



Unintended Consequences

*The economic
impact of
cutting
public sector
wages
and benefits*



INSTITUTE FOR WISCONSIN'S FUTURE
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Summary

Wisconsin citizens are a diverse group, but there is agreement around the need to focus on job creation in the state. New state leaders have developed one strategy to boost job numbers in Wisconsin—by cutting public employees' compensation using furlough days, higher insurance payments and increased pension contributions.

Examination of this proposal using economic simulations shows that reducing household income for state, local and public school workers, as the governor and others want, will lead to reduced economic activity and the loss of 9,900 private-sector jobs in the state, further depressing the recession-plagued economy.

The state leaders promoting these cuts operate on the assumption that public sector employment is somehow 'different' from employment in the private sector. Under this view, cuts to public employees are painless to the rest of the state's residents.

In fact, reducing compensation for state and local employees carries a large and hidden cost. Basic economics shows that prosperity is based on consumers having money to spend. Public sector employees are consumers just like their neighbors whose paychecks come from private employers.

When public employees face reductions in their income, they cannot afford to buy as much from the grocery store, the furniture outlet or the car dealer. At a time when Wisconsin is trying to grow the economy, cutting the disposable income of state, local and school district public sector families undermines purchasing power, the most crucial element in economic recovery and growth.

Using economic modeling software, it is possible to simulate how proposed reductions in public sector worker household income would directly harm Wisconsin's economy. This includes detailed financial models of every county in the state which estimates the ripple effect of cuts in consumer disposable income in local communities.

This analysis shows that the proposed cuts in public worker compensation would lead to the loss of \$660 million a year in economic production in the private sector. It would eliminate \$46 million in property taxes or shift them to other taxpayers. It would noticeably increase the state unemployment rate.

Taking one billion dollars in purchasing power out of the hands of public sector households over the biennium would have a ripple effect in the economy equivalent to laying off sizable numbers of private sector employees in every county. For example, in Brown County the job loss would be the same as losing the entire payroll of Fleet and Farm of Green Bay. In Dane County, it would be like losing the payroll of Dean Health Systems; in Marathon County, like losing Kraft Foods. This "compensation cut" plan is a failed strategy that hurts economic recovery in Wisconsin.

Background

Public documents indicate that during his gubernatorial campaign and since his election, Gov. Scott Walker has insisted that a core part of his economic strategy is to cut sharply into the take-home pay of public sector workers, at the state, county, municipal and school district levels. This would be implemented initially through mandatory furlough days (unpaid days off) along with increased employee contributions both to health insurance and pensions.

Milwaukee Journal Sentinel put it simply: "There's little doubt about where Gov. Scott Walker is coming from when it comes to public employees and the size of state government. With a hole of about \$3 billion in the state budget, Walker aims to wring as many concessions as possible from state workers."¹

Walker's detailed proposals will not be known until he releases his budget in late February. But comments already made give a clear sense of what a concessions package might look like. A widely reported summary puts it this way:

"As a short-term measure, Walker wants to require workers to make a 5% contribution to their pensions. State union workers have traditionally not contributed to their plans. He also wants to increase employees' share of health costs to 12%--up from 4% to 6%, depending on the bargaining unit."² Walker said this would amount to \$154 million over six months.

In addition, it is assumed that the state employee labor contracts will maintain eight unpaid days a year.

It is clear that local governments and school districts are being urged to replicate compensation cuts for county workers, municipal workers and public school employees. The Associated Press reported:

"Wisconsin Gov. Scott Walker promised a gathering of Wisconsin's mayors and local leaders that any cuts in state aid to their communities and school districts will be paired with relief from pension and health care costs. Walker told the community leaders at the League of Wisconsin Municipalities meeting that he wants to give the maximum flexibility needed to deal with any budget cuts."³

This report focuses on the economic consequences of Walker's plan. It does not consider other effects of such a move, including the reduction in important public services that result from widespread furlough days and the increase in state unemployment benefits as a result of the unemployment ripple effects.

