Response to the Economic Policy Institute Regarding Connecticut State Government Employee Compensation

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In September 2015 the Yankee Institute released my report, "Unequal Pay: Public vs. Private Sector Compensation in Connecticut," which compared the salaries and benefits of Connecticut state government employees to the compensation those employees would be likely to receive in private sector jobs.[1] The report found that on average, state government employees receive salaries roughly in line with private sector workers but more generous health coverage, pensions and retiree health care. These more generous fringe benefits, which are the source of significant budgetary problems for the state of Connecticut, created an overall compensation premium for state government employees of between 25 and 46 percent over private sector levels. The Yankee Institute report's findings have resonated with policymakers in Connecticut and produced consternation among public employee union leaders.

On December 6 2016, the Economic Policy Institute (EPI), a labor union-funded think tank in Washington, DC, published what can only be called an attempted take-down of the Yankee Institute report.[2] EPI's article, authored by Monique Morrissey, argues against almost any research methodology that would cause Connecticut state government employee to appear more highly paid, however often such methodologies have been used in the past – including in multiple studies published by the Economic Policy Institute itself. It then accuses me of "stacking the deck" by utilizing those methodologies. The EPI has not disclosed if the report was commissioned by Connecticut public sector labor unions.

Honest researchers can disagree on how best to compare public and private sector compensation, and reasonable adjustments to the methodology I used may produce slightly different measures of the pay premium received by state government employees in Connecticut. Indeed, in the study itself I provide a range of values for the future pension benefits earned by state government employees. Likewise, I also note in the study that researchers disagree on whether to control for firm size in comparing public and private wages. I chose to include such a control, which has the effect of reducing measured pay for state government employees by about six percent.

But most of the data and methods employed in my Yankee Institute article are standard and have been used in dozens of other studies of public sector pay. In these areas, Morrissey's argument is not with me but with decades of research on public sector pay. Where I have used more innovative approaches they are well-backed by research and

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[1] The report is available at www.yankeeinstitute.org/policy-papers/unequal-pay/

[2] Monique Morrissey. "Unequal public-sector pay in Connecticut? Yes—taxpayers are getting a bargain!" Economic Policy Institute, December 6, 2016. Available at http://www.epi.org/publication/unequal-public-sector-pay-in-connecticut-yes-taxpayers-are-getting-a-bargain/.

expert opinion, to which I provide citations both in the Yankee Institute study and in the discussion below.

Despite taking a throw-everything-and-see-what-sticks approach, Morrissey's article represents a step forward for public pay research published by the Economic Policy Institute. For instance, in numerous previous studies comparing government and private sector compensation, the EPI has refused to acknowledge that the retiree health benefits accruing to public employees add even a penny to their compensation. These previous studies failed to even mention retiree health care. Morrissey acknowledges that retiree health benefits must be counted and relies on the same government accounting disclosures that I have used for a number of years. Likewise, Morrissey acknowledges that the value of the future pension benefits accruing to today's employees depends upon the pension plan's benefit formula, not the amount the government chooses to contribute (or not contribute) to the pension plan this year. Unfortunately, Morrissey also touts government pension accounting figures that nearly everyone else in the financial world believes dramatically understate the costs of public pension benefits. But given where the EPI began – with methodological approaches that in some cases simply made no sense whatsoever – Morrissey's concessions are a big improvement.

My study, like most others on the topic, starts by comparing the wages of public and private sector employees using regression analysis, in which public and private sector salaries are compared after controlling for factors such as age, education. Following the wage analysis, I compare the generosity of benefits between state government and the private sector, include health coverage, pensions, retiree health care and more. Totaling the differences in salaries and benefits allows for a comparison of total compensation for Connecticut state government employees to that of comparable workers in the private sector.

For those interested in specific topics I here respond to several points, starting with the valuation of public sector pension benefits, which has the largest effects on the study's results.

Valuing Public Employee Pensions: By far the most important single issue discussed by Ms. Morrissey is how to value the future pension benefits that Connecticut state workers earn each year. Unlike previous EPI studies, Morrissey acknowledges that the value of pension benefits accruing to employees – often called the "normal cost" of the plan – is independent of the amount that the state contributes to the pension plan this year. That's important, because under law pension benefits must be paid even if the government hasn't contributed enough over the years to fully fund them.

