



## CITY OF BEVERLY HILLS STAFF REPORT

**Meeting Date:** March 6, 2012

**To:** Honorable Mayor & City Council

**From:** Eliot Finkel, City Treasurer & Chair, Employee Compensation Review Committee

**Subject:** Survey Comparing City of Beverly Hills' Compensation to the Private Sector

**Attachments:**

- 1) "The Truth about Public Employees in California: They are Neither Overpaid nor Overcompensated" from the Center on Wage and Employment Dynamics, a division of the Institute of Research on Labor and Employment at the University of California, Berkeley
- 2) "Are California Public Employees Overpaid?" a report by The Heritage Foundation and the American Enterprise Institute (HF/AEI)
- 3) Draft Employee Compensation Comparison
- 4) The Waters Consulting Group, Inc. (WCG) Proposal

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### INTRODUCTION

At the direction of the City Council, City Treasurer Eliot Finkel convened a group of Beverly Hills residents and concerned citizens to review the employee compensation practices of the City of Beverly Hills.

Employee Compensation Review Committee (ECRC) formerly known as the Pension Review Task Force members are:

**Eliot Finkel**, City Treasurer and founder of Eliot Finkel Investment Counsel, LLC  
**Abner Goldstine**, Senior Vice President of Capital Research and Management Co.  
**Gene Krieger**, Vice Chairman & COO of Shamrock Capital Advisors  
**Kathy Reims**, Former Chair of the Planning Commissioner  
**David Schwartz**, Partner, Irell & Manella LLP and Member Little Hoover Commission  
**Joan Seidel**, Former City Treasurer and President of Morton Seidel & Co. Inc

## **THE PROCESS**

Over several meetings in 2011, the ECRC received briefings on the City's historical and current compensation philosophy, policies, procedures, practices and a review of the current total compensation survey process.

In addition to the presentations, there was significant discussion among the ECRC members regarding the differences and similarities in public and private sector employment. The purpose of the discussion was to help determine a public/private compensation comparison model.

## **DISCUSSION**

Public/private employee compensation comparisons are rare because of significant obstacles to getting detailed private sector information. One recent research paper published by the Center on Wage and Employment Dynamics, a division of the Institute of Research on Labor and Employment (CWED) at the University of California, Berkeley, was entitled "The Truth about Public Employees in California: They are Neither Overpaid nor Overcompensated". A critique of that report by The Heritage Foundation and the American Enterprise Institute (HF/AEI) was entitled "Are California Public Employees Overpaid?"

The HF/AEI report questioned two assumptions in the CWED report. First, do employees place a premium on the greater job security of public sector employment? Second, are the assumptions regarding CalPERS estimated pension contributions reasonable? The Pension Task Force had the same problem with CalPERS as we reported to you on August 2, 2011.

The reports agreed that education level was the most important single factor in determining overall compensation. Less educated public sector employees are better paid than the private sector employees while more educated employees are better paid in the private sector than in the public sector. The CWED report used statewide data for their research which, judging by the average employee compensation may not be comparable to employee compensation in the Beverly Hills area.

Unsatisfied with the geographic scope of the academic studies, the ECRC explored conducting our own private compensation survey of neighboring cities and the private sector in the Beverly Hills area. Three qualified firms that conducted the most public-private sector compensation comparisons in our area in the last five years were identified and interviewed. Two of the three interviewed firms submitted a proposal to conduct the requested survey. These proposals were reviewed and evaluated by the ECRC. The firms that submitted proposals were The Waters Consulting Group, Inc. (WCG) and the Davis Company.

The Waters Consulting Group (WCG) was selected as the most qualified to conduct such a study. WCG has worked extensively with public sector organizations on their compensation systems, including municipalities of a similar size and complexity to Beverly Hills.

The current plan is for staff to work with WCG to identify comparable public/private positions and local private sector firms that might participate in a survey and allow data

to be collected such as salaries, starting salaries, employee longevity, benefits, education levels, etc. This data will be examined by the ECRC to determine if completion of a private sector study would generate useful data. Should a private sector survey be deemed worthwhile, WCG would be retained to conduct the study. If a private sector study is not deemed worthwhile, the ECRC will proceed using only existing public sector data and the funds requested below will not be spent. The ECRC will present its findings and recommendations to the City Council with or without a private sector study.

The ECRC wants to emphasize that there is no inherent reason to believe the City's current compensation levels, processes and policies are unfair. In some cases the compensation policies of ECRC members own firms are similar to the City's.

### **FISCAL IMPACT**

The one-time cost of contracting for a private sector total compensation survey will be \$25,000 - \$30,000 depending on the number of benchmark jobs, number of benchmark organizations selected, and the level of complexity involved in capturing the private sector data.

Funds for this project are not currently budgeted. In order to proceed, up to \$30,000 is requested to be appropriated from general fund reserves to fund this project.

### **RECOMMENDATION**

If the City Council approves moving forward in this direction, the ECRC recommend the City council appropriate up to \$30,000 from general fund reserves, approve the ECRC to draft an agreement with WCG, and approve a purchase order up to \$30,000 with WCG to provide the private sector/public sector compensation survey.

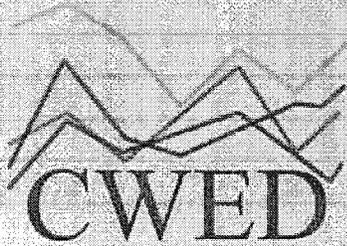


Eliot Finkel

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City Treasurer & Chair, Employee  
Compensation Review Committee

# **Attachment 1**



Center on Wage and Employment Dynamics

POLICY BRIEF

October 2010

Institute for Research on Labor and Employment  
University of California, Berkeley

# The Truth about Public Employees in California: They are Neither Overpaid nor Overcompensated

Sylvia A. Allegretto and Jeffrey Keefe\*

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## Introduction

Recently, there has been a great deal of debate and consternation over the compensation of public-sector employees across the U.S. It has been asserted that state and local government employees are overpaid compared to workers in the private sector. In California government workers have been vilified as scandals and anecdotes pass as confirming evidence of exorbitant pay. This research is especially important given the outrage over the pay of municipal officials in Bell, California. The outrage over what happened in Bell is reasonable and just. Many of the players immediately resigned and on September 21, 2010 eight city officials were arrested.<sup>1</sup> Those arrested include the former city manager of Bell, Robert Rizzo, who was making nearly \$800,000 a year. Rizzo was charged with 53 counts. It is alleged that Rizzo, without approval from the City Council, actually wrote the conditions of his own contract—the case keeps growing in terms of scope and involved officials. It is clear by the arrests and scores of allegations that the situation in Bell was not in line with usual procedures.

While anecdotes that stem from public-sector corruption capture much attention, it is a data-driven analysis of public-sector pay and compensation that is needed to answer the question: How do the pay and benefits of public sector workers compare to those in the private sector? This is a legitimate question that should not be answered anecdotally. The research in this paper investigates empirically whether California public employees are overpaid at the expense of California taxpayers.

The results from this analysis indicate that California public employees, both state and local, are not overpaid. The wages received by California public employees are about 7% lower, on average, than wages

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We thank Adam Dunn and Laurel Lucia for helpful comments.

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received by comparable private sector workers; however, public employees do receive more generous benefits. An apples-to-apples comparison, or one that controls for education, experience, and other factors that may influence pay, reveals no significant difference in the level of employee compensation costs on an annual or per hour basis between private and public sector workers.

Nonetheless, there are substantially different approaches to staffing and compensation between the private and public sector. Specifically, there are important workforce differences between the two sectors in terms of educational attainment. On average, California's public sector workers are more highly educated. Of full-time workers, 55% hold a four-year college degree in the public sector compared to 35% in the private sector. Educational attainment is the single most important predictor of earnings—thus it plays a vital role in this analysis. On average, California state and local governments pay college-educated labor less than private employers. The earnings differential is greatest for professional employees, lawyers and doctors. On the other hand, the public sector appears to set a floor on compensation. The earnings of those with a high school degree or less is higher in state and local government than it is for similar workers in the private sector.

There are other significant personnel differences between the public and private sector workforces. The age (median) of a typical worker in state and local government is 44 compared to 40 in the private sector. Furthermore, the state and local government workforce has more women (55%) compared to the private sector (40%).

In general, better educated and older, more experienced workers earn more than less educated and younger workers while women earn less than men. Thus, comparisons between the two sectors must take into account these and other differences such as race and experience when making pay comparisons. Simply comparing average pay between the two sectors, without taking into account workforce differences, would be highly misleading.

Benefits are also allocated differently between private and public sector full-time workers in California. State and Local government employees receive a higher portion of their compensation in the form of employer-provided benefits and the mix of benefits is different from the private sector. While some benefits may be more generous in the public sector, it is a serious error to imagine that comparability requires that each and every element of compensation be the same. When total compensation—both the cost of employer-provided benefits and direct pay—is taken into account state and local public sector workers in California are similarly compensated to workers in the private sector.

