most states repealed them, dissatisfied with the distortions and complexities that they spawned. Furthermore, Cline and Neubig (2010) argue that in considering the introduction of a radically new tax, the burden of proof lies with the proponents of change. In my book, attempts to reform sales taxes—extending their base to consumer services and electronic commerce—are better options than replacing them with radically new tax regimes that look better on paper than in practice.

The general sales tax, although battered, is not becoming obsolete. It will be an integral part of state and local tax systems for a long time to come.

REFERENCES


Panel Discussion


State and Local Fiscal Reforms

Chris Edwards

This paper discusses four reforms for state and local governments to consider: abolishing corporate income taxes, privatizing government activities, trimming public sector compensation, and reforming public sector labor laws. These may seem like disparate policy ideas, but the common theme is that governments need to be smaller, more efficient, and more flexible if America is to prosper in an age of intense global competition.

With large budget deficits and huge pension-funding gaps, many state and local governments face major financial challenges. But private businesses and individuals also face financial challenges, especially in a sluggish economy. As such, policymakers should try to reduce the burdens of taxes, spending, and regulations on the private sector. I have identified four areas for improvement, which are discussed in the following sections.

REPEALING STATE CORPORATE INCOME TAXES

Fiscal policy is not concerned just with governments raising enough revenue to match the spending desires of policymakers. That is the case because merely raising revenue creates distortions that damage the private sector economy. Governments should try to both minimize their funding needs and raise revenues with the least-damaging tax structures. Corporate income taxes are probably the most economically damaging state taxes, at least relative to how much revenue is raised. Policymakers should consider repealing these taxes to improve the efficiency of state fiscal systems.

All states except Nevada, South Dakota, and Wyoming impose corporate income taxes or similar levies such as gross receipts taxes (Padgitt, 2009). State corporate income taxes raised just 2.6 percent of total state revenues and 4.0 percent of state tax revenues, on average, over the past decade (U.S. Bureau of Economic Analysis [BEA], 2010). Thus, states receive little revenue from the corporate income tax, but the tax substantially distorts business decisionmaking and imposes large compliance costs on firms. One study found that business compliance costs for the state corporate tax were about twice as high as for the federal corporate tax relative to tax collected (Slemrod and Blumenthal, 1993). Tax Notes editor David Brunori (2002) notes that state corporate income taxes “consume an inordinate amount of intellectual firepower and economic resources in terms of planning, compliance, and administration.”

1 See Table 3.3. Data are shown as the average for 2000 to 2009.
The corporate income tax problem is compounded by the fact that many corporations carry out production, distribution, and other activities in numerous states, all of which want to grab their share of corporate earnings. A three-factor formula of property, payroll, and sales is generally used to “apportion” a firm’s profits among state governments, but varied and inconsistent formulas are used and the definitions of the factors are subject to disputes. The complexity of state corporate taxation is magnified because of uncertainty in the rules for “nexus,” or the standards for how much presence a company must have in a state before it is required to pay taxes.

 Businesses must track different income tax rules for every state in which they operate. They must also separate “business income” from “non-business income.” Business income is apportioned among the states, whereas nonbusiness income (such as interest) is assigned to the corporation’s state of commercial domicile. This distinction is complex and subject to legal disputes. Some states allow separate reporting for each company in a corporate group, whereas others require combined reporting for the whole corporate group. States also differ on taxation of firms’ foreign affiliates.

To make it all worse, state policymakers carve out preferences and loopholes in the corporate tax base so it resembles Swiss cheese (Fisher, 2002). Incentive packages for favored companies and fancy credits for job training and other activities have proliferated. Such narrow breaks are unfair to businesses that pay the full tax load, and they expose government officials to corruption as firms lobby for special deals. Even if state corporate taxes were a good idea in theory—and they are not—state politicians have shown that they are incapable of enacting simple corporate taxes in practice.

The other factor to consider is the revolution in corporate taxation around the world during the past three decades (Edwards and Mitchell, 2008). Following Britain’s lead in the mid-1980s, all major economies have cut their corporate tax rates. Just since the mid-1990s, the average top corporate tax rate in the 30-nation Organisation for Economic Co-operation and Development has fallen from 38 percent to 26 percent. During the same period, the average rate in the European Union plunged from 38 percent to 23 percent (KPMG, 2009). The figures in these reports include both national and subnational taxes.

