The New York Fiscal Crisis and Needed Reform

I spent a number of years, both in Washington, DC and overseas, in "economic development", e.g. in foreign aid. And I learned first-hand the truism that aid is a means by which economists experiment overseas with policies they wouldn't recommend at home. The biggest hypocrisy in this business is that of pension reform. In the 1990s in Latin America and the ex-Soviet Union one of the biggest problems with unsustainable government expenditures was the pension schemes in these countries. So the 'rich' countries recommended to the 'poor' countries that they needed to reform their pension plans. In most cases these reform recommendations were followed and this helped the countries get their bloated government budgets under control. And of course, unfortunately, this wise reform has not been followed 'at home'.

The simple solution was to go from defined benefit pension plans to plans with defined contributions. In other words, instead of guaranteeing a certain amount of retirement benefits, benefits would be based on the performance of the economy as whole.

It is conventional wisdom (in this case true) that government spends money where it can garner votes from its spending. In the US it is the Democrats who get votes from the government labor unions. And, government labor unions are the biggest and most powerful unions in the United States (that is, well, after as we are seeing with the General Motors "restructuring", the United Auto Workers). It is therefore thusly that we continue to have defined benefits for public sector workers in the United States, whereas the private sector has moved mostly to defined contributions, e.g. 401k plans and the like. This has contributed to, according to some studies, retirement and health benefits for public sector workers which are almost twice that of the private sector.

Then when you combine the fact that it is very difficult to fire labor union employees, let alone public sector labor union employees, and that pay rises with tenure and not performance in the public sector, you get a bloated top-heavy public sector, which, again is protected by the special interest politics under our increasingly failed two-party political system. And, some studies again show that, averaged-out for the economy as a whole, actual pay plus benefits for public sector employees are almost twice that of the average private sector wage. (In general at lower pay levels the public sector pays more than the private sector and at higher pay levels the private sector pays more. But the average public sector employee makes about twice that of the average private sector employee, thus the joke, "I should have listened to my Uncle and got a government job".)

In the economic principles class I teach, using a mainstream macroeconomic textbook by Gregory Mankiw, we learn that political economy is about trade-offs between economic efficiency and economic equality. Which leads us to ask, where is the economic equality in a society where in general government employees make twice as much money as private people?

The downturn in stock market values (a logical adjustment to a longish monetary easing and then a monetary tightening) and the housing bubble crash (actually a mortgage-backed-securities crash) has therefore meant that the trust funds for the defined benefit public pensions have taken a big hit. This in turn has exacerbated the financial crises faced by states and cities and elicited calls for federal bailouts to the states and cities to cover the short-falls in the short-term. This is all very predictable. The solution is, not as Paul Krugman recommends, tax increases (which just chases taxpayers away from your jurisdiction), but in fact reform of the public pension schemes to make them equitable with the private sector. If the private sector takes a hit during a downturn, why should not the public sector?

On a separate but related issue, we all know that New York City went bankrupt in 1975. A recent conference on the lessons learned from this crisis sponsored by the Manhattan Institute held at St. Francis University in Brooklyn found that, "the problem was never a lack of revenue, but an excess of spending". This again should be obvious. It is well known that the State of California might go bankrupt by the end of this summer, its budget short-fall at this point is projected to be around 13% of the state's budget. The State of New York's budget short-fall comparatively is projected to be only around 5%. Is it too much to ask that New York spending be cut by 5%?

However that’s just the short-term. In the long-term we must deal with public employee pay and pensions, to make them more equitable with that of the private sector (and not to denigrate public employees….we all need jobs ! I too had one of these jobs, good work if you can get it). Salaries are 60% of the state budget, so this is where reform must occur.

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