Draft essay for review and comment.
Contact: carlsonhrconsultant@gmail.com

A Public Policy Tale By

Charles E. Carlson

In Fall 2008, the U.S. economy teetered on the precipice of total financial collapse. With a big mortgage on our future, the federal government bought us a little time to consider our alternatives and try to find a safe path.

With demand for goods and services fell dramatically, businesses cut back dramatically, laying off millions of workers and freezing or slashing the pay and benefits of many of those who were able to keep their jobs. Pension savings and housing values disappeared overnight with planning for retirement turning into hoping for some sort of partial retirement someday.

While this is the “new normal” for most Americans, public employees have come through relatively unscathed. Aside from furlough days and some pay freezes, employment, public employee pensions, and extraordinary employer---paid healthcare plans have remained intact.

This will change very soon, and I believe the public sector employees’ status of preferred economic treatment is about to come crashing down. Federal bailout subsidies are running out, state government operating deficits are soaring across the nation, and huge obligations for unfunded benefits are coming due. We have all the factors pulling us into another financial crisis.

However, it is my belief that we have a narrow window of opportunity to use the power of social contracts and effective strategic planning to find our way out of this mess. We have a chance if we can find public sector leaders who have the courage to face the facts, are willing to think longer term rather than acting expediently, and will begin to make painful critical choices for the future.

Copyrighted January 2011 by Charles E. Carlson

Although adverse consequences of a generation of poor public policy choices are inevitable, we can mitigate their impact and make our way to a better day sooner than later. This essay states my case for taking this path.

The Scene

Twenty---five years ago, public employee pay and benefits finally mirrored industrial America. Historically, government jobs paid less but were more secure. In the 1970's, this began to change. Through extensive reliance on collective bargaining, state and local public employers negotiated or legislated pay that more closely matched the private sector and created employer---paid benefit plans typical of steel, auto, and other heavy manufacturing industries.

Today, many of those plants are closed, jobs have been lost overseas, and formerly high paid American factory workers are looking for any kind of job they can find. Meanwhile, public employee jobs have continued to be relatively secure, pay is now competitive, and benefits are far superior to that of the average American worker.

We now are faced with the economic reality that the foundation for a relatively rich public employment system is funded by large amounts of debt as elected officials failed to fund their negotiated commitments. In fact, according to the Wisconsin Taxpayers Alliance, state and local government debt has increased at a 7.6% average annual rate over the past twenty years.

The great recession of 2008 hit state and local revenues very hard. Forty---six states faced budget shortfalls this year and had to try to close an overall $130 billion budget gap. Similar gaps are predicted for 2012 and
2013. Wisconsin, for example, faces a budget reconciliation bill in the next legislative term. Then, they will have to grapple with a $2.5 billion deficit in the 2011---13 biennium.

A recent Pew Study Center Report stated:

…the recession has cost Wisconsin 140,000 jobs and one---eighth of its

Copyrighted January 2011 by Charles E. Carlson

manufacturing workforce, according to the Center on Wisconsin Strategy, a nonprofit group based at UW---Madison. What's more, the report continued, Wisconsin's unemployment rate rose 4.4 percent from the second quarter of 2008 to the same point in 2009.

The fallout from the economic downturn --- reduced revenues and more demand for state safety---net programs --- left the state with a $6 billion shortfall in its 2009---11 budget, the report stated. That's a budget gap of 23.2 percent.

"The budget would have fallen short even without the national economic crisis, although the recession made the state deficit much larger than expected," the study observed, citing Andrew Reschovsky, a professor of public affairs and applied economics at UW---Madison. "Federal stimulus funds of $2.2 billion helped plug some budget shortfalls this year. For the rest, lawmakers raised taxes on the wealthy, hospitals and smokers, and cut spending by $3 billion, mostly by cutting salaries for state employees."

Still, the report continued, experts predict Wisconsin could face a $2 billion deficit during the next biennium, which starts July 1, 2011, after the federal stimulus runs out.

