

# THE EFFECT OF TAX LIMITATION LEGISLATION ON PUBLIC SECTOR LABOR MARKETS: A COMMENT

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## I. Introduction

**T**HIS brief comment presents my views about the current relative economic status of state and local government employees and the growth of collective bargaining and influence of unions in the public sector. With these remarks as background, I then discuss the likely effects of tax limitation legislation on public sector labor markets.

## II. Public Employee Compensation

A popular belief seems to be that public employees are overpaid, in the sense that they receive higher levels of compensation than do comparable private sector workers. While this is almost certainly a valid conclusion for federal government employees, it does *not* appear to be universally true for state and local government employees. In the most comprehensive study of the subject to date, Sharon Smith estimated the net wage rate premiums that were paid to state and local employees in 1973 and 1975 vis-à-vis comparable quality private sector employees.<sup>1</sup> After controlling for a vector of personal characteristics designed to measure employees' quality and experience, she concluded that males employed by state and local governments received lower wage rates than males with comparable measured characteristics employed in the private sector.<sup>2</sup> In contrast females, especially those employed by state governments received positive wage premiums over their private sector counterparts.<sup>3</sup> However, the magnitude of these differentials declined between 1973 and 1975. Table 1 presents estimates of these overall net differentials as well as estimates, by occupation category and region of the country. While the differentials' magnitudes vary across categories and regions, in almost all cases

the relative earnings position of state and local government employees declined between 1973 and 1975. Moreover, earnings growth data for all private sector and state and local government employees (Table 2) suggest that the relative wage position of the government employees has continued to decline in recent years.

Contrary to popular opinion then, the relative wage position of state and local government employees has declined in recent years and, at least for males, wages on average are likely to currently be below the levels paid comparable quality private sector workers. Of course, one might reply that public employees historically have enjoyed greater job stability and the evidence supports this contention.<sup>4</sup> One might also argue that focusing on wage rates alone understates the relative compensation of public sector employees as fringe benefits, especially pensions, are often alleged to be higher in the public than the private sector. Indeed, to support this latter contention, one might argue that politician-employers are more willing to grant pension than wage increases to public employees, as they can often hide the true long-run costs of the former from the public, thereby increasing their short-run probabilities of reelection. However, this line of reasoning ignores the fact that the more generous retirement benefits in the public sector can at least partially be attributed to most public sector pension plans requiring employee contributions, while most private sector plans are not contributory.<sup>5</sup> In sum, the evidence probably does *not* suggest that the total compensation levels of most state and local government employees are currently considerably above the levels of comparable individuals employed in the private sector.

## III. Public Employee Unionization

The extent of public employee unionization has increased rapidly since the early

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Table 1

Implied Estimated Percentage Differences Between the Wages of State and Local Government Employees and Comparable Private Sector Employees: 1973 and 1975

A) In the Aggregate <sup>1</sup>	Male			Female			
	1973	1975		1973	1975		1975
a) State	0.0	-3.0		13.0			7.0
b) Local	-4.0	-4.0		7.0			2.0

  

B) By Occupation <sup>b</sup>	Professionals	Managers	Clerks	Service	Crafts	Oper.	Laborers
	Male State 1973	1.4	1.4	-1.4	20.9*	-9.6*	-3.8
1975	-3.7	-5.8	-1.5	19.7*	-7.1	-16.5*	-9.3*
Male Local 1973	-7.6*	-12.2*	-10.4*	23.4*	-14.0*	-8.3*	-6.3
1975	-13.9*	-14.6*	-6.6	27.1*	-12.2*	-6.1*	-0.1
Female State 1973	19.7*	25.8*	2.9	24.6*		49.2*	
1975	2.7	19.7*	3.9	24.6*		-8.9	
Female Local 1973	11.6*	4.6	-5.9*	7.4*		23.4*	
1975	1.5	12.7*	-5.6*	12.7*		-8.0	

  

C) By Region <sup>c</sup>	Northeast		Northcentral		South		West	
	1973	1975	1973	1975	1973	1975	1973	1975
Male State	-5.7	-7.7*	-2.0	-4.4	0.6	0.6	8.9*	4.8
Male Local	-2.9	-2.2	-7.1*	-6.2*	-6.3*	-7.5*	-0.5	-3.2
Female State	4.6*	11.6*	11.6*	8.1*	18.5*	18.5*	11.6*	-0.5
Female Local	1.9	0.5	18.5	0.2	5.0*	2.7	8.1	3.6

\* underlying regression coefficient was statistically significant from zero at .05 level of significance, two-tailed test (no tests of significance were reported for the aggregate results in panel (A))

Source: Implied estimates from Sharon Smith, Equal Pay in the Public Sector: Fact or Fantasy (Princeton University Industrial Relations Section, 1977).