Public employers contribute on average 35.7% of employee compensation expenses to benefits, whereas private employers devote 30% of compensation to benefits. Public employers provide better health insurance and pension benefits. Public employers contribute 11.8% to insurance, mainly health insurance, compared to a 7.7% contribution by private employers. Retirement benefits also account for a substantially greater share of public employee compensation, 8.2% compared to 3.6% in the private sector. Most public employees also continue to participate in defined benefit plans managed by the state, while most private sector employers have switched to defined contribution plans, particularly 401(k) plans. On the other hand, public employees receive considerably less supplemental pay and vacation time, and public employers contribute significantly less to legally-mandated benefits.

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Thus, the difference in workforce characteristics and benefit allocations between the public and private sectors is why a regression-adjusted analysis is employed in this research. The regression framework allows a comparison of similar workers controlling for factors which influence compensation levels. A standard wage equation produced a surprising result: full-time state and local employees are under-paid by about 7% compared to their private sector counterparts. However, a re-estimated regression equation of total compensation (which includes wages and benefits) demonstrates that there is *no* significant difference in total compensation between full-time state and local employees and private-sector employees.

## The Challenge of Analyzing Public Employee Compensation

To answer whether California public employees are overpaid two simple but related questions need to be asked: compared to whom? And compared to what? The standard of comparison for public employees is usually similar private sector workers, with respect to education, experience, and hours of work.

Ideally, we would compare workers performing similar work in the public sector with the private sector, but this is not always possible. There are too many critical occupations in the public sector, for example, police, fire, and corrections, without appropriate private sector analogs. Even private and public teaching is significantly different. Public schools accept all students, while private schools are sometimes highly selective and may exclude or remove poor performers and special needs or disruptive students. Consequently, comparing workers of similar “human capital” or fundamental personal characteristics and labor market skills is considered the best alternative. Analyses based on comparisons of personal characteristics capture most of the important and salient attributes in comparable work studies.

Prior research reveals that education level is the single most important earnings predictor for all workers. Education helps create work-relevant skills. People invest heavily in their own and their children’s education by buying homes in communities with good schools and by paying or taking on debt to attend schools, colleges, and universities. Empirically, education is followed by experience in advancing earnings. People learn by doing and by working in a variety of job tasks as they advance through occupational levels. Most occupations reward experience and on-the-job learning as they are associated with more competent and productive performance.

Other factors widely found to affect compensation include gender, race, ethnicity and disability. However, productivity-related human capital differences (e.g., training and education) are inter-mingled with labor market disadvantages stemming from historical patterns of discrimination. We account for all of these factors in our study. When analyzing hours of work most studies exclude part-time workers for a number of reasons: their hours of work vary, they earn considerably less than comparable full-time workers, they are more weakly attached to the labor force, and they often lack benefit coverage. This study follows standard practice by focusing on full-time public and private sector employees, who represent over 80% of the state’s labor force, and by controlling for hours worked per year.

It is well known that an employer’s organizational size greatly influences employee earnings. We are fortunate to be able to account for the size of the firm where each sampled full-time worker was employed. This control variable is made possible by the Integrated Public Use Microdata Series of the March Current

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Population Survey data (IPUMS-CPS). The basic wage gap due to organizational size is 35%. Large firms with more than 500 employees comprise less than one third of 1% of all firms but provide jobs for nearly half of all private sector workers (Oi and Idson 1999; U.S. BLS 2005). Large organizations employ more educated, experienced, and full-time workers, nonetheless even after accounting for these factors; large organizations pay a premium (Troske 1999). When benefits are included in the comparison, the compensation premium for workers at large firms grows. Whereas the private sector has a relatively small number of large organizations, the public sector has relatively few small organizations. Over 79% of California public employees work in organizations employing more than 100 employees.

What should be compared? Comparing wages is insufficient, since employee compensation increasingly includes employer-provided benefits. Regardless of whether employees are compensated with wages or benefits, the essential issue in making a comparison is the cost to private or public sector employers of employing a worker. Employer costs may include not only wages, but paid time off for holidays, vacations, personal and sick days; supplemental pay including over time and bonuses; insurances, particularly health insurance but also life and disability insurance; retirement plan contributions whether defined benefit or defined contribution including 401(k) plans; and legally-mandated benefit contributions such as unemployment insurance, Social Security, Medicare, disability insurance, and workers compensation. Thus, we conclude that the cost of employing a worker, which includes wages and other benefits, is the reasonable comparison. The next, and more difficult, issue is finding the appropriate data to make the comparison.

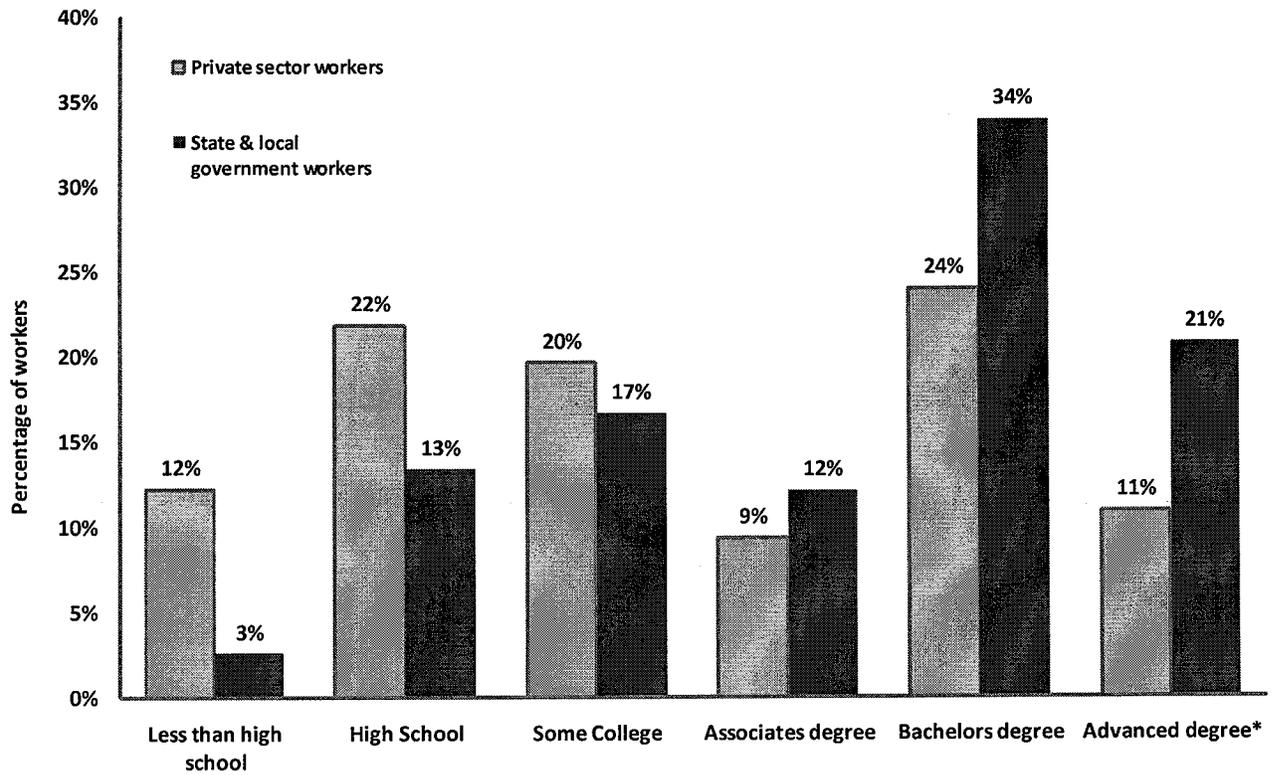
In this study we use the Integrated Public Use Microdata Series (IPUMS) of the March Current Population Survey (CPS) to obtain wage and demographic data. The CPS is a monthly U.S. household survey conducted jointly by the U.S. Census Bureau and the Bureau of Labor Statistics. The March Annual Demographic File and Income Supplement is the most widely used source of earnings data used by social scientists (King, et al. 2009). For the purpose of comparability, self-employed, part-time, agricultural, and domestic workers are excluded.

The most reliable source of benefit information in the United States is the Employer Costs for Employee Compensation (ECEC) survey, which is collected by the U.S. Department of Labor, Bureau of Labor Statistics (BLS). The ECEC includes data from both private industry and state and local government employees and provides data for private employers by firm size. Larger employers, those with over 100 employees, are significantly more likely to provide employees with benefits. This is due, in part, to their ability to spread administrative costs over a larger group. For insurance purposes, larger firms can more readily diversify risks by dint of their size. Because state and local governments resemble large private-sector firms, the compensation cost analysis will control for employer size in making comparisons.