At the local level, property values have fallen rapidly, and cities, counties, and school districts are faced with falling property tax collections. Because the drop in property tax revenues tends to lag the decline in property values and general economic conditions, the real fiscal impact on local units of government is only now beginning to really hurt.

Two of the major objectives of the federal economic recovery program were (1) maintain the social safety net provided by state and local government and (2) pump billions into the U.S. economy by giving borrowed money to local governments to assure continued employment of teachers, police officers, firefighters, and other public employees as sales, property, and income tax revenues plummeted. Without this massive assistance, state and local government would have contracted even more than they have.

Recently, on CBS' "60 Minutes", Wall Street analyst Meredith Whitney predicted the imminent collapse of the public sector, beginning with the

Copyrighted January 2011 by Charles E. Carlson

states. “The most alarming thing about the state issue is the level of complacency. It has tentacles as wide as anything I’ve seen. I think next to housing this is the single most important issue in the United States, and certainly the largest threat to the U.S. economy.” (Whitney also predicted the 2008 market crash.)

A California Early Tremor

I think there was an instructive precursor of this looming public sector economic crisis in the mid---1990’s in California. The value of this story is the critical role strategic planning played in bringing one city through a major fiscal crisis.

Some background…

The City of Irvine incorporated in Orange County California in 1970 along the Interstate system, emerging from the Irvine Company’s strawberry farms and orange orchards to became a planned community model. The City grew very rapidly, then ran up against the severe restrictions of California Proposition 13, a constitutional amendment enacted by statewide referendum in 1978 to limit the growth of property taxes. As a result, California cities, including Irvine, found it increasingly difficult to develop alternate sources of revenue to meet growing demands for community services.

A recession in the early 1990’s depressed property values and reduced tax revenues, creating a serious fiscal problem. The City of Irvine’s leaders were determined to meet the challenge head on.

Although it already had started to trim employee positions in 1989---90, the City realized it wasn’t going to be enough with the economy stagnating. The property tax base was eroding in real dollar terms, and the City projected continued stagnation. While it experienced a positive increase from 1990---91 through 1993---94, property values starting sliding downward again.

Copyrighted January 2011 by Charles E. Carlson

As the table below shows, their concerns turned out to be accurate with property values per capita declining (16%) over a ten---year period. In
1993, the City's administrators concluded from a thorough analysis that staying the present course would lead to a $4.5 million annual deficit.

Fiscal Year	Resident Populatio n	City Pay + Benefits Per Cap*	Assessed Value Per Cap*
87---88	100,266	307	95,217
88---89	103,116	325	90,971
89---90	105,757	369	90,022
90---91	109,935	334	92,127
91---92	111,418	343	97,933
92---93	116,127	319	98,082
93---94	121,173	305	95,553
94---95	123,217	283	89,620
95---96	127,556	268	87,366
96---97	129,672	262	80,211
Change	29%	---15%	---16%

*Real dollars; adjusted for inflation

To attack the problem, the City administrative staff relied on extensive internal and external input to create a strategic plan draft for the City Council to consider. The plan called for:

1. restructuring how the City does business
2. refining service priorities

Copyrighted January 2011 by Charles E. Carlson

3. evaluating revenue sources

A critical first step was coming to agreement on what the City's "core" services had been and what would they would be in the future. For example, public safety and infrastructure protection were deemed vital to the future. Second, every attempt was made to reduce operating overhead through outsourcing non---core services such as information technology and legal services

Included in this restructuring was the elimination of 51 full---time positions and over 20 part---time staff. Cost savings from these staff reductions were projected to be $3.3 million annually.