In the United States, the federal corporate tax rate of 35 percent has not been cut in more than two decades. At the state level, the average top rate in the 43 states that currently have corporate income taxes has actually increased slightly since 1980, from 7.0 percent to 7.5 percent today. As a result, America is in a very uncompetitive position with the second-highest corporate tax rate among industrial countries: 40 percent (including the federal rate and the average state rate). The U.S. rate is 17 percentage points higher than the average rate in the European Union.

As we try to revive the national economy—and as states such as Michigan try to revive their state economies—repealing state corporate income taxes and related levies would be an excellent way to encourage long-term investment and job creation. As corporate profits become more mobile in the global economy, state corporate taxes will become even more difficult to enforce. As Brunori (2002) notes: “The only people who really make money from the state corporate income tax system are the major law firms and big accounting firms.”

States should repeal corporate income taxes and offset any revenue losses by repealing business subsidies and other unwarranted giveaways on the spending side of their budgets. Actually, the corporate tax base has become so responsive in the global economy that governments may not lose any revenue in the long run from corporate income tax repeal because repealing the tax would cause an inflow of investment, which would generate higher state revenue from other types of taxes (Edwards, 2007). Either way, states should throw in the towel on the corporate income tax.

**PRIVATEZATION OF GOVERNMENT ACTIVITIES**

In recent decades, governments on every continent have sold major state-owned assets to private
investors. Airports, railroads, energy utilities, highways, and other assets have been privatized. The privatization revolution has overthrown the belief widely held in the twentieth century that governments should own the most important industries in the economy. Privatization can often reduce costs, improve service quality, and increase innovation in formerly moribund government industries.

Privatization of state government assets makes sense for many reasons. First, asset sales can help cut state debt levels. Second, privatization can reduce the responsibilities of governments so that policymakers can better focus on their core activities. Third, there is vast foreign privatization experience on which to draw in pursuing U.S. reforms. Fourth, privatization would spur economic growth by opening new markets to entrepreneurs and promoting innovation to industries.

Transportation infrastructure is one of the most promising areas for privatization reforms. Before the twentieth century, transportation infrastructure was usually financed and built by the private sector. More than 2,000 companies built private toll roads in America in the eighteenth and early nineteenth centuries (Klein, 1994). Most of these roads were put out of business by the spread of the railroads, which were also mainly privately financed. Then entrepreneurs financed and built networks of electric streetcars in America beginning in the 1880s, with systems installed in more than 850 American cities (O’Toole, 2009, p. 136). Until the early 1960s, urban mass transit in the United States was mainly provided by private bus companies (O’Toole, 2009, p. 138).

Almost any service supported by customer fees and advertising can be privatized. A big advantage of privatized infrastructure is that private companies can freely tap debt and equity markets for capital expansion to meet rising demand. By contrast, government infrastructure is subject to the politics and uncertainties of government budgeting processes. As a consequence, government infrastructure projects are often old, congested, and poorly maintained.

Today, several states are moving ahead with privately financed and operated highways. The Dulles Greenway in northern Virginia is a 14-mile private toll highway opened in 1995, which was financed by private bond and equity issues. In the same region, Fluor-Transurban is building and mainly funding high-occupancy toll lanes on a 14-mile stretch of the Capital Beltway. Drivers will pay to use the lanes with electronic tolling, which will recoup the company’s roughly $1 billion investment.

How about airports? Nearly all major U.S. airports are owned by state and local governments. By contrast, airports have been fully or partly privatized in many foreign cities, including Athens, Auckland, Brussels, Copenhagen, Frankfurt, London, Melbourne, Naples, Rome, Sydney, and Vienna. Britain led the way with the 1987 privatization of British Airports Authority, which owns Heathrow and other airports. A recent survey identified 100 companies around the world that own and operate airports, finance airport privatization, or participate in projects to finance and operate new airport terminals (Bentley, 2008).