¹ *Milwaukee Journal Sentinel*, "PolitiFact: Is Walker right on state being able to curtail bargaining rights for state employee unions?" Jan. 7, 2011. <http://www.jsonline.com/news/statepolitics/113070094.html>

² Lee Bergquist and Jason Stein, "Walker looks at showdown with state employees," *Milwaukee Journal Sentinel*, Dec. 7, 2010. <http://www.jsonline.com/news/statepolitics/111463779.html>

³ Scott Bauer, "Wisconsin governor promises flexibility to deal with cuts," *The Associated Press*, Jan. 28, 2011. Accessed at: <http://www.bloomberg.com/news/2011-01-28/wis-gov-promises-flexibility-to-deal-with-cuts.html>

Costing out the proposal

The cost-out examines the impact of compensation cuts on employee disposable income. These cuts are derived from proposed reductions in employee take home pay based on a package that includes:

- For state employees, eight furlough days each year. Based on 260 working days in the year, this amounts to a 3.1% cut in pay.
- For state employees, payments for insurance and pension that total \$308 million a year (twice the amount Walker cited for six months of increased payments). Based on a total state payroll in 2009 of \$3.9 billion, this amounts to a 7.8% cut in pay.
- For employees of local governments and schools, we assume all county and municipal employees would also have eight furlough days per year. This does not include public school employees because state law mandates a minimum number of school days in the year, so it would be illegal to shut down schools for, say, eight days a year.
- For employees of local governments and schools, we assume that increased contributions for insurance and pension would be half the rate put in place for state employees. In other words, workers for counties, municipalities and schools would take a 3.9% cut in pay because of the increased contributions.

This leads to a final package:

- For state employees, a total cut in compensation of 10.9% (furlough days, contributions to insurance and pensions).
- For employees of county and municipal government, a total cut of 7.0% (furlough days, contributions to insurance and pensions at half the rate of state employees).
- For school employees, a total cut of 3.9% (contributions to insurance and pensions at half the rate of state employees, but no furlough days).

The total value of the package is \$994 million; in effect, one billion dollars.

Unit of Government	Payroll Size	Reduction in Employee income
State	\$ 3.9 billion	\$ 429 million
Local	\$ 4.8 billion	\$ 335 million
School District	\$ 5.9 billion	\$ 230 million

Methodology: Estimating the ripple effect of public sector employee compensation cuts

Economic modeling software can be used to estimate the economic impact of this billion-dollar cut in public workers' purchasing power. Such software simulates the economy at a county level of detail. It is widely used by planners and analysts working in the private sector, public sector and academia. This report used the simulation software known as IMPLAN, which has been widely used since 1993 and is considered an industry standard. IMPLAN version 3.0 was used, with data to the county level from 2009, supplemented by additional 2009 data from the Wisconsin Department of Workforce Development. IMPLAN is made by MIG Inc., based in Hudson, Wisconsin. Its client list includes more than 25 federal agencies, 40 state governments (including Wisconsin), 200 colleges and universities (5 in Wisconsin), 70 local government and planning agencies, and 100 private organizations.

The type of simulation is known as an input/output model. It divides the economy into 440 distinct sectors and then uses data to determine how changes in any one of these sectors influence activity in each of the other sectors. The sectors range from such categories as "dairy cattle and milk production" to "power-driven handtool manufacturing" to "performing arts companies" and "home health care services." One can imagine the simulation as being like a table with 440 rows and 440 columns, with each entry detailing the economic interaction between a economy sector from a row with an economy sector from a column.

The software can estimate the impact of a wide variety of economic scenarios. It estimates both the immediate effects of a cut and the 'ripple effects' as activity in one sector produces effects in other sectors. For example, an increase in orders for a manufacturing firm has direct impacts for that firm and for that firm's suppliers. But it also has "induced" impacts throughout the economy. New orders to Company X lead to increased business in Supplier Y, whose workers in turn will spend their wages on groceries, entertainment, health care and other items.