However, in valuing the value of pension benefits earned by state employees this year, Morrissey relies on government accounting statements that nearly the entire financial world believes dramatically understate the value of these benefits. Connecticut assumes that it will earn an 8 percent annual return on its investments, and calculates the normal cost of accruing pension benefits using that 8 percent assumption. Morrissey then compares that public pension normal cost to the contributions that private sector employers make to their employees' 401(k) plans. Under EPI's methodology, Connecticut pensions are *only* 66

percent more generous than private sector retirement plans. Yet the true difference is much larger.

Boston College Prof. Alicia Munnell – a pensions expert who heads the Center for Retirement Research and was recently contracted by the State of Connecticut to analyze its pensions – states the case clearly:

> Contributions to private sector 401(k) plans and public sector defined benefit plans are *not comparable*. The public sector contribution guarantees a return of about 8 percent, whereas no such guarantee exists for 401(k)s. Thus, the public sector contribution under-states public sector compensation.[3]

Morrissey's claim is that employer contributions to private sector 401(k)s and public sector defined benefit plans *are* comparable. What she ignores is that the market fails to produce 8 percent returns – which is very likely[4] – Connecticut taxpayers must pay more to protect Connecticut public employees against losses to their pension benefits. Private sector workers with 401(k)s, by contrast, bear the market risk themselves. To make government defined benefit plans comparable with private sector 401(k)-style plans, it is necessary to adjust the pension plan normal cost calculated by the state using an 8 percent return to a lower interest rate to account for the fact that the state is guaranteeing those higher returns to participants.

One option is to value pensions using the yield on U.S. Treasury securities. This would show the cost of delivering what Connecticut pensions have promised: a legally-guaranteed benefit that will be paid, no-matter-what. A number of academic studies of pensions have used this approach.[5] A second option is to value Connecticut pensions using the yield on corporate bonds, which is how private sector defined benefit pension are required by the federal government to value their liabilities. I provide both figures to give readers a reasonable range of values.

But the values used by Morrissey, which are calculated as if 8 percent annual investment returns could be guaranteed, are not reasonable. In 2008, then Vice-Chairman of the Federal Reserve Board Donald Kohn stated simply that "The only appropriate way to calculate the present value of a very-low-risk liability is to use a very-low-risk discount rate," a direct rebuke to the type of measurement Morrissey uses. Likewise, in a 2012 survey of prominent academic economists conducted by the University of Chicago, literally 98 percent agreed that valuing pension benefits using a high discount rate – as state and local pensions currently do, and as Morrissey thinks public pay comparisons should do – "understate[s] their pension liabilities and the costs of providing pensions to public-sector workers." For that reason, the bond rating agencies Moody's no long accepts pension

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[3] Munnell, Alicia H., Jean-Pierre Aubry, Josh Hurwitz, and Laura Quinby, "Comparing Compensation: State-Local Versus Private Sector Workers," Center for Retirement Research at Boston College, State and Local Pension Plans No. 20 (Chestnut Hill, MA: September 2011). Emphasis added.

[4] See Biggs, Andrew. "The Public Pension Funding Trap." *The Wall Street Journal*. May 31, 2015.

[5] Novy-Marx, Robert, and Joshua Rauh. "Public pension promises: how big are they and what are they worth?." *The Journal of Finance* 66.4 (2011): 1211-1249.

liability figures calculated by states using high interest rates, instead re-calculating them using a corporate bond yield.

In a 2011 study of federal employee benefits, the Congressional Budget Office used a methodology similar to mine in valuing federal pensions.[6] The CBO chose to use "a discount rate derived from the rate of return on Treasury securities" – precisely what I did in my high-value scenario for Connecticut pensions, to which I added a lower-value scenario where pensions were valued using the interest rate paid by corporate bonds.

The federal government's Bureau of Economic Analysis also values public pension liabilities by discounting future benefit payments using a corporate bond yield. In addition to being counted as liabilities of state governments, these accruing benefits are counted in the official National Income and Product Accounts of the United States as compensation to state and local government employees. Those official figures on public employee pension compensation are based a method very similar to the one I use in the Yankee Institute study. They do not rely on the types of figures that Morrissey claims are authoritative.

Morrissey, of course, is free to disagree with these approaches, though she would have to augment this disagreement with reasons why a government pension that, in effect, guarantees participants an 8 percent average return on their contributions is no more valuable than a 401(k) plan in which employees can receive 8 percent returns only by taking on significant investment risk. Regardless, her article should acknowledge that she is part of a very small minority of economists who favor methods that dramatically understate the value of public sector pension benefits.