In the United States, there is some growing interest in airport privatization, or at least in leasing airport operations to private contractors. Chicago has been close to finalizing a deal on privatizing Midway airport, for example, but the financial crisis has postponed that plan for now (Merrion, 2010). In 2009, a $140 million privately financed, built, and operated airport opened near Branson, Missouri, for commercial flights by AirTran and other carriers.

Seaports, which in the United States are virtually all owned by state and local governments, represent another potential area of privatization. Many U.S. ports do not operate at top efficiency levels because of inflexible union work rules and other factors. A U.S. Maritime Administration report in 2005 found that “American ports lag well behind other international transportation gateways such as Singapore and Rotterdam in terms of productivity” (U.S. Department of Transportation, 2005, p. 28). Numerous countries around the world have privatized their seaports. One Hong Kong company, Hutchison Whampoa, owns 30 ports in 19 countries. In Britain, 19 ports were privatized in 1983 to form Associated British Ports; today about two-thirds of British cargo goes through private ports.3

3 See www.abports.co.uk.
What is America waiting for? Privatization would allow state governments to raise funds from asset sales to reduce their debt loads. Private firms could more easily gather financing for new capital investments than governments, which are always complaining that they are cash strapped. And because of the vital role played by highways, airports, and seaports in the economy and international trade, privatization should be a high-priority reform area for states to foster greater economic growth.

REFORMING PUBLIC SECTOR COMPENSATION

With large budget gaps in many states, substantial savings could be gained by cutting the generous compensation packages of the nation’s 20 million state and local workers. In 2009, wages and benefits of non-federal government workers totaled $1.1 trillion, which accounted for half of total state and local government spending (BEA, 2009b). Are state and local workers overpaid? A comparison of the average compensation per hour worked in state and local governments with that for U.S. private sector jobs can help answer this question. According to the Bureau of Labor Statistics (BLS), public sector compensation averaged $39.66 per hour in 2009, which was 45 percent higher than the private sector average (BLS, 2009a). Looking just at wages, the public sector advantage was 34 percent. However, a recent job-for-job comparison of private sector and state and local workers by USA Today showed that wages were similar, on average (Cauchon, 2010).

It is the benefits side of state and local government compensation that is out of line. Health and pension benefits are excessive. The BLS data show that public sector benefits per hour are 70 percent higher than in the private sector. In addition, public sector workers receive one high-value non-monetary benefit: very high job security. “Layoffs and discharges” in the public sector occur at just one-third the rate of the private sector in good times and bad (BLS, 2009b).

Public sector pension benefits are receiving a great deal of media scrutiny—and for good reasons. As baby boomers in public sector workforces retire, the large and underfunded (or overpromised) benefits in government pensions are starting to have a big impact on state and local budgets. Also, media articles have revealed many pension abuses in states across the nation. In 2009, employer-provided pension plans were available to 99 percent of full-time state and local workers but just 74 percent of full-time private workers (BLS, 2010b, Table 1). Public sector pension plans are generally much more generous than private plans. One study found that the median public sector defined-benefit plan paid benefits more than twice as high as the median private plan (Pew Center on the States, 2007, p. 11).

State and local pension plans have a funding gap of about $1 trillion, according to official estimates. But those estimates underestimate the poor shape of pension plans because they rely on optimistic assumptions to value future liabilities. A recent study by Robert Novy-Marx and Joshua Rauh (2009) found that governments are “severely underestimating” their pension liabilities by the use of high discount rates. Using more realistic assumptions, the authors found that state and local pensions were underfunded by $3.2 trillion. At more than $27,000 for every U.S. household, that figure indicates a huge exposure for state and local taxpayers.

Factors driving up costs in public sector defined-benefit plans include the following:

- Early retirement. Public sector workers generally retire earlier than private sector workers and enjoy generous pension benefits for life indexed for inflation. They can typically retire at age 55 after 30 years of work, as in California’s Public Employees’ Retirement System (CalPERS) system (Dohm, 2000, p. 21). In CalPERS, workers receive an annual

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4 See Tables 3.3 and 6.2D.

5 These data include full-time and part-time workers (see Tables 3 and 5).

6 See PensionWatch (www.pensionsunami.com) for recent articles.


pension equal to 60 percent of their final salary after 30 years. Public safety workers in CalPERS can retire at age 50 after 30 years of work with benefits equal to 90 percent of their final salary. These lucrative benefits have put CalPERS in deep financial trouble.