## **Education Is the Most Important Factor in Determining Earnings**

Educational attainment is the single most important predictor of earnings. The strong positive association between higher levels of education and higher earnings in the labor market is a crucial factor in this analysis. There are two important issues here: 1.) California public employees are substantially more educated than their private sector counterparts, and 2.) the returns to education are not the same across the two sectors.

**Chart 1 Educational attainment of California workers in the private sector versus those in state and local government**



Source: Current Population Survey, IPUMS 2009. \*Includes Professional, Masters and Doctorate degrees.

Chart 1 illustrates the dissimilar distributions of education for workers in the private and public sectors. Approximately 55% of California public employees hold a Bachelors or advanced degree compared to 35% of private-sector workers. Table 1 shows the educational distribution for the total private sector and by firm size in the first four columns and for the public sector in column 5. The *returns to education*, which is the average increase in earnings associated with incremental increases in educational attainment, are reported in the last column of Table 1. The percentages for each level of education are in comparison to workers who have not completed high school.<sup>2</sup> For example, a high school graduate, all else being equal, earns on average 39% more than a worker without a high school diploma. The education premium jumps to 57% on average if the worker attended some college or 70% if the worker holds an Associates degree. Completing college with a Bachelors degree yields a 98% premium and a professional degree (law or medicine) increases average earnings by 178% compared to an individual without a high school diploma. A Masters degree yields an average 128% pay premium and a Doctorate produces a 159% return.

**Table 1 The distribution of educational attainment and average returns to education for workers in California**

| Highest degree earned | Private sector employers |                   |                      |                       | State and local government | <i>Earnings return to education compared*</i> |
|-----------------------|--------------------------|-------------------|----------------------|-----------------------|----------------------------|---|
|                       | All                      | 1 to 99 employees | 100 to 499 employees | 500 or more employees |                            |   |
| Less than high school | 12%                      | 19%               | 15%                  | 8%                    | 3%                         | <i>base</i>                                   |
| High school           | 22%                      | 24%               | 21%                  | 21%                   | 13%                        | <i>39%</i>                                    |
| Some college          | 20%                      | 18%               | 18%                  | 21%                   | 17%                        | <i>57%</i>                                    |
| Associates degree     | 9%                       | 7%                | 9%                   | 10%                   | 12%                        | <i>70%</i>                                    |
| Bachelors degree      | 24%                      | 21%               | 25%                  | 25%                   | 34%                        | <i>98%</i>                                    |
| Professional degree   | 2%                       | 2%                | 1%                   | 2%                    | 2%                         | <i>178%</i>                                   |
| Masters degree        | 8%                       | 4%                | 8%                   | 9%                    | 16%                        | <i>128%</i>                                   |
| Doctorate degree      | 1%                       | 1%                | 1%                   | 1%                    | 3%                         | <i>159%</i>                                   |
| Bachelors degree plus | 35%                      | 29%               | 35%                  | 37%                   | 55%                        | --  |

\*Comparisons are in reference to the base group of less than high school. Thus, the earning of those with a high school degree is, on average, 39% higher than those without a high school degree. Columns may not add to 100% due to rounding.

Source: Current Population Survey: IPUMS 2009.

The public sector and larger private sector organizations employ more highly educated workers. Smaller private sector organizations utilize more workers with a high school degree or less compared to either larger private sector firms or state and local government. Only 3% of state and local government workers lack a high school education compared to 12% of private sector employees. The number of private-sector employees without a diploma falls to 8% within firms of 500 or more employees.

As mentioned earlier, the returns to education are not the same across the two sectors. As a result of the relatively high level of unionization, the public sector has established a floor on earnings, allowing those with a high school education or less to earn considerably more than their private sector counterparts (Asher and DeFina 1999). On the other hand, college educated private sector employees earn considerably more than similarly educated public sector workers. These dynamics are reported in Table 2.

For the most part, a comparison of average earnings shows that less educated public sector workers earn more than their private sector counterparts—this differential increases when benefits are taken into account (benefit calculations are described in detail in the next section and in the Appendix). However, just 16% of public sector workers have a high school degree or less compared to 34% in the private sector. The majority of public sector workers (55%) have a Bachelors degree or more compared to the private sector (35%). Public sector pay for these educated workers is considerably less than that of equivalent private sector workers. When benefits are included in the comparison public sector workers with at least a Bachelors degree are less compensated than those in the private sector.

**Table 2 Annual earnings and total compensation comparisons by level of education for workers in California**

| Education level             | Private sector | Public sector | Difference: public-private | Public sector premium/penalty |
|-----------------------------|----------------|---------------|----------------------------|-------------------------------|
| <b>Annual wage earnings</b> |                |               |                            |                               |
| Less than high school       | \$25,964       | \$29,640      | \$3,677                    | 14%                           |
| High school                 | \$39,642       | \$38,903      | -\$739                     | -2%                           |
| Some college                | \$45,609       | \$47,717      | \$2,107                    | 5%                            |
| Associates degree           | \$53,376       | \$53,617      | \$241                      | 0%                            |
| Bachelors degree            | \$72,313       | \$62,337      | -\$9,976                   | -14%                          |
| Professional degree         | \$185,465      | \$163,949     | -\$21,515                  | -12%                          |
| Masters degree              | \$107,017      | \$71,527      | -\$35,490                  | -33%                          |
| Doctorate degree            | \$124,851      | \$108,897     | -\$15,954                  | -13%                          |
| <b>Total compensation</b>   |                |               |                            |                               |
| Less than high school       | \$33,607       | \$41,725      | \$8,118                    | 24%                           |
| High school                 | \$50,563       | \$54,269      | \$3,706                    | 7%                            |
| Some college                | \$57,229       | \$66,094      | \$8,865                    | 15%                           |
| Associates degree           | \$66,695       | \$73,622      | \$6,927                    | 10%                           |
| Bachelors degree            | \$88,852       | \$84,040      | -\$4,812                   | -5%                           |
| Professional degree         | \$228,913      | \$217,343     | -\$11,570                  | -5%                           |
| Masters degree              | \$131,040      | \$94,753      | -\$36,288                  | -28%                          |
| Doctorate degree            | \$153,980      | \$144,470     | -\$9,511                   | -6%                           |

Source: Current Population Survey: IPUMS 2009.

For example, a full-time worker without a high school education earns on average 14% more when employed by state and local government (\$29,640) compared to the private sector (\$25,964). When the comparison is total compensation (including benefits), the public sector premium jumps to 24% for workers without a high school diploma (\$41,725) compared to similarly educated private sector employees (\$33,607).

Just considering wages, high school graduates approach earnings equivalency between private and public sector with public sector workers earning wages 2% less than their private sector counterparts. Nonetheless, when we examine total compensation, high school graduates earn \$3,706 (7%) more annually in the public sector.

However, the wages and total compensation received by public sector workers at higher levels of education are less than comparable workers in the private sector. The relatively better benefits received by educated public sector workers are not enough to compensate for the pay difference. For example, government workers with a Bachelors degree earn on average 14% less than similarly educated workers in the private sector. When considering total compensation, these public-sector workers still receive 5% less.

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## The Growing Role of Benefits in Employee Compensation Costs

Benefits, once referred to as fringe benefits, account for an ever-increasing portion of employee compensation costs. Benefit growth is partially fueled by the tax deductibility of health insurance payments and pension contributions which allows employers to compensate employees without either the employer or employee paying income tax at the time of compensation. Sometimes referred to as tax “efficient” compensation, the Federal government foregoes \$300 billion annually in income tax revenue to subsidize these benefits (U.S. Congress, Joint Committee on Taxation 2006). Health insurance and pension benefits are particularly attractive to middle and upper income employees who face higher marginal income tax rates.

Organizational size is the single strongest predictor of employee benefit participation and compensation. For example, employee participation in retirement plans varies considerably by organization size. Organizations with 1 to 99 employees have employee pension participation rates of 38%, organizations with 100 to 499 employees have participation rates of 64% and organizations with 500 or more employees, 81% of employees participation in retirement plans. The pattern is similar for health insurance benefits. Organizations with 1 to 99 employees have employee participation rates in medical insurance of 43%, organizations with 100 to 499 employees have participation rates of 61% and organizations with at least 500 employees have a 71% participate rate in medical insurance plans. This pattern is replicated for prescription drug and dental care plans (U.S. DOL BLS September 2009, Bulletin 2731).

The Employer Costs for Employee Compensation (ECEC) survey provides the only valid and reliable estimate in the United States of benefit costs incurred by employers. It is conducted quarterly by the U.S. Bureau of Labor Statistics. The ECEC includes data from both private industry and state and local government employees and provides data for private employers by firm size. This study uses these ECEC sample estimates to calculate relative benefit costs for private and public employees in California. (Please see data Appendix for more a detailed description).

Public sector employees received more of their compensation in the form of benefits than private sector workers. The distribution of employer costs of compensation for all private firms and by size along with those of state and local government is listed in Table 3. In the table the positive correlation between firm size and the benefit share of total compensation is evident.