Claims of "Cherry Picking" Employees to Study: Morrissey accuses me of "cherry picking" the population to study by focusing only on state government employees in non-public safety positions. As the paper makes clear, however, there are good reasons for limiting the study to regular state government workers. First and foremost, if state lawmakers are considering how to reform compensation practices for state government employees, they need to know the compensation received by state government employees, not an average of compensation received by state and local government employees. At the level of practical policymaking, Morrissey's insistence on lumping all government employees together makes no sense.

But there are other reasons as well. Local government employees were excluded because each government may offer a different benefits package, making it extremely labor-intensive, and perhaps impossible, to gather all the relevant data. Public school teachers were excluded because they have a shorter work year and because calculating comparable private sector wages for teachers involves more complex methodological issues than for other employees. And public safety workers were excluded because these occupations are more dangerous than other jobs and pay higher wages and benefits as compensation for that risk. Including public safety workers would likely have made Connecticut public employees appear more "overpaid," not less. Including local government employees, public school teachers and public safety occupations would have made the study considerably more

[6] Falk, Justin R. "Comparing Benefits and Total Compensation between Similar Federal and Private-Sector Workers." *The BE Journal of Economic Analysis & Policy* 12.1 (2012).

complex, but it's not at all clear why merging these distinct worker groups would produce a better or more useful study.

Excluding part-time workers: Morrissey criticizes my study for focusing on full-time, full-year employees, claiming that this somehow skews the results. However, excluding part-time employees is the standard practice in these types of studies. For instance, in a 2011 Congressional Budget Office analysis of federal employee pay, the CBO stated: "To improve the accuracy of the analysis, we also excluded part-time and part-year workers and individuals who worked multiple jobs. Wages tend to be measured with more error for people who worked less than 35 hours in a usual week or less than 50 weeks during the previous year…" Indeed, the Economic Policy Institute's own past work on public employee pay also excludes part-time employees, stating: "When analyzing hours of work, most studies exclude part-time workers because they earn considerably less than comparable full-time workers, are more weakly attached to the labor force, and often lack benefit coverage."[7] So Morrissey criticizes me for following a practice that her own institute states that "most studies" follow.

Moreover, including part-time employees would very likely have *increased* the measured compensation premium for Connecticut state workers. Part-time government employees generally receive full-time salaries pro-rated to their hours of work, while in the private sector part-time employees often receive less-than-proportional pay. Likewise, private sector employees are often not offered health and retirement benefits, while most part-time Connecticut state government employees are offered these benefits. Had I included part-time, part-year Connecticut state government employees in my sample – as Morrissey insists is appropriate but which she does not do in her own calculations – the measured salary premium for government employees would have increased by about 10 percentage points. The total compensation premium would have increased by a greater amount due to more generous benefits to part-time employees in the public sector.

Controlling for place of residence: Morrissey criticizes my Yankee Institute study for analyzing wages while including "tight" controls for the area of the state in which the employee lives. The purpose of these geographic controls, which the Census Bureau calls Public Use Microdata Areas (PUMAs), is to better account for differences in costs of living and wage levels in different parts of the state. If, for instance, public employees disproportionately live in high-wage, but high cost-of-living urban areas while private sector employees are more likely to live in lower cost rural areas, wage comparisons should reflect that fact. My approach was built on research from Prof. Lori Taylor of Texas A&M University, a former Federal Reserve economist, which showed that (in evaluating public school teacher wages) these tight geographic controls can have important effects on the results. Prof. Taylor has subsequently been contracted by a number of states to apply these geographic controls to these states' analyses of public school teacher pay.[8] The federal government's National Center for Educational Statistics produces a nationwide

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[7] Jeffrey Keefe. "Public versus private employee costs in Pennsylvania: Apples-to-apples study provides accurate comparison of compensation." Economic Policy Institute, August 18, 2011.
[8] Taylor, Lori L. "Comparing teacher salaries: Insights from the US census." *Economics of Education Review* 27.1 (2008): 48-57.

Comparable Wage Index which reports how earnings for college graduates differ from one small geographic area to the next.