- **Pension formulas.** Virtually all public sector plans calculate benefits based on pay during the last one to three years of work. Private plans are more likely to use a lower-cost approach, such as the last five years of pay or career-average pay (Foster, 1998). Also, public plans typically have a more generous factor to adjust pension benefits for number of years worked. In the public sector, benefits equal to about 60 percent of pay after 30 years of work is typical. In some jurisdictions, government workers inflate or “spike” their pension earnings by receiving big raises or working overtime in their final year or two on the job.9

- **Double dipping.** In California, New Jersey, Utah, and other states, public workers can “retire” early and then either resume their existing job or take a new job, thus receiving a salary and pension at the same time (Heath, 2009).

- **Disability claims.** Excessive and fraudulent disability claims are a growing problem. In Nevada, “[F]iremen hobbled by heart disease can collect an inflation-protected $40,000 a year for life on top of their pension. That applies even if they’re healthy enough to work in another occupation” (Fitch, 2009). Walters (2007) notes that “hundreds of local governments and several states are wrestling with what some view as out-of-control disability pension and health insurance systems hard-wired to allow police and fire personnel to retire early and with very generous benefits. At the same time, they may pursue other full-time careers.”

- **Excessive benefits.** News articles have revealed eye-popping annual pension amounts received by civil servants in run-of-the-mill positions in cities across the nation. In California, 6,144 of the retired public employees in the CalPERS plan and 3,090 of the retired teachers in the state teachers’ plan receive annual pension benefits of more than $100,000.10

Excessive pension benefits are creating a looming crisis for government budgets and state taxpayers. To make matters worse, governments have also built up large unfunded costs in their retiree health care plans, a type of benefit that is rare in the private sector. With a colleague, I estimated that state and local health obligations are under-funded (or overpromised) by at least $1.4 trillion, or about $12,000 per U.S. household (Edwards and Gokhale, 2006).

A final looming threat to taxpayers is the large amount of bond debt that governments are accumulating. Total state and local bond debt jumped 92 percent between 2000 and 2009—from $1.2 trillion to $2.3 trillion (Federal Reserve Board of Governors, 2009; see Table D.3). Governments are using debt to fund investments formerly funded on a pay-as-you-go basis, and some governments are using debt to paper over routine budget shortfalls, which is the height of fiscal irresponsibility.

Policymakers should stop piling costs onto the next generation of young taxpayers. Government spending should be cut and bond debt reduced. New state and local employees should be offered defined-contribution plans, not defined-benefit plans. Pension and health care premiums for state and local workers should be increased. Retirement ages and years-of-service requirements for pensions should be raised. Pension and health care benefits should be cut. Government staffing levels should be reduced. This may all sound quite drastic to some folks, but the huge structural gaps in government finances will not go away without dramatic action on the spending side of budgets.

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9 For example, see Revel et al. (2004).

10 For information on the CalPERS and California State Teachers Retirement System (CalSTRS) $100,000 clubs, see http://californiapensionreform.com.
REFORMING PUBLIC SECTOR UNION LAWS

Spending reforms, such as privatization and cuts to employee compensation, often face substantial political opposition. Reforms are more difficult to achieve, particularly in states with union participation in their public sector workforces. Public sector unions have a substantial effect on state fiscal policies through aggressive lobbying, particularly in states that allow public sector collective bargaining and forced union dues.

In 2009, 39 percent of state and local public sector workers were members of unions—more than five times the 7 percent share in the private sector (BLS, 2010a). Before the 1960s, unions represented less than 15 percent of the state and local workforce (Freeman, 1986, p. 45). At that time, courts generally held that under the 1935 Wagner Act, public sector workers did not have the same union privileges—such as collective bargaining—as did private workers.

That viewpoint changed during the 1960s and 1970s, as a flood of pro-union laws in dozens of states triggered a dramatic rise in public sector unionism (Freeman, 1986, pp. 47 and 48). Many states passed laws (i) encouraging collective bargaining in the public sector and (ii) imposing compulsory union dues and fees.