On average, benefits costs are 30% of total compensation for private firms as compared to 35.7% for state and local governments. Private sector benefits costs range from 27.2% for small private employers with less than 100 employees to 33.5% for private employers with 500 or more employees. The compensation data reveal considerable variation within the private sector and between the private sector and state and local government compensation. Public employees not only receive more of their compensation in benefits, but the mix of benefits is different among paid leave, supplemental pay, insurances, retirement security and legally mandated benefits. While overall paid leave costs are similar, private sector employees receive more vacation pay while public employees receive greater sick leave compensation (not shown). Holiday and personal time compensation is similar. Supplemental pay accounts for just 1.1% of compensation for public employees (mostly from overtime pay) but accounts for 3.5% of large firm private sector worker compensation (generally due to bonuses given by large firms).

**Table 3 The distribution of employer costs of compensation for private employers by firm size and for state and local government**

| Employer Costs                              | Private sector employers |                   |                      |                       | State and local government |
|---|--------------------------|-------------------|----------------------|-----------------------|----------------------------|
|   | All                      | 1 to 99 employees | 100 to 499 employees | 500 or more employees |                            |
| <b>Total compensation</b>                   | <b>100%</b>              | <b>100%</b>       | <b>100%</b>          | <b>100%</b>           | <b>100%</b>                |
| <b>Wages and salaries</b>                   | <b>70.0%</b>             | <b>72.8%</b>      | <b>69.6%</b>         | <b>66.5%</b>          | <b>64.3%</b>               |
| <b>Total benefits (itemized below)</b>      | <b>30.0%</b>             | <b>27.2%</b>      | <b>30.4%</b>         | <b>33.5%</b>          | <b>35.7%</b>               |
| <i>Paid leave (Vacation, holiday, sick)</i> | 7.4%                     | 6.2%              | 7.3%                 | 9.2%                  | 8.6%                       |
| <i>Supplemental pay (bonus, overtime)</i>   | 2.8%                     | 2.3%              | 2.9%                 | 3.5%                  | 1.1%                       |
| <i>Insurance (health, life, disability)</i> | 7.7%                     | 7.0%              | 8.2%                 | 8.2%                  | 11.8%                      |
| <i>Retirement benefits</i>                  | 3.6%                     | 2.5%              | 3.4%                 | 5.6%                  | 8.2%                       |
| <i>Legally required</i>                     | 8.5%                     | 9.3%              | 8.7%                 | 7.0%                  | 6.0%                       |

Source: BLS ECEC December 2009 data. Unpublished compensation data for the Pacific Census division.

On the other hand, public employees receive considerably more of their compensation from employer-provided insurance. Insurance accounts for 7.7% of private sector compensation but 11.8% of state and local government employee costs. Retirement benefits also account for a substantially greater share of public employee compensation, 8.2% compared to 3.6% in the private sector. As with most benefits, the differences between private and public employees' compensation costs shrink for larger private-sector firms.

Legally required benefits account for a greater share of the small employers' compensation, as organizational size increases these benefits costs decrease in relative importance. In local and state government employment, legally required benefits represent a substantially smaller share of benefit costs for several reasons. First, a nontrivial number of public employees do not participate in social security, which partially explains their higher pension costs.<sup>3</sup> These employees are not eligible for Social Security benefit payments at retirement unless they chose to work in another job elsewhere which is covered by Social Security. Second, state and local governments do not participate in the federal unemployment system. Lastly, since state and local governments offer more stable employment they pay lower rates into the state unemployment insurance trust fund, because unemployment insurance contribution rates are partially experience rated.<sup>4</sup>

In summary, state and local government workers receive more of their compensation in employer-provided benefits. Specifically, public employers contribute relatively more toward employee health insurance and retirement benefits costs. Public employee benefit costs, however, are relatively lower for supple-

mental pay and legally required benefits than those of private sector employees. To determine whether public employees are overpaid, the specific question that should be addressed is whether higher benefit costs more than offset the lower wages paid to California public employees. That is the question we turn to next.

## Assessing Private and Public Relative Pay and Benefits

The IPUMS-CPS data are used to assess the relative employment costs of private versus public sector workers in California. The CPS data on individuals provides information on an array of demographic characteristics including full-time status, education level, occupation, years of experience (as a function of age), gender, race, organizational size, and industry. In California, there are important differences between state and local government workers compared to those in the private sector. On average, government workers are: more experienced (22 years versus 20 years); more likely to be female (55% to 40%); work more hours (37 to 39); more likely to be Black (11% to 6%); less likely to be Asian (12% to 14%); and less likely to be Hispanic (25% to 35%).

California public employees work on average more hours per year than their private sector counterparts, making them unique among public sector workers throughout the country. However, the distribution of relative hours is uneven. Table 4 reports average annual hours of work for the two sectors and by educational attainment for full-time workers. On average public employees worked almost three days or 1.1% more than workers in the private sector. However, public employees with a professional or Masters degree worked fewer hours, 4.7% and 3.8% less, respectively. In California, differences in the number of work hours do not appear to sharply delineate private from public employment as it does elsewhere in the country (Keefe 2010a).

**Table 4 Annual hours of work by education level for full-time private and public sector workers in California**

|                                   | Private sector | State and local government | Public to private |
|-----------------------------------|----------------|----------------------------|-------------------|
| Average for all full-time workers | 2,110          | 2,133                      | 1.1%              |
| By education level                |                |                            |                   |
| Less than high school             | 1,968          | 2,031                      | 3.2%              |
| High school                       | 2,057          | 2,046                      | -0.6%             |
| Some college                      | 2,096          | 2,057                      | -1.9%             |
| Associates degree                 | 2,088          | 2,109                      | 1.0%              |
| Bachelors degree                  | 2,170          | 2,160                      | -0.5%             |
| Professional degree               | 2,504          | 2,386                      | -4.7%             |
| Masters degree                    | 2,260          | 2,174                      | -3.8%             |
| Doctorate degree                  | 2,389          | 2,470                      | 3.4%              |

Source: Current Population Survey: IPUMS 2009.

What is the relative pay and total compensation of public sector workers compared to those in the private sector? The CPS data on earnings with the ECEC data on benefits allow us to answer these questions. The ECEC data are employed to calculate total employer compensation costs for each employee in the sample.<sup>5</sup> Each observation has an earnings and total compensation measure. Table 5 reports the results of a standard earnings equation on four measures: annual and hourly earnings; and annual and hourly total compensation.

**Table 5 Regression adjusted wage and compensation premium for public sector workers in California**

|                          | Earnings   |           | Total compensation |        |
|--------------------------|------------|-----------|--------------------|--------|
|                          | Annual     | Hourly    | Annual             | Hourly |
| State & local government | -7.77% *** | -6.36% ** | 0.89%              | 2.29%  |
| State government         | -7.55% *   | -8.92% *  | 1.07%              | -0.28% |
| Local government         | -7.86% *** | -5.38% *  | 0.01%              | 3.28%  |

Control variables: hours of work, education, experience, organizational size, gender, race, and disability.

Significance levels: probability estimate 0 is \* >.05, \*\*>.01, and \*\*\*>.0001

The estimates represent the earnings and total compensation premium of California state and local government workers relative to private sector workers. Columns 1 and 2 provide estimates for employee wages. The annual wages of state and local California public employees are 7.77% less than comparable private sector workers (earning results are all statistically significant). The estimates in rows 2 and 3 separate out state and local workers. State workers earn 7.55% less than workers in the private sector and local government workers earn 7.86% less. The results in column 2 compare hourly wages. Overall, the hourly wages of California's state and local employees are 6.36% less than employees in the private sector. Separately, the hourly wage gap is 8.92% for state and 5.38% for local government workers in California.

Now that it has been established that public sector workers are *not* overpaid what happens when benefits are considered? Results on total compensation, annual and hourly, show that the more generous benefits received by public sector workers is just enough to make up for the significant negative wage gap—these results are reported in columns 3 and 4. Importantly, the point estimates are very small and none of the estimates are statistically different from zero. *There is no measurable difference in total compensation between public and private sector workers.*

The results presented here provide strong evidence that California public employees are not over-compensated when compared to similar private sector workers.

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## Conclusion: Are California Public Employees Overpaid? No.

The estimates from the wage analysis indicate that California public workers, both state and local, are not overpaid. An apples-to-apples comparison which accounts for education, experience, hours of work, organizational size, gender, race, ethnicity, and disability reveals no significant difference between private and public employee compensation costs.

The data analysis, however, reveals substantially different approaches to staffing and compensation between the private and public sectors. On average, California public sector workers are more highly educated than those in the private sector workforce (55% of full-time California public sector workers hold at least a four year college degree compared to 35% of full-time private sector employees).

The public sector appears to set a floor on compensation particularly improving the earnings of workers without a high school diploma compared to similarly educated workers in the private sector. This result is due in part because the earnings floor has collapsed in the private sector (Lee 1999).