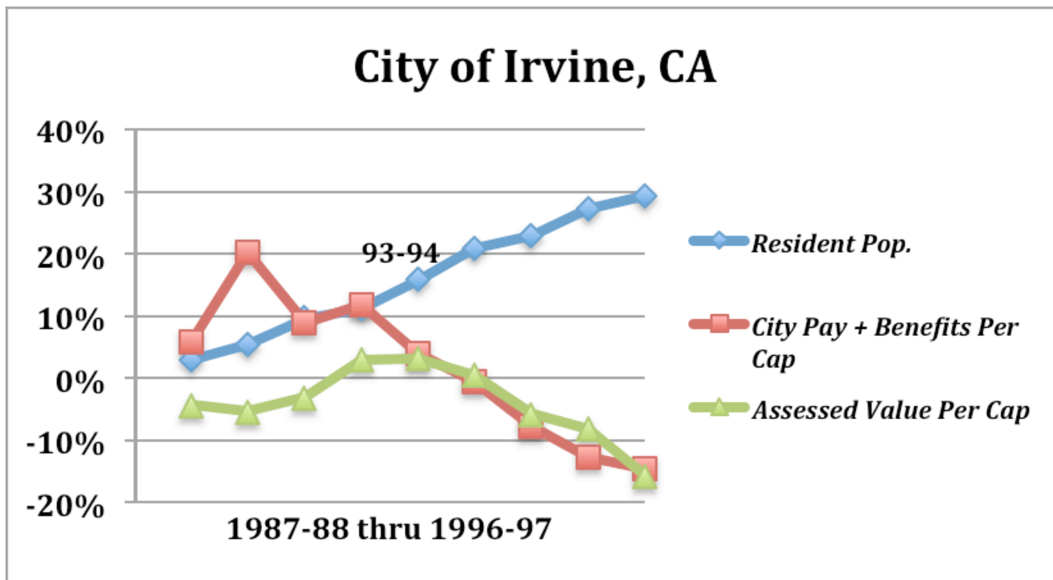
In developing the plan, the administration encouraged all staff to contribute their suggestions, and over 1,300 recommendations pored in. Active employee participation in the process became a key to the plan's success.

The City Council adopted the plan in January 1994 and required the administration to submit annual analysis of results as well as plan refinements. The City mitigated the negative impact on employees by relying heavily on attrition, voluntary retirements or resignations to bring the per capita payroll costs in line with revenue projections.

What were the results?

In the first five years of this ten---year period, per capita payroll costs increased 11% adjusted for inflation. In the five years following implementation of the strategic planning process, payroll costs per capita declined (---24%) for a net change of (---15%) for the period, roughly mirroring the decline in property values.

Copyrighted January 2011 by Charles E. Carlson



In the midst of this strategic planning and implementation process, the bottom fell out.

Bankruptcy

I entered the plan implementation process in 1993 when the City hired me as a consulting project director to restructure its compensation system. When we finished the research and design portions of the consulting project, the City retained me as chief negotiator to bargain implementation with its four collective bargaining units that covered almost all the City's employees, including all but the top managers. My charge was to implement a new, trimmed down job classification system based upon objective job evaluation and thorough market analysis and clear the way for a pay---for--- performance option to pay delivery.

On December 6, 1994, we were at the bargaining table with the police union dealing with significant contract issues related to the City's strategic initiatives. In order to accomplish our strategic objectives, we needed increased productivity from the sworn officers.

The City and the Irvine Police Association, as well as the department's command staff bargaining unit, had agreed in earlier contracts to a four---day workweek. In addition, the union had an exclusive arrangement to provide protective services to the large regional entertainment complex. This arrangement generated tremendous amounts of overtime that the officers could take as pay or compensatory time off at a time---and---one---half rate.

The unfunded compensatory time obligation caused by the combination of a short work week schedule, internally mandated staffing levels, and the time commitments required to serve the entertainment complex was growing geometrically. The City directed its bargaining team to solve the problem.

In an afternoon bargaining session, we offered the police union a total buy---out of the outstanding compensatory time off balances. Moments after I made the offer, the Director Administration was called away from the bargaining table to take a phone call. He returned to the room a few minutes later looking like someone had just died. He handed me a note telling me to immediately withdraw the buyout offer because Orange County had just declared bankruptcy. The news hit like a tsunami.