While geographic issues are less important for state government employees than for public school teachers, due to differences in how employees are distributed throughout the state, employing geographic controls can still add to the analysis. Morrissey argues that using the full 43 PUMAs in Connecticut cuts things too finely. Perhaps she is correct. But if wages are analyzed using only the Census Bureau's 6 larger "SuperPUMAs," relative wages for Connecticut state government employees decline by only about 1.5 percentage points. It is only be eliminating *any* controls for different costs of living within the state that larger effects on measured government employee pay can be generated. But doing so assumes that the cost of living and wages are identical in, say, Fairfield and Windham counties, despite Fairfield having an average home price roughly twice that of Winfield.

To account for these differences in the local cost of living, the federal government pays its employees in Fairfield, Litchfield and New Haven counties annual salaries 2.3 percent higher for the same jobs than those paid in Connecticut's lower-cost counties. If the federal government itself accounts for local differences in the cost of living in setting pay in Connecticut, analyses of public employee pay should also attempt to do so.

I*ncluding college majors in wage comparisons*: My comparison of Connecticut state government wages to those paid in the private sector controls not only for the level of education – high school graduate, college graduate, Master's degree, etc. – but also for the field of study that the employee majored in as an undergraduate. This is designed to account for the fact that some college majors – such as those in STEM fields – are correlated with significantly higher wages once the student graduates. Including college majors is not a methodological cure-all, but it helps account for significant pay differences between employees with seemingly identical educational credentials. And there are many academic studies that analyze wage differences while controlling for college majors.

The effects of including college majors are small, increasing relative wages for Connecticut government workers by only around 1.5 percent; in some states, including college majors makes public employees appear *less* well-paid.

If college majors were indeed a strong indicator of the sector in which an employee worked, including them might not make sense. But, in the Census data I used for analyzing state government employees, college major is not a strong predictor of whether a person works for government or the private sector. This shouldn't be surprising: fields such as business, economics, accounting, nursing, and psychology have applicability in either government or the private sector. And all of those college majors are among the 15 most popular both inside and outside of Connecticut state government. So the idea that college majors are included as a way to skew the study's results is simply incorrect.

Controlling for race and gender in wage comparisons. Morrissey criticizes my study for comparing state government and private sector wages while controlling for factors including race and gender. This, of course, ignores the fact that most pay research, including work on federal employee wages published by the Congressional Budget Office in

2011, includes very similar variables. In fact, the EPI's *own research* on public sector pay also controls for race, gender, ethnicity and citizenship, among other factors.[9]

Inclusion of occupational controls: My wage analysis does not include control variables for specific occupations; that is, it does not directly compare wages for, say, plumbers in state government and the private sector. The reason for not including such specific occupational controls is that many occupations exist only in the public or the private sectors, but not both. However, I do include controls for eight broad occupational groups, which is designed to capture attributes of these occupations that can affect pay that are not associated with employee characteristics. For instance, certain occupations might be perceived as undesirable, for reasons of physical exertion, risk or stress, and thus must pay more than other occupations demanding similar employee skills. Morrissey states that these occupational categories constitute "bad controls" that may skew the results. If so, the effect is small: excluding the broad occupational controls reduces measured relative pay for Connecticut state employees by about one percent.

Nevertheless, it is worth pointing out that peer-reviewed public pay studies commonly include occupational control groups, and some include more occupational categories than my study did. The CBO's 2011 federal pay analysis, for instance, included 24 occupational categories.[10]

Retiree health coverage. Connecticut state government employees eligible for health benefits in retirement, funded mostly by the government. The value of these future benefits to the average Connecticut state government employee is 13.6 percent of annual wages, according to actuarial disclosures made by the state. In other words, eligibility for retiree health coverage is equivalent to an almost 14 percent annual increase in salaries for Connecticut state government employees. Morrissey confuses the discussion of state employee retiree health coverage by pointing out that not all *local* government employees – a group not included in my study – are eligible for benefits. In the context of a study on state government employees, Morrissey's point is irrelevant.

Morrissey also argues that the value of retiree health coverage in the private sector is higher than the figure I use in my study. Morrissey relies on data showing that 28 percent of large private sector firms in Connecticut offer health benefits to their current retirees. She then estimates the value of private sector retiree health coverage by multiplying the value of state government retiree health care by 28 percent. In other words, she claims that coverage of private sector employees is identical to that of state government workers with

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[9] See Keefe (2011) and numerous other EPI studies by Keefe.