Today, about 26 states have collective bargaining for essentially all state and local workers. An additional 12 states have collective bargaining for a portion of their state and local workers. The remaining 12 or so states do not have collective bargaining in the public sector (Government Accountability Office, 2002, p. 8).

The union shares of state and local workforces vary widely and are strongly correlated with state rules regarding collective bargaining (Edwards, 2010a). The rules range from states that actively require it, to states that allow it, to states that ban it (such as Virginia and North Carolina). In states that require collective bargaining, at least 50 percent of public workers are unionized. In states with no collective bargaining, public sector union membership averages just 17 percent (Farber, 2005, p. 20).

State union shares are also correlated with “agency shop” rules. Agency shop rules require workers to either join the union or pay a fee to the union. Today, 28 states have agency shop rules, whereas 22 are “right-to-work” states where workers cannot be forced to join a union or pay union fees. Right-to-work states generally have much lower union shares in their workforces (Farber, 2005, p. 22).

Union public sector workers have much higher average wages and benefits than nonunion public sector workers. Specifically, BLS data show that union members have a 31 percent advantage in wages and a 68 percent advantage in benefits over nonunion members (Edwards, 2010e). However, part of this union-nonunion pay difference stems from general labor market variations across states. States with generally higher wages tend to be more unionized. Analyses that hold constant such cross-state differences find that public sector unions increase average pay levels by roughly 10 percent.

Besides raising compensation costs, unions reduce government efficiency in other ways. Unions tend to protect poorly performing workers, they often push for larger staffing levels than required, and they discourage the use of volunteers in government activities. Unions also tend to resist the introduction of new technologies and create a more rule-laden workplace. Simple regression analyses show that states with higher union shares in the government workforce have more government debt and receive poorer grades on public management, based on Pew Center research criteria.

A final type of inefficiency created by public sector unions is the cost of strikes in those states that allow it. In November 2009, for example, transit workers in Philadelphia went on a six-day strike over disagreements regarding pay, which created chaos for 800,000 residents of the city who rely on government rail and bus services (Lattanzio, 2009).

In the private sector, businesses can mitigate such union-caused inefficiencies. In response to

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11 These totals have changed a bit since this 2002 study.
12 See National Right to Work (www.nrtw.org/rtws.htm).
13 See Edwards (2010a,b).
14 See Edwards (2010c,d).
union demands for higher pay, for example, businesses can substitute capital for labor. Unfortunately, public sector managers have little incentive or flexibility to make such changes.

Public sector unions have a broad effect on fiscal policy, as they are some of the nation’s most powerful special interest groups. The National Education Association (NEA), the American Federation of Teachers (AFT), the American Federation of State, County and Municipal Employees (AFSCME), and the Service Employees International Union (SEIU) have more than 7 million members combined, and they are very well financed. The NEA and AFT, for example, collect about $2 billion per year in member dues and fees, most of which is from jurisdictions with agency shop rules (National Institute for Labor Relations Research, 2008).

With their large war chests, public sector unions are active in political campaigns. Over the past two decades, AFSCME was the second-largest contributor to campaigns in the United States. The NEA was the eighth largest, the SEIU eleventh largest, and the AFT thirteenth largest (Center for Responsive Politics). During 2007 and 2008, public sector unions spent $165 million on campaigns and ballot measures (National Institute on Money in State Politics).

These groups generally favor increases in government spending, partly because they personally benefit from expanded programs. In states such as California and Oregon, they have spent millions of dollars on various ballot measures, nearly always favoring the side of higher taxes and spending. Public sector unions fight against school choice, privatization, and many other policies that can improve government efficiency.

To conclude, collective bargaining gives a privileged position in our democracy to government insiders who focus on expanding the public sector to their personal benefit. Monopolies in the business world usually create higher-cost and lower-quality services. Monopoly unions create similar problems in labor markets. With the many large fiscal challenges facing governments—such as huge pension-funding gaps—policymakers need flexibility to make tough budget decisions. But powerful unions make budget reforms more difficult.

To put citizens and taxpayers back in control of their governments, collective bargaining and forced union dues should be outlawed in the public sector, following the successful policies of Virginia and North Carolina. Public employees should be free to join worker associations, but they should not be given a special legal status and handed extra power to block needed fiscal reforms.

REFERENCES


Panel Discussion