Benefits are allocated differently between private and public sector full-time workers in California. State and local government employees receive a higher portion of their compensation in the form of employer provided benefits, and the mix of benefits is different than the private sector. Public employers underwrite 35.7% of employee compensation in benefits, whereas private employers devote 30% of compensation to benefits. Public employers provide better health insurance and pension benefits. Insurance accounts for 7.7% of private sector compensation but 11.8% of state and local government employee costs. Retirement benefits also account for a substantially greater share of public employee compensation, 8.2% compared to 3.6% in the private sector. Public employees continue to participate in defined benefit plans managed by the state, while private sector employers have switch to defined contribution plans, particularly 401(k) plans. On the other hand, public employees receive considerably less supplemental pay and vacation time, and public employers contribute significantly less to legally mandated benefits.

Union status was omitted from this study of earnings and compensation comparisons, since it has been a focal point of the compensation controversy. This means that, in essence, we are statistically comparing unionized public sector workers with all private sector workers – both union and nonunion – rather than with their union counterparts. Unionized private sector workers have both better pay and higher benefits, of course, so our standard of comparison is very conservative.

It is alleged by many governors and others that public employee unions and collective bargaining have produced an over compensated work force.<sup>6</sup> While this is a provocative hypothesis, its main assertion has been falsified by this analysis. The average value in total compensation received by state and local government employees is similar to that of their private-sector counterparts. This finding has now been replicated nationally in several other studies (Keefe 2010; Schmitt 2010; Thompson and Schmitt 2010; Bender and Heywood 2010).

Alternately, high unionization rates may be a response to monopsony power (where one employer dominates) exercised by government over many critical occupations, where employees have no viable labor-

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market alternatives to government employment. Additionally it is well known that taxpayers do not want to pay higher taxes. Taxpayers exert considerable pressure on elected representatives to resist increases in compensation, which creates a formidable incentive and opportunity to hold government pay below market rates. Unionization represents a viable legal response to employer labor market power. The pattern of California public employee unionization is consistent with broader global patterns of unionization. For example, a study of 27 developed countries found a pattern of public employee unionization consistent with that of California (Blanchflower 2006). The study reports that union density is negatively correlated with education in the private sector and positively correlated in the public sector—just as we observe in California. Possibly, a more important question for policy makers, rather than why highly educated public employees are unionized, is why relatively less educated and low-paid private sector employees are inadequately represented by unions.

In sum, when state and local government employees are compared to private sector workers with similar characteristics they earn about 7% less on average. When benefits are taken into account the disparity no longer exists as total compensation costs, on average, are similar between the two sectors.

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## Data Appendix

This study uses the Integrated Public Use Microdata Series (IPUMS) of the March Current Population Survey (CPS). The CPS is a monthly U.S. household survey conducted jointly by the U.S. Census Bureau and the Bureau of Labor Statistics. The March Annual Demographic File and Income Supplement is the most widely used source for earnings used by social scientists (King et al. 2009). This sample provides organizational size which is a critical variable for our analysis of benefits. The sample is restricted to California employees and excludes self-employed, part-time, agricultural, and domestic workers. The IPUMS-CPS identifies an employee's full-time status, education level, and experience level as a function of age minus years of education plus five, gender, race, employer organizational size, and industry. The IPUMS-CPS sample was selected for this analysis because the March CPS Annual File provides information on organizational size, not provided by the larger CPS sample in the Merged Outgoing Rotation Groups (MORG).

The Employer Cost of Employee Compensation (ECEC) for the Pacific Census Division (California, Washington, Oregon, Hawaii, and Alaska) data were used to calculate total compensation costs. The ECEC survey and method of data collection is expensive, thus the sample is not sufficiently large enough to provide reliable state level benefit cost estimates. The BLS did share their unpublished sample estimates for individual states with assurances that there is not significant differences in the relative distribution of benefits across them.

**Table A1 Benefit mark-up adjustment to wages by occupation and firm size**

| Occupation                            | Private sector firm size |                      |                       | State and local government |
|---------------------------------------|--------------------------|----------------------|-----------------------|----------------------------|
|                                       | 1 to 99 employees        | 100 to 499 employees | 500 or more employees |                            |
| All workers                           | 1.2310                   | 1.2535               | 1.2624                | 1.3519                     |
| By occupation:                        |                          |                      |                       |                            |
| Management, business, and financial   | 1.1960                   | 1.1967               | 1.2157                | 1.3084                     |
| Professional and related              | 1.2038                   | 1.2064               | 1.2501                | 1.3251                     |
| Sales and related                     | 1.1926                   | 1.2433               | 1.2032                | 1.3699                     |
| Office and administrative support     | 1.2363                   | 1.2776               | 1.3038                | 1.4531                     |
| Service                               | 1.2150                   | 1.2765               | 1.3494                | 1.4089                     |
| Construction                          | 1.3151                   | 1.4184               | 1.3476                | 1.4139                     |
| Installation, maintenance, and repair | 1.2348                   | 1.2967               | 1.3043                | 1.3756                     |
| Production                            | 1.2714                   | 1.2886               | 1.3006                | 1.3832                     |
| Transportation and material moving    | 1.3125                   | 1.3370               | 1.3365                | 1.4199                     |

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This study uses these ECEC sample estimates to calculate relative benefit costs for each private and public employee in the California sample. The calculation was done by calculating the relative benefit mark-up for each private sector employee based on the size of the organization that employed the worker and their occupation. The mark-ups are reported in Table A1. State and local government employees' wages were similarly marked up using a benefit weight calculated using the ECEC data. It is assumed that when employees share information about their earnings they do not distinguish paid time off from time worked in salary data. Therefore paid time off is not included in the mark-up. CPS wages also include supplemental pay.

The mark-up used in this study for benefits does not include paid leave or supplemental benefits. The average mark-up for state and local government employees was 0.3519. The average mark-up for workers in small, median and large private sector firms was 0.2310, 0.2535, and 0.2624, respectively. IPUMS CPS sample for California from 2009 was used for the estimates shown and the sample size was 4835.

## Endnotes

<sup>1</sup> There have been eight arrests in Bell over the pay scandal: <http://abcnews.go.com/US/bell-calif-city-leaders-arrested-salary-scandal/story?id=11691192>.

<sup>2</sup> A standard earnings equation using CPS data for full-time workers in California was estimated to produce the estimates of the returns to education.

<sup>3</sup> The Social Security Act of 1935 excluded state and local workers from mandatory coverage. Legislation in the 1950s allowed states to elect voluntary coverage for their employees (Munnell and Soto 2007).

<sup>4</sup> The less an employer's former employees use unemployment the lower the rates and vice versa.

<sup>5</sup> The data appendix provides details on the merged data set and the methods used to create it.

<sup>6</sup> See Keefe 2010b page 3.

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# **Attachment 2**

# A REPORT OF THE HERITAGE CENTER FOR DATA ANALYSIS

ARE CALIFORNIA PUBLIC EMPLOYEES OVERPAID?

JASON RICHWINE AND ANDREW BIGGS

CDA 11-01 • March 17, 2011



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# ARE CALIFORNIA PUBLIC EMPLOYEES OVERPAID?

JASON RICHWINE AND ANDREW BIGGS

**Abstract:** *While it is clear that federal workers' wages and benefits are above market levels, it is less clear whether state and local employees are similarly overpaid. In the past year, several organizations have published studies arguing that state and local workers are underpaid. But these studies undercount or omit important benefits that public workers enjoy, leading to a substantial understatement of state and local compensation. Using the example of California, this paper provides a full accounting of state and local compensation, correcting the omissions of past studies. The conclusion is that California public employees earn up to 30 percent more in total compensation than comparable private-sector workers.*

Public-private pay comparability has become a major political issue in the past year, with some observers claiming that public workers are overpaid, and others claiming they are paid too little. An important aspect of this debate is the difference between federal workers on the one hand and state and local workers on the other. Although federal workers earn higher wages and benefits than comparable private workers,<sup>1</sup> the state and local situation is more complicated. Compared to private workers, state and local workers tend to earn less in wages, but more in benefits. The net impact on overall pay is controversial.

The Center for State and Local Government Excellence,<sup>2</sup> the Center for Economic and Policy Research,<sup>3</sup> the Economic Policy Institute,<sup>4</sup> and the Center on Wage and Employment Dynamics (CWED)<sup>5</sup> have all released similar studies arguing that the compensation that state and local workers receive is less than or equal to that of comparable private workers.