A) Implied from Table 3.7, using private sector weights

B) Implied from Tables 4.1, 4.2, and 4.3

C) Implied from Tables 3.1 and 3.2

1960's, and the state and local sector represents one of the few sectors in the economy in which unions are currently not losing ground. Although accurate statistics on public sector unionization are hard to come by, one comprehensive survey article concluded that the percentage of full-time state government employees that belonged to labor organizations was over 38 percent in 1976.<sup>6</sup> In the same year, the comparable figure for local government employees was 54 percent. These numbers should be contrasted with the less than 25 percent of the private non-agricultural sector which is organized. Since commentators have asserted that a likely outgrowth of tax limitation legisla-

tion will be an increase in union strength and union militancy, it is useful to summarize what we know to date about the effects of public sector unions on wages and benefits.<sup>7</sup>

There have been numerous studies published on the effect of public sector unions on wages. The consensus seems to be that state and local government employees' unions have raised their members' wages by roughly 5 to 15 percent above the earnings levels of comparable public employees in areas in which public employees are not unionized.<sup>8</sup> These differentials are smaller than the union/nonunion differentials which have been observed in the private sector.

Table 2

Cumulative Growth Rates in Earnings in the  
Private and State and Local Government Sectors

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1970-1977	57.4	62.2	54.6	50.1	60.0	54.0	53.9
1975-1977	15.4	15.7	12.2	12.2	12.4	11.8	11.6

where

- (1) Average weekly earnings of nonsupervisory workers in the private non-agricultural sector
- (2) Average hourly earnings of nonsupervisory workers in the private non-agricultural sector
- (3) Average monthly earnings (AME) of full-time equivalent (FTE) state and local government employees
- (4) AME of FTE state and local government educational employees
- (5) AME of FTE state and local government noneducational employees
- (6) AME of FTE state government employees
- (7) AME of FTE local government employees

Sources:

- (1) and (2) U.S. Department of Labor, *Employment and Earnings*, October 1978, Table C1 (percentage change in annual average earnings).
- (3) thru (7) U.S. Bureau of the Census, *Public Employment in 1977* (and earlier issues), Tables 7 and 8 (percentage change in October earnings figures).

Given the growing importance of fringe benefits in public sector compensation, one may be tempted to argue that measured union/nonunion wage differentials *understate* the true public sector union/nonunion total compensation differentials. Presumably this would occur because tastes for fringe benefits differ across individuals and there is no easy way to communicate the preferences of the average municipal employee in cities without municipal unions to municipal employers. As such, compensation in these cities would be more heavily weighted towards money wages than it would in cities in which municipal employees were unionized.<sup>9</sup>

In fact, however, this argument does not appear to be always correct. In an unpublished Cornell master's thesis, David Rogers has shown that several types of nonwage benefits received by police and fire fighters were less generous in cities in which police and fire fighter unions

existed than they were in nonunion cities in 1975, *ceteris paribus*.<sup>10</sup> A possible explanation for Rogers' findings is that cities in which public employees' benefits are initially poor are the ones which are most susceptible to successful union organizing drives. When the time approaches to negotiate a contract in such a city, the union strives to improve its members' nonwage benefits. However, if municipal employers are resistant to making concessions on these issues, the union may maximize its members' welfare by settling for larger wage increases rather than substantial benefits improvement.<sup>11</sup> As a result, one would simultaneously observe positive union/nonunion earnings differentials and negative union/nonunion benefits differentials in the public sector. Put another way, the true effect of municipal employees' unions on their members' total compensation may be overstated, *not* understated, by estimates of union/nonunion wage differentials in the public sector.

Their overall effect on total compensation may be significantly less than 5 to 15 percent.

A recent Cornell Ph.D. dissertation has also shown that unions tend to increase the share of municipal expenditures which go towards municipal labor costs.<sup>12</sup> Together with the evidence that municipal employee unions have had only a small effect on their members' compensation level, this leads one to conjecture that public employee unions are primarily "defensive organizations" and are concerned with their members' employment levels, as well as their wages.

#### IV. Tax Limitation Legislation and Public Sector Labor Markets

Why should the analysis of the effect of tax limitation legislation on public sector labor markets be any different than the analysis of any decline in a community's "ability to pay?" Presumably, in the latter case public sector unions and public employers can push for an increase in the size of the public sector relative to total community resources, while in the former case they are prevented from doing so by law. Hence, their option is reduced to pushing for a larger share of public expenditures to be devoted to personnel costs. Because of this, to the extent that tax limitation legislation imposes effective constraints on public sector budgets, wage elasticities of demand for public employees must increase.<sup>13</sup> The less favorable (from the employees' perspective) trade-off between wages and employment should lead to a further reduction in the short-run in the relative earnings position of state and local government employees.

Will this decline be a permanent one? I doubt it. In choosing between government and private employment, potential employees weigh both the pecuniary and nonpecuniary conditions of employment in each. A simultaneous reduction in wages and employment stability in the public sector invariably must lead to increased job turnover among younger more capable existing government employees who have private sector alternatives and to a decline in the number and quality

of new job applicants to the state and local sector.<sup>14</sup> Eventually, relative wages must rise if municipalities hope to maintain the same quality of their workforces.

