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# UPJOHN INSTITUTE

## Employment Research

APRIL 2012

### In this issue . . .

*Marta Lachowska  
and Stephen A. Woodbury*  
Labor Force Participation  
in Mississippi and Other  
Southern States

*Nancy Mohan and Ting Zhang*  
What Determines  
Public Pension Investment  
Risk-Taking Policy?



### New and Recent Books

Vol. 19, No. 2

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*Marta Lachowska and Stephen A. Woodbury*

## Labor Force Participation in Mississippi and Other Southern States

**T**he labor force participation rate (LFPR) is a key social indicator. Along with the unemployment rate, the LFPR is of paramount concern to states because work and earnings from employment are central determinants of living standards.

The LFPR varies dramatically among the states. In 2011, the LFPR was less than 60 percent in three states (Mississippi, Alabama, and West

references, see Lachowska and Woodbury [2012a,b.]

The LFPR gap between Mississippi and other states is longstanding. Figure 1 shows time series of the LFPRs of Mississippi and a group of 12 states—referred to as the Blueprint states—chosen by the state of Mississippi to craft its “Blueprint Mississippi,” an economic development effort sponsored by the Mississippi Economic Council of the Mississippi Chamber of Commerce. The Blueprint states include the four states contiguous with Mississippi (Louisiana, Arkansas, Tennessee, and Alabama), plus Texas, Oklahoma, North Carolina, South Carolina, Kentucky, Georgia, and Florida.

Figure 1 shows that LFPRs in Mississippi and the Blueprint states trended upward from the mid 1970s until the mid 1990s, following a broad national trend (Aaronson, Davis, and Hu 2012). Since the mid 1990s the LFPRs in Mississippi and the Blueprint states have all fallen—a trend that started even before the recession of 2001. The figure also shows that, throughout this time period, Mississippi’s LFPR has been 3–4 percentage points below the LFPR of the Blueprint states, and that Mississippi’s LFPR dropped by nearly 2 percentage points following Hurricane Katrina in August 2005, temporarily creating an even larger than usual gap between Mississippi and the Blueprint states.