While these studies measure wage differences more or less properly, none of them considers the full benefit premium enjoyed by public workers. A full accounting of benefits needs to include retiree health care, job security, and pension funding

1. James Sherk and Jason Richwine, "Federal Pay Still Inflated After Accounting for Skills," Heritage Foundation *WebMemo* No. 3012, September 14, 2010, at <http://www.heritage.org/research/reports/2010/09/federal-pay-still-inflated-after-accounting-for-skills>.
2. Keith A. Bender and John S. Heywood, "Out of Balance," Center for State and Local Government Excellence, April 2010, at <http://www.slge.org/vertical/Sites/%7BA260E1DF-5AEE-459D-84C4-876EFE1E4032%7D/uploads/%7B03E820E8-F0F9-472F-98E2-F0AE1166D116%7D.PDF> (March 14, 2011).
3. John Schmitt, "The Wage Penalty for State and Local Government Employees," Center for Economic and Policy Research, May 2010, at <http://www.cepr.net/documents/publications/wage-penalty-2010-05.pdf> (March 14, 2011).
4. Jeffrey Keefe, "Debunking the Myth of the Overcompensated Public Employee," Economic Policy Institute *Briefing Paper* No. 276, September 15, 2010, at [http://epi.3cdn.net/8808ae41b085032c0b\\_8um6bh5ty.pdf](http://epi.3cdn.net/8808ae41b085032c0b_8um6bh5ty.pdf) (March 14, 2011).
5. Sylvia A. Allegretto and Jeffrey Keefe, "The Truth About Public Employees in California: They Are Neither Overpaid Nor Overcompensated," Center on Wage and Employment Dynamics *Policy Brief*, October 2010, at <http://www.irle.berkeley.edu/cwed/wp/2010-03.pdf> (March 14, 2011).

using the proper private-sector discount rate. After including these missing pieces of the benefits picture, state and local compensation is substantially higher than the estimates in the existing studies—and well above market levels.

Because state-level benefit data vary widely in quality and availability, it is not possible to provide precise numerical pay comparisons for each state at this time. This paper focuses exclusively on public workers in California, a large state with reasonably good benefit data. Although the numbers discussed here are specific to California, the basic approach could theoretically be replicated for any state, provided the data are available. Because the CWED report also focuses on California, we frequently contrast our methods and results with theirs.

## WAGES

Our public–private wage comparison is very similar to that of the CWED. Both studies use the same dataset and the same basic regression analysis, which allows us to isolate the wage effect of public employment after controlling for a variety of worker characteristics.

**Data and Methods.** We combined the years 2006 through 2010 of the Current Population Survey’s Annual Demographic Supplement, which contains information on annual earnings. The five-year average is more representative of recent trends in government pay, and the larger sample size allows us to add more detailed control variables.

The analysis is limited to adult civilians working full time during the whole previous year. Workers with imputed earnings were dropped, since the imputation process does not take government status into account. Those with annual earnings that seem too low for full-time work (less than \$9,000) were also dropped.

In addition to dummy variables for federal, state, and local government employment, the following controls are used: usual hours worked per week, experience (age minus education minus six), experience<sup>2</sup>, years of education, firm size (six categories), broad occupation (10 categories), immigration status, race, gender, marital status, and year dummies to account for inflation. Also included are interaction terms: (experience x education), (experience<sup>2</sup> x

education), (marital status x gender), and (gender x race).

**Choice of Controls.** Most control variables in wage regressions are uncontroversial, but there is some debate among economists over whether to include certain ones. For example, our inclusion of firm size means that California state workers are effectively compared only to workers at large firms (1,000+ employees), which tend to pay higher salaries than smaller firms.

Since firm size is a characteristic of employers rather than employees, including firm size is controversial. Some argue that larger firms tend to pay higher wages because they are more successful, that a state government cannot be “successful” in any market sense, and therefore that a firm size control is inappropriate. However, working at a large firm partially reflects an employee’s preferences for the characteristics that large firms tend to exhibit. If state and local workers quit in favor of private-sector jobs, they would likely choose a private firm that is above average in size. For that reason, controlling for firm size is our preference for both wages and benefits.<sup>6</sup> Excluding the firm size control would make the observed state and local wage penalties substantially smaller than what is reported here.

Some economists also control for union status, but that does not seem appropriate: Collective bargaining drives up wages, and California’s decision to allow state workers to unionize is essentially another means of boosting compensation. One could argue that union membership, like firm size, is also a state worker’s revealed preference that he would continue to seek in the private sector. Unlike firm size, however, this preference could be driven mainly by the higher wages and benefits of unionized labor, which should be included in state and local compensation. Controlling for union status would likely raise this paper’s estimate of the wage penalty but would not change any of the conclusions.

The CWED report includes firm size but excludes union status, just as we do.

**Results and Conclusion.** We regressed the log of annual earnings on the control variables listed above. Results are displayed in Table 1. The first column lists key independent variables, and the second col-

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6. An interesting compromise on firm size is used in “The Economic Policy Institute Is Wrong: Public Workers Are Overpaid,” Center for Union Facts, February 22, 2011, at [http://www.unionfacts.com/downloads/Public\\_Sector\\_UnionsBrief.pdf](http://www.unionfacts.com/downloads/Public_Sector_UnionsBrief.pdf) (March 14, 2011).

**Wage Regression Results, 2006–2010**

| Control Variable      | Coefficient (%) |
|-----------------------|-----------------|
| Hours worked per week | 1.7             |
| Experience (in years) | 3.9             |
| Education (in years)  | 9.9             |
| Foreign-born          | -11.4           |
| Married               | 18.0            |
| Black                 | -16.6           |
| Hispanic              | -10.7           |
| Female                | -14.0           |
| Federal worker        | 4.8             |
| State worker          | -10.2           |
| Local worker          | -0.6            |
| Observations          | 25,576          |
| Adjusted r-squared    | 0.506           |

Note: All coefficients significant at 95 percent level or higher, except local worker. Additional controls not shown. See text for details.

Source: Authors' calculations using data from the U.S. Census Bureau, Current Population Survey.

Table 1 • CDA 11-01  heritage.org

umn shows the percentage increase in wages associated with a one-unit increase in each variable. For example, an additional year of education leads to a 9.9 percent increase in wages, all else equal.

The most important variables in the list are state and local government status. After controlling for observable skills and a detailed list of personal characteristics, state workers in California earn about 10.2 percent less in wages than private-sector workers. Local workers see a much smaller, statistically insignificant penalty of 0.6 percent. Combining state and local workers together yields a significant penalty of 3.7 percent (not shown in the table).

## BENEFITS

This paper's wage results are similar to those of the CWED, but we begin to diverge with benefits. We first review the "standard" benefit calculations used by CWED and other groups, and then describe the omitted or undercounted portions.

**"Standard" Benefit Calculation.** The U.S. Bureau of Labor Statistics (BLS) publishes benefit-wage ratios for private and state and local workers collected through the federal government's Employer Costs for Employee Compensation (ECEC) survey. These figures include: paid leave (vacation, holiday, or sick pay), supplemental pay (overtime and bonuses), insurance (life and health coverage), retirement and savings (which includes employer contributions to defined-benefit and defined-contribution pension plans), and legally required benefits, such as Social Security and Medicare payroll taxes.

In the Pacific region of the U.S. Census, which includes California, benefits for state and local employees were 55.5 percent of wages (37.5 percent of total compensation). For private-sector workers in large firms, benefits equaled 50.3 percent of wages (33.5 percent of compensation). The BLS does not release state-specific data due to small sample sizes.<sup>7</sup>

**Omitted or Undercounted Benefits.** Available benefits data are not nearly as detailed as wage data. CWED and other organizations do a reasonable job of approximating total employee compensation given the limited BLS data they use. However, the BLS data are incomplete, leading CWED and others to omit or understate two important benefits for public-sector employees: retiree health care and defined-benefit pensions.

**Retiree Health Benefits.** Because there are no payments to active employees, retiree health benefits are not included in BLS compensation data. For private-sector workers, this omission is generally unimportant—private workers retire later, relatively few private workers receive retiree health coverage, and eligibility has been tightened and premiums increased for those who do. By contrast, almost 90 percent of state and local governments offer retiree health benefits to employees who retire in their 50s, with the government paying much of their costs, often including Medicare premiums and deductibles.<sup>8</sup> State actuarial reports show that the annual accruing costs of California retiree health benefits

7. If California has more generous public-sector benefits than other states in the region (which is likely, given our review of the pension and retiree health data), then the BLS Pacific Region figures may slightly understate total California compensation. The effect would be small because of the size of California's population relative to that of other states.

8. The Pew Center on the States, "Promises with a Price: Public Sector Retirement Benefits," December 2007, at [http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/State\\_policy/pension\\_report.pdf](http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/State_policy/pension_report.pdf) (March 16, 2011).

equal approximately 10.2 percent of wages or 6.5 percent of total compensation.<sup>9</sup>

Moreover, even these actuarial figures will understate the true value of retiree health coverage. The reason is that the costs of coverage are calculated as the amount by which retiree coverage increases costs for the employer plan by increasing the average age of the covered population. The retiree otherwise would have to purchase coverage in the individual health market, which is approximately 25 percent more expensive for a given policy than group coverage.<sup>10</sup> Thus, the true subsidy to the individual is the employer cost plus the cost difference between individual and group health coverage. In this case, the total subsidy would equal about 12.8 percent of wages or slightly more than 8 percent of total compensation.