The role of public sector unions must also be considered. New York City's ongoing financial crisis has given us one observation which suggests that in the short-run even strong unions may be willing to accept wage freezes and/or real and relative wage cuts to avoid the need for layoffs during periods of financial stringency.<sup>15</sup> However, as the period of tightness lengthens, pressure builds up to grant substantial wage increases to the remaining public employees. This pressure will be magnified if a union perceives that any reduction in employment necessary to finance the salary increases, will come from normal attrition rather than layoffs. Again, the result will be rising municipal employee wage levels and declining employment levels.<sup>16</sup> If, as noted above, unions succeed in diverting funds from nonpersonnel municipal expenditure categories to the personnel budget, the decline in employment may be arrested. However, in this case, the value of the alternative uses of the diverted funds will be a cost borne by taxpayers.

Of course my analysis is colored very heavily by the initial experiences under proposition 13 in California and by New York City's financial problems. If tax or expenditure limitation legislation in other states do not prove to be binding constraints on state and local government labor markets, but merely serve to limit the rate of expansion in public sector budgets, the problems will be less severe. Indeed, a situation in which unions and public employers know that the total employment budget will increase over time, but at a rate which is less than in previous years, provides opportunities for productivity bargaining and incentive compensation schemes, as unions (employers) seek to increase their compensation (maintain local government services). Unions are more likely to agree to work-rule changes when the size of the pie is increasing than when it is contracting. Hence, perhaps it would be wise not to generalize too much from the California experience under proposition 13.

<sup>1</sup>Sharon Smith, *Equal Pay in the Public Sector: Fact or Fancy* (Princeton University Industrial Relations Section, 1977).

<sup>2</sup>Some of her estimates are reproduced in Table 1.

<sup>3</sup>The contrasting male and female results are attributed by Smith and others to less wage discrimination against females in the public than in the private sectors.

<sup>4</sup>See for example, Farrell Bloch and Sharon Smith, "Human Capital and Labor Market Employment," *Journal of Human Resources*, Fall 1977, for evidence on this point. Of course, tax limitations and events like the New York City fiscal crisis may alter the relative security of public employment and I will return to this point below.

<sup>5</sup>On this point, see Robert Tilove, *Public Employee Pension Funds* (Columbia University Press).

<sup>6</sup>John Burton, "The Extent of Bargaining in the Public Sector," in Benjamin Aaron, et al., eds., *Public Sector Bargaining* (Industrial Relations Research Association, 1978).

<sup>7</sup>See "Collective Bargaining in California Likely to be Affected by Proposition 13," *Government Employee Reactions Report* (Bureau of National Affairs, August 7, 1978).

<sup>8</sup>See for example, Ronald Ehrenberg and Gerald Goldstein, "A Model of Public Sector Wage Determination," *Journal of Urban Economics*, June 1975.

<sup>9</sup>This line of reasoning goes back at least as far as Richard Lester, "Benefits as a Preferred Form of Compensation," *Southern Economic Journal*, April 1967.

<sup>10</sup>David Rogers, "Municipal Government Form, Unions, and Wage and Nonwage Compensation in the Public Sector" (unpublished Cornell University M.S. thesis, 1979).

<sup>11</sup>Public employers may prefer to grant wage increases rather than benefit increases if they view the

costs of the latter as being open-ended. For example, an agreement to pay 80 percent of an employee's health insurance premium may lead to increased costs in future years as health insurance premiums rise.

<sup>12</sup>Jan Baderschneider, "The Impact of Collective Bargaining Laws Covering Police and Firefighters on Municipal Budgeting" (unpublished Cornell University Ph.D. dissertation, 1979).

<sup>13</sup>My research on the demand for public employees concluded that labor demand curves in the public sector were, in the main, inelastic during the 1960's. See for example, "The Demand for State and Local Government Employees," *American Economic Review*, June 1973; *The Demand for State and Local Government Employees* (D.C. Heath, 1972); *An Economic Analysis of Local Government and Wages* (Final Report Submitted to the U.S. Department of Labor, December 1973); and Orley Ashenfelter and Ronald Ehrenberg, "The Demand for Labor in the Public Sector" in Daniel Hamermesh, ed., *Labor in the Public and Non-Profit Sectors* (Princeton University Press, 1975).

<sup>14</sup>Some of these patterns have been observed following Proposition 13 in California.

<sup>15</sup>After Proposition 13 passed in California, the price localities had to pay for receiving a share of the state surplus allocation was to agree to grant wage increases to their employees which were no greater than the increase granted to state employees. However, this latter increase was zero percent that year (1978).

<sup>16</sup>The relative sizes of the wage increases and employment decreases, *ceteris paribus*, might be conjectured to be a function of the initial relative size of the public sector, as public employees in their roles as local voters influence municipal budgetary decisions. For an interesting theoretical treatment of the role of public employee voting power, see Paul Courant, Edward Gramlich, and Daniel Rubinfeld, "Public Employee Market Power and the Level of Government Spending" (mimeo, University of Michigan Institute of Policy Studies, 1977).