The simulation can be fine-tuned in various ways. For example, there would be different impacts from cutting one billion dollars in spending power from the wealthiest households in Wisconsin compared with the same dollar cut from the poorest households in Wisconsin. That's because spending patterns are different for the two groups: wealthy households spend much less of their income than do poor households on purchases that boost the local economy. For wealthy households, a much larger portion of income goes into savings, investments and such purchases as vacation travel which takes money out of the state.

Annual wages for Wisconsin public sector workers average between \$33,000 and \$59,000, depending on the branch of government and its geographical location. For this simulation, it was assumed that public employee income cuts were distributed among households ranging from \$15,000 in annual income to \$150,000, with most of it concentrated in the range from \$25,000 to \$75,000.

Finally, because these are estimates based on models and simulations, all results have been rounded off (to two significant digits). The model provides very specific results, but using rounded numbers makes clear that these are estimates rather than actual results.

Findings

The proposal to slash public sector compensation is not an effective strategy to grow the Wisconsin economy or boost employment. In fact, the compensation cuts will result in a significant loss of purchasing power by public employee households with a ripple effect that does significant harm to the economy.

- About 9,900 private sector jobs would be lost statewide—each with an average wage of \$39,000—because of the reduced purchasing power of public sector workers.
- About \$660 million in economic value added would be lost to the state. Value added is the creative activity in the economy; for a business, it’s approximately the difference between how much was spent on raw materials and how much was received in sales revenue. This figure means a \$660 million yearly cut from Wisconsin’s and the nation’s Gross Domestic Products.
- About \$46 million worth of property tax revenue would be lost, due to the decreased economic activity. This money would either be cut from local and school budgets or shifted to other property taxpayers.

The table below summarizes the impact in Wisconsin and in nine of Wisconsin’s most populous counties which have a significant number of state employees.

Induced impact of \$1 billion cut in public sector compensation

	Jobs lost	Lost value of economic activity*	Property taxes lost or shifted
STATE OF WISCONSIN	-9,900	-\$660,000,000	-\$46,000,000
Brown County (Green Bay)	-420	-\$25,000,000	-\$1,600,000
Dane County (Madison)	-3,100	-\$200,000,000	-\$14,000,000
Eau Claire County (Eau Claire)	-210	-\$12,000,000	-\$800,000
La Crosse County (La Crosse)	-200	-\$11,000,000	-\$760,000
Marathon County (Wausau)	-150	-\$8,700,000	-\$610,000
Milwaukee County (Milwaukee)	-1,500	-\$97,000,000	-\$6,000,000
Outagamie County (Appleton)	-210	-\$13,000,000	-\$880,000
Racine County (Racine)	-210	-\$12,000,000	-\$890,000
Winnebago County (Oshkosh)	-290	-\$16,000,000	-\$1,200,000

*This column gives “value-added” that is foregone. ‘Value added’ is the difference between total output and the cost of all inputs.

Conclusion

The economic ripple-effect analysis is unequivocal. The proposed plan to reduce compensation for public sector workers and their families is a lose-lose proposition.

- a) Furlough days at the state and local level reduce the availability of vital services to Wisconsin residents.
- b) When public sector workers in Brown County, for example—or any other county in the state—have less to spend, it leads to reduced economic activity in thousands of businesses not only in Brown County but in neighboring counties and throughout the state.
- c) Reduced economic activity leads to further job loss in the private sector and additional losses in tax revenue to the state, deepening the state budget deficit. A vicious downward spiral can be activated.
- d) State leaders cannot make up for the loss in consumer purchasing power by an equivalent amount of tax cuts. That would worsen the deficit and cancel out any savings created by cuts to public sector compensation. According to the Governor, the main goal of cutting public workers' compensation is to solve the deficit problem.

Public sector workers are moderate income people who spend the vast majority of their income on consumer goods—unlike rich households who save the bulk of their wealth. Attempting to right the economy by slashing compensation for public sector workers is like trying to save weight on an overloaded boat by tossing the motor overboard. It just doesn't help in getting you where you want to go.

At a time when job creation and economic growth are priorities for people across Wisconsin, it is clear that the “cut compensation” strategy will not move the state forward.



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