*Proper Pension Discount Rate.* An important difference between public-sector and private-sector employment is the predominance of traditional defined-benefit pensions in the public sector versus 401(k)-type defined-contribution plans in the private sector. All pay comparisons to date have failed to capture certain important distinctions between the two.

In a defined-benefit pension plan, employer contributions are only a proxy by which one *infers* the value of the future pension benefit, which is the actual compensation paid to workers. To infer that value accurately, one must consider both the size of the employer contribution and the implicit rate of return paid on it from the time of payment through the time the benefit is received.

For defined-contribution pension plans, the return on contributions is straightforward. Individuals may invest employer contributions as they choose, in assets with a mix of risk and return they find optimal. For comparability with defined-benefit pension plans, which are generally riskless to the employee, individuals would need to invest

defined-contribution assets in guaranteed U.S. Treasury securities, currently yielding around 4 percent annually over 20 years.

For defined-benefit plans, however, the implicit rate of return on contributions is a function of the plan's benefit formula. This return can differ from person to person, but on average it will equal the discount rate or assumed investment return for the program as a whole.

In private-sector defined-benefit plans, by law the discount rate equals the interest rate on a portfolio of high quality corporate bonds. Currently, such a portfolio yields approximately 5.5 percent. State and local pensions generally assume a more aggressive discount rate of 8 percent, based on the expected return on assets held by the fund. This means that the employer contribution today is equal to the eventual benefit discounted back to the present at a 5.5 percent (private) or 8 percent (public) interest rate. Put another way, it means that public-sector employees receive a guaranteed return of 8 percent on their employers' pension contributions.<sup>11</sup>

If one compares only the size of employer contributions while excluding the implicit return, one would understate true compensation delivered through defined-benefit pensions. To account for this, we multiply defined-benefit pension contributions by an adjustment factor designed to compensate for the different implicit rates of return on various pension plans.

We use a stylized age-earnings profile to calculate these factors using age-specific earnings information developed by the Social Security Administration.<sup>12</sup> As most state and local employees have roughly 25 years of service at retirement and retire in their mid-50s, we generate earnings from age 20 to age 55, with retirement at age 56. For each pension type, we use an iterative process to calculate the contribution rate that, compounded at the pension type's

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9. "State of California Retiree Health Benefits Program," Gabriel Roeder Smith & Company, October 23, 2009, at [http://www.sco.ca.gov/Press-Releases/2010/OPEB\\_February\\_2010.pdf](http://www.sco.ca.gov/Press-Releases/2010/OPEB_February_2010.pdf) (March 14, 2011).

10. Melinda Beeuwkes Buntin, José S. Escarce, Kanika Kapur, Jill M. Yegian, and M. Susan Marquis, "Trends and Variability in Individual Insurance Products," *Health Affairs*, September 24, 2003, at <http://content.healthaffairs.org/content/early/2003/09/24/hlthaff.w3.449.full.pdf+html> (March 14, 2011).

11. It makes no difference to the employee whether the actual return on assets equals 8 percent; investment risk is borne by the plan sponsor.

12. Michael Clingman and Kyle Burkhalter, "Scaled Factors for Hypothetical Earnings Examples under the 2010 Trustees Report Assumptions," Social Security Administration *Actuarial Note* No. 2010.3, February 2011, at <http://www.retirement.gov/OACT/NOTES/ran3/an2010-3.html> (March 16, 2011).

specific implicit rate of return, will generate the same benefit in retirement. The base pension is a defined-contribution plan; the adjustment factor for the other plans equals the defined-contribution plan's required contribution rate divided by the plan's own contribution rate.

This adjustment factor, which is greater than 1 as long as the expected return exceeds the riskless return, is multiplied by each sector's employer contribution to defined-benefit pension plans. The resulting value equals the equivalent employer contribution, were all workers to hold defined-contribution pensions. The adjustment factors are 1.20 for private-sector defined-benefit plans, and 1.67 for state and local defined-benefit plans.<sup>13</sup>

These values are then multiplied by the normal cost of California pension plans, which is the cost of benefits (as a percent of wages) accruing in a given year. Based on a weighted average of normal costs for California's major pension funds—CalPERS; CalSTRS; the University of California pension; and the pensions of city employees in Los Angeles, San Francisco, and San Diego—the higher implicit return on public defined-benefit pensions increases the compensation of California's government workers by approximately 4 percent.<sup>14</sup>

## JOB SECURITY

The final factor considered in this paper is job security. According to the BLS Job Openings and Labor Turnover Survey (JOLTS), a private-sector worker has an approximately 20 percent chance of being fired or laid off in a given year, while for state and local employees the probability is only 6 percent. This effectively gives state and local employees an insurance policy against being discharged. What follows is an attempt to put a dollar value on that insurance.

In *The Wealth of Nations*, Adam Smith originated the idea of what today are called "compensating wage differentials," that is, changes to wages that balance the positive or negative characteristics of jobs. Smith explains how this applies to the risk of unemployment:

Employment is much more constant in some trades than in others. In the greater part of

manufactures, a journeyman may be pretty sure of employment almost every day in the year that he is able to work. A mason or a bricklayer, on the contrary, can work neither in hard frost nor in foul weather, and his employment at all other times depends on the occasional calls of his customers. He is liable, in consequence, to be frequently without any. What he earns, therefore, while he is employed must not only maintain him while he is idle, but make him some compensation for those anxious and desponding moments which the thought of so precarious a situation must sometimes occasion.... *The high wages of those workmen, therefore, are not so much the recompense of their skill as the compensation for the inconsistency of their employment.* (Emphasis added.)

Just as positions with a high incidence and duration of unemployment should pay a compensation premium, positions with greater job security—such as in the public sector—should pay less than similar jobs in the private sector.

**Theory.** To estimate the value of job security on effective compensation, we use what in financial economics is termed a "certainty equivalent," a guaranteed payment that individuals would find equally attractive compared to a higher but uncertain payment. For example, an individual might be willing to accept a guaranteed payment of \$45,000 in lieu of a 50 percent chance of winning \$100,000. The more risk-averse individuals are, the lower the certainty equivalent is relative to the probability-weighted expected value of the risky payment.

How much salary reduction would a private-sector worker accept to have the job security of a public-sector employee? To calculate this value, we begin with an isoelastic utility function of the form

$$u(c) = \frac{c^{1-\rho}}{1-\rho}$$

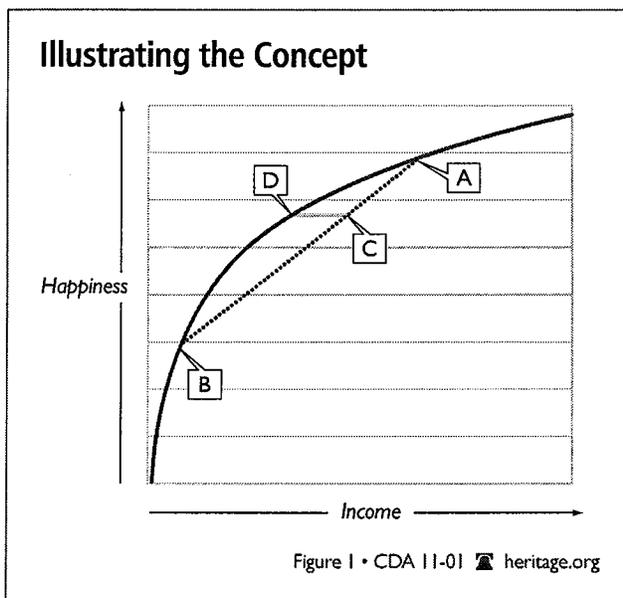
where  $u$  is the utility derived from consumption  $c$ , and  $\rho$  is the coefficient of constant relative risk aversion (CRRA). Utility generated by income will rise as income rises, but at a decreasing rate. Moreover, the rate at which the marginal utility of consump-

13. While not applicable in this study, the adjustment factor for federal-employee defined-benefit pensions is 1.33.

14. These estimates account for employees who lose their contributions either by leaving government employment before vesting, or who die before claiming benefits. The difference in pension benefits for full-career employees would be larger than shown here.

tion declines increases with the risk aversion of the individual. A more risk-averse individual will be willing to accept a lower-certainty-equivalent income because the increase in expected utility by accepting employment risk is lower.

**Graphical Illustration.** The theory may be more understandable using a simple chart. Figure 1 shows a stylized utility function, where the curved line shows the relationship between income (on the horizontal axis) and utility (on the vertical axis). Higher income generates more happiness, but at an ever-declining rate. Point A represents the income/utility if the individual keeps his job throughout the year, while Point B represents the income/utility should he lose his job. Point C, which lies between the two, represents the individual's expected utility from his employment—the probability-weighted average of the utilities at Points A and B.