What had happened in Orange County?

Some years earlier, Orange County created the Orange County Investment Pool. By 1994, the Pool had accumulated $7.6 billion in deposits. In addition to county funds, approximately 200 local public agencies, including the City of Irvine had invested in the fund.

The Investment Pool was attractive because it had provided a very significant investment yield historically. With all the pressure on local government to find revenue sources, the Investment Pool provided the county and the public agency participants and much---needed source of income.

The County Treasurer managed the Pool, and investment yields were so high because he invested the deposits in derivatives and other high---

Copyrighted January 2011 by Charles E. Carlson

income investments. Most unfortunately, he then used the investments as collateral to borrow more money and invested it in more market bets. In December 1994 the market turned upside down, the chits were called in, and the Investment Pool could not cover its bets.

The County and many other jurisdictions with money invested in the fund were forced to declare the protection available in bankruptcy. Orange County became the largest municipal bankruptcy in U.S. history.

The City of Irvine and many local units of government followed the county into bankruptcy protection. In addition, the problems for the City of Irvine and dozens of other Orange County public jurisdictions were exacerbated by their pension plans. Relying on the high returns of the Pool, many had opted out of the California Public Employee Retirement System in favor of creating their own pension programs with commitments staked on the future of the Orange County investment pool.

The bankruptcies and the pension debacle had an enormous immediate impact on union negotiations, and everything was on the table – jobs, pensions, benefits, and pay. As we worked our way through the bankruptcy, we were able to accomplish all of our negotiation objectives, with the unions agreeing to substantial wage freezes in the early years of multi---year agreements. In return, we were able to preserve City jobs and avert lay---offs.

As part of its work on the strategic plan, the City conducted a comparative analysis of its expenditure levels relative to peer communities in California. We learned from this process that the City's disciplined implementation of its strategic plan, including a successful labor negotiation process, had brought Irvine more in line with expenditure and service levels in its key peer comparison communities.

Irvine always has strived to be a model community with excellent services, and the measured comparison with its peer communities was very important analysis. While the community's leaders worked hard to find

financial stability and pick the right services and delivery model, it was with a clear expectation and intention that the City rank above average in service delivery.

We concluded from our comparative analysis that Irvine had managed to steer through all of this financial and political turbulence and maintain a favorable competitive position. This gave the City Council the political permission to begin to take its foot off the brake and begin allocating additional resources in support of the adopted strategic community priorities.

Orange County emerged from bankruptcy approximately 18 months after it filed for protection. The Investment Pool had lost about 20% of its value, and Irvine had taken its share of the economic loss. As you would expect, the economic and political aftershocks continued for years.

Lessons learned

What have we learned from this experience? If this could happen to a rapidly growing suburban area, could it happen to any local government?

Mark Baldassare of the Public Policy Institute of California authored a significant analysis of the Orange County meltdown in When Government Fails: The Orange County Bankruptcy. He concluded that there were three underlying conditions that contributed significantly to this fiscal catastrophe.

Political fragmentation
- *Lack of a central political authority*
- *Many local governments*
- *Overlapping jurisdictions and decentralized services*
- *Elected officials who are locally oriented*

Voter distrust
- *Opposition to most tax increases*
- *Belief that government wastes a lot of money*
- *Maintenance of spending for middle---class services favored*
- *Cuts in spending for welfare programs favored*

State fiscal authority
State expenses exceed revenue
State programs shifted to local governments
Local governments pay larger share of state programs
Local government funds shifted to state budget

A lot of these descriptors seem to me to fit the situation today. If Wall Street analyst Whitney's prediction is correct, many state and local governments are in for a big fall very soon that will seriously threaten the U.S. economy. Time is short. Can we avoid disaster?

I believe what we learned from the City of Irvine's strategic planning experience is instructive and could be very helpful if immediate steps are taken. I believe the City managed its way through the bankruptcy in a reasonably stable and successful manor because it was able to rely on the strategic plan it developed and began to implement BEFORE the bankruptcy.