[10] Other examples include Belman, Dale, and John S. Heywood. "Public-sector wage comparability: the role of earnings dispersion." Public Finance Review 32.6 (2004): 567-587; Bender, Keith A., and John S. Heywood. "Comparing public and private sector compensation over 20 years." Washington, DC: Center for State and Local Government Excellence and National Institute on Retirement Security (2010); Disney, Richard, and Amanda Gosling. "Does it pay to work in the public sector?." Fiscal Studies 19.4 (1998): 347-374; Even, William, and David Macpherson. "Methodology for Estimating Compensation Differentials for State and Local versus Private Sector Workers." WI: MacIver Institute (2012).

the exception that fewer private sector workers receive that coverage. But this claim is likely to be wrong, for two reasons.

First, state governments offer more generous retiree health benefits in dollar terms than do private sector firms, who make retirees bear a larger share of health premiums as well as imposing larger deductibles and co-pays. For instance, in 2013 the average annual retiree health benefit paid out by the Connecticut Other Post-Employment Benefits Program was $7,189 per beneficiary.[11] We don't know the average dollar benefits paid out by Connecticut private sector firms. However, a Mercer nation survey of private firms that offer retiree health coverage to current retirees found that the average annual employer cost was $7,587 for retirees under age 65 and $2,886 for retirees over age 65, where retiree health coverage is limited to supplementing Medicare benefits.[12] If we assume that the average relevant employee retires at age 61 and survives to age 83, average annual employer costs would be $3,741, half the dollar value of what Connecticut currently pays out to retirees. This alone justifies reducing the EPI's estimate of the value of private sector retiree health coverage by roughly one-half.

Second, I cite multiple sources indicating that many of the 28 percent of large private sector firms that offer health coverage to their current retirees will not offer the same benefits to future retirees, both by reducing the number of current employees who will become eligible for benefits and reducing the dollar value of those benefits for those who do become eligible. This justifies a further reduction in the value of private sector retiree health coverage for current employees, because fewer of them will receive benefits than do current private sector retirees and those who do will likely receive benefits that are of lower value.

If Morrissey has evidence that this contraction of the eligibly and generosity of retiree health coverage for current private sector workers has not taken place, she should state it. Instead, she simply ignores the argument.

The relative compensation of Connecticut state government employees: Finally, I raise an ancillary point that puts some of the above discussion in a broader context. Honest analysts can argue about methodological differences and it is possible that reasonable methodological changes would result in Connecticut state government employees having a smaller (or larger) compensation premium relative to private sector workers in the state. Another measure of interest, however, is how well Connecticut compensation compares to that paid to state government employees in *other* states. In a 2014 study co-authored with Jason Richwine, I conducted a similar comparison of state government compensation for each individual state, where in each state public employee salaries and benefits were compared to amounts paid in the private sector.[13] Connecticut paid the highest relative salaries and benefits of any state government in the country. That is, public sector

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[11] Author's calculations from Segal Consulting. "State of Connecticut Other Post-Employment Benefits Program Actuarial Valuation and Review of Other Postemployment Benefits (OPEB) as of June 30, 2013." Published February 20, 2014.
[12] Mercer. "Mercer's National Survey of Employer-Sponsored Health Plans." February 2013.
[13] Biggs, Andrew G., and Jason Richwine. "Overpaid or underpaid? A state-by-state ranking of public-employee compensation." American Enterprise Institute Working Paper 415891 (2014).

compensation in Connecticut was higher relative to private sector pay than in any of the other 50 states.

Even if reasonable changes to my methodology produced a smaller compensation premium in Connecticut, Connecticut would remain among the very most generous states for state government employee compensation in the country. If Connecticut state government employees receive total salaries and benefits that are in line with private sector pay, as Morrissey alleges, then governments in states such as Virginia and Indiana – which in our report paid far less than Connecticut – would be facing a crisis of mass resignations and unfilled positions. Alternately, if other states can attract and retain employees while paying considerably less than Connecticut, then Connecticut probably can do so as well – regardless of how what wage regressions and valuations of pension benefits tell us about total employee compensation. The fact that these lower-paying states are able to hire and retain workers and indeed are often referred to as being among the better-managed states in the country, implies that Connecticut could probably maintain an adequate state employee workforce at lower costs to the government.

In sum, comparing public and private sector salaries and benefits is not a straightforward task. There are limitations on data, methods that may not perfectly account for these limitations and, yes, errors made by researchers themselves. My work is not immune to those criticisms. But the Economic Policy Institute chooses to criticize almost every aspect of my study, including those which closely follow the Institute's own past work on public sector pay. This suggests that the intent of the EPI's work is less to shed light than to cloud the important issues at hand.