Point D lies to the left of Point C and represents the certainty-equivalent income—that is, the compensation with zero probability of discharge that would generate the same utility as the non-guaranteed compensation the individual currently receives.

**Data.** Using this utility function, we first calculate the utility of total compensation for a worker

assuming he retains his job full time, assuming total compensation of \$85,000. The utility in the case the worker becomes unemployed is then calculated, which involves assumptions about the duration of unemployment, the level of unemployment benefits, and the compensation of the new job the individual may find. For the baseline case, the following is assumed: 19 weeks of unemployment, unemployment benefits of \$450 per week (the California maximum), and a current position pay premium of 15 percent (based on our previous wage and benefit calculations). Using these assumptions, annual compensation in the event of unemployment is \$54,400, for which the authors also calculate a utility value.

The expected utility is the weighted average of utility if the individual remains employed throughout the year and his utility if the individual is discharged. In this exercise, we do not wish to calculate the salary reduction an individual would accept to have a zero probability of being discharged, but merely the difference between the private-sector rate (20 percent) and the public-sector probability (6 percent). Thus, we approximate by assigning a probability of discharge equal to the difference between the two (14 percent). Expected utility is equal to the weighted utilities of consumption assuming the individual is discharged (14 percent probability) or remains employed throughout the year (86 percent probability).

To calculate the utility of consumption, a value for the risk-aversion of public-sector employees is required. Based on data from the Panel Study of Income Dynamics, one study calculated a CRRA for public employees of 5.4, significantly higher than the estimate for private-sector workers of 2.8.<sup>15</sup> Other studies have also concluded that public employees are more risk-averse than private-sector workers.<sup>16</sup>

The certainty-equivalent compensation is derived by calculating the riskless compensation whose utility would equal the expected utility of compensation under the risk of unemployment. This value is \$73,840. The base compensation of \$85,000 exceeds this value by approximately 15 percent,

15. Alicia H. Munnell, Kelly Haverstick, and Mauricio Soto, "Why Have Defined Benefit Plans Survived in the Public Sector?" Center for Retirement Research *State and Local Pension Plans Issue in Brief* No. 2, December 2007.

16. Don Bellante and Albert N. Link, "Are Public Sector Workers More Risk Averse than Private Sector Workers?" *Industrial and Labor Relations Review*, Vol. 34, No. 3 (April 1981), pp. 408–412.

thereby generating this paper's estimate of the job security compensation premium. Using a more conservative assumption that California public-sector workers, were they to work in the private sector, would have half the probability of becoming unemployed (perhaps due to their higher average education) and the job security pay premium would be around 5 percent.<sup>17</sup>

## CONCLUSION

Whether public-sector employees receive above-market compensation is an empirical question that demands a thorough accounting of wages, benefits, and job security. In the case of California public employees, wages are slightly lower in the public

sector. Initially, benefits appear only slightly higher, implying rough parity in compensation between the public and private sectors. However, properly accounting for retiree health benefits and defined-benefit pension plans generates a public compensation premium of around 15 percent. The additional job security granted to public-sector employees is equivalent to an approximately 15 percent increase in public compensation, meaning that the total public-sector pay premium in California may be as high as 30 percent.

—*Jason Richwine is Senior Policy Analyst in the Center for Data Analysis at The Heritage Foundation and Andrew Biggs is a Resident Scholar at the American Enterprise Institute.*

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17. At this point it is difficult to estimate probabilities and durations of unemployment for public-sector workers, though we are investigating possible methods to do so.

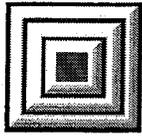
# **Attachment 3**

# Employee Compensation Comparison

|  | Beverly Hills Safety | Beverly Hills Non-Safety | Neighboring Cities Non-Safety | Private Sector |
|--|----------------------|--------------------------|-------------------------------|----------------|
| Employees  | 207                  | 468                      |                               |                |
| Average Base Salary                                      | \$96,000             | \$55,100                 |                               |                |
| Special Pay (Education, Assignment Bonuses)              | \$9,000*             | \$3,500                  |                               |                |
| Overtime   | \$17,000             | \$470                    |                               |                |
| Other Benefit Cost (Medical, Dental, Etc.)               | \$20,600             | \$13,500                 |                               |                |
| City's portion of the pension cost                       | \$27,000             | \$6,100                  |                               |                |
| Employee portion of pension (currently paid by the City) | \$9,500*             | \$4,700                  |                               |                |
| <b>Total:</b>  | <b>\$179,100</b>     | <b>\$83,370</b>          |                               |                |

**\* Currently included in final year salary for pension calculation.**

# **Attachment 4**



**THE WATERS  
CONSULTING  
GROUP, INC.**

January 10, 2012

Mr. Mark Brower  
Senior Budget and Financial Analyst  
City of Beverly Hills  
455 N. Rexford Dr.  
Beverly Hills, CA 90210  
(via email at [mbrower@beverlyhills.org](mailto:mbrower@beverlyhills.org))

**Re: Compensation Survey Work Plan**

Dear Mr. Brower:

We would like to thank you for taking the time to discuss with us the possibility of conducting a total compensation survey for the City of Beverly Hills. Last week's conference call helped identify the questions the City is seeking to answer as part of this process, as well as the type of comparison you would like to conduct. We understand that the City is seeking the assistance of a qualified compensation consultant to conduct a total compensation analysis of both the public and private sector (where relevant). The ultimate goal is to compare the combined value of salaries and benefits with the appropriate labor market to ensure Beverly Hill's offerings meet the needs of the City in a thoughtful and cost-effective way.

WCG has worked extensively with public sector organizations on their compensation systems, including municipalities of a similar size and complexity to Beverly Hills, and has proposed a work plan and corresponding professional fee structure that meets our understanding of the City's desired scope of work and involvement in this process. We have described below the recommended work plan and would be pleased to collaborate with all appropriate stakeholders, including elected and appointed officials and City staff, in further refining our proposed methodology to best suit your needs.

1. Project planning and administration for the lifetime of the project, including the initial onsite strategy meeting as well as meetings with the City's Leadership Team, elected officials and others as designated by the City and The Waters Consulting Group, Inc. (WCG)
2. Comprehensive Total Compensation Survey
  - a. **Salaries:** This phase of the project will involve determining the pay levels of incumbents in similar positions in selected organizations using custom and/or published market data. WCG's preferred strategy for the number and type of positions within the City is to use both a custom survey and published public and private salary data on a local, regional, and national basis.
    - i. To select the appropriate benchmark positions, WCG will work with the City in identifying those that are commonly found in other local government providers, cities of comparable size and complexity, as well as

private sector entities. The selection of jobs will ensure a broad representation of departments, pay grades, work duties, and essential functions.

- ii. Market definition, which is a significant policy decision in a project of this nature, should be based on the identification of the City's competition for talent. Some factors that may be used to identify such organizations are size, operating budget, location/proximity, population change, and similarity in services provided. It is our understanding that the City has already defined what organizations will be surveyed, though WCG would be happy to review this list and submit for approval changes we believe to be appropriate.

- b. **Benefits and Other Compensation:** In addition to gathering direct pay data for benchmark positions, WCG will collect from comparable organizations the value of benefit offerings such as supplemental pay, medical/dental/vision contributions, paid time off, retirement, deferred compensation, disability programs, wellness programs, safety programs, cafeteria benefits, and other remuneration such as bonuses and gainsharing. WCG will work closely with the City's Project Team in identifying the total compensation elements to be collected via custom and/or published surveys. As indicated during our multiple discussions, total compensation information is often difficult to secure from the private sector. WCG has been successful gathering such information from private organizations by working onsite, directly with each employer and supplementing the data collected through the use of relevant published private sector data sources. We understand this is the process the City has opted to explore and have included in our professional fee structure the time necessary for doing, inclusive of up to ten private sector benchmark organizations.

The fees associated with a total compensation study inclusive of 15 benchmark jobs and up to 20 benchmark organizations (including 10 private sector) is \$24,900. For a study inclusive of 25 benchmark jobs, the fees are \$29,900. For a study inclusive of 50 benchmark jobs, the fees are \$39,900. Project related expenses are additional and will be billed at cost. Optional/variable services will be billed at the rate of \$175.00 per hour, approved in advance, plus related expenses.

If you have any questions regarding the revised work plan and professional fees, please contact me at (214) 466-2443, my direct line, or by email at [tlcox@watersconsulting.com](mailto:tlcox@watersconsulting.com). We look forward to working with you and other members of the City's staff, as well as elected and appointed officials, on this important project.

Sincerely,

*TL Cox*  
*Director of E-Solutions and Senior Consultant*

CITY OF BEVERLY HILLS, CALIFORNIA

THE WATERS CONSULTING GROUP, INC.

By: x \_\_\_\_\_  
Name:  
Title:

By: x \_\_\_\_\_  
Name: ROLLIE O. WATERS, CMC  
Title: PRESIDENT