The City faced the facts. It conducted a realistic financial analysis and concluded it had to adopt radical change. Through the planning process, it imposed fiscal discipline until its finances were in better shape.

The City implemented extensive staff reductions through attrition, early outs, and restricted hiring. It made critical decisions about what services to offer and what to decline or outsource.

The four staff employee unions agreed to wage freezes, the slimmed down job classification plan, and a new performance management system. City leaders in turn protected the remaining jobs and implemented the California Public Employee Retirement System, creating greater security for employee pensions.

All of this was possible because the City had a detailed plan hammered out with substantial community and staff input. It provided a path to follow.

I believe this story demonstrates a sharp contrast between what we usually regard as rational market philosophy and behavioral economics. It seems to me that a rational---based market reaction to the facts of that decade

would have been every person for his or herself. Certainly, the political fragmentation that Baldassare analyzes so well in his post---crisis analysis pointed in that direction, and there were significant expected reactions – suits were filed to try to recover losses, people blamed the County Treasurer who pled guilty to several felonies related to his activities involving the pool.

You might think that Orange County learned a valuable lesson not to be repeated. Not so. Real reform is painful, and people behave in predictably irrational ways. More recently, another Orange County Treasurer was stripped of his Investment Pool authority for making speculative investments, again trying to beat the market.

An October story in the Orange County Register points to a recent report that estimates Orange County could have underfunded employee pension obligations of as much as $41 billion, depending on the market return assumptions. Public employee unions are beginning to agree to concessions such as delaying retirement dates for new employees and having employees make some contribution to their own retirement programs.

In fairness, the unions there are moving as fast as politically practical barring a total system collapse. Union members are not likely to permit their leaders to surrender more than minimal change until they actually have no other choice.

Because this essay is directed primarily to a Wisconsin audience, what lessons can we bring home from California. As most of us know, Wisconsin has been a social laboratory of workers' rights for a hundred years. The concepts and early model legislation underlying workers compensation, unemployment insurance, and social security came out of a long---standing partnership between the University of Wisconsin and the Wisconsin legislature. Wisconsin also adopted one of the earliest private, as well as public, employee collective bargaining laws.

Mark Eisen, in his recent Isthmus article "Targets on Their Backs", contends that public employee unions are still working off of a fifty---year---old

Copyrighted January 2011 by Charles E. Carlson

labor relations model that is out of touch with today's economic and political reality. The deeper underlying problem is that elected officials, so far, have been beholding to public employee unions that help elect them.

I believe the political equation is changing so rapidly public managers and public employee unions are engulfed by the lead wave of this perfect storm. Orange County, for example, has a newly elected County Treasurer who ran on a platform of radical pension reform. This man was the County Supervisor who warned of imminent danger in the Investment Pool twenty--- five years ago just before the bankruptcy took the County down.

Wisconsin just elected a Republican governor who has demanded state employee unions either agree to massive changes or he will seek repeal of their bargaining rights. Local governments and school districts rely on the state for substantial financial support, and the governor is likely to have the same message for local governments and their employee unions.

We now find ourselves facing the perfect storm of Whitney's analysis. On the surface, our problems are fossilized in public employee collective bargaining agreements that permit early retirement, guaranteed payouts, and very little or no contribution from employees.

Of course, changes are so difficult because public employee unions are so effective in influencing election outcomes. Unlike the private sector, public employee unions have a major impact on the selection of the government board of directors.

If Whitney is accurate, and the public sector collapses the American economy again in twelve months or so, the changes will be revolutionary instead of evolutionary. I think 2011 is the critical year.

What the City of Irvine managed to accomplish in the mid---1990's seems to me is a classic example of the critical role social contracts play in effective strategic planning. The City relied on extensive public dialogue and input to fashion and adapt a strategic policy that provided political and economic stability when the storm erupted.

As we head into very uncertain times, I believe we need to draw on successful experiences like this…very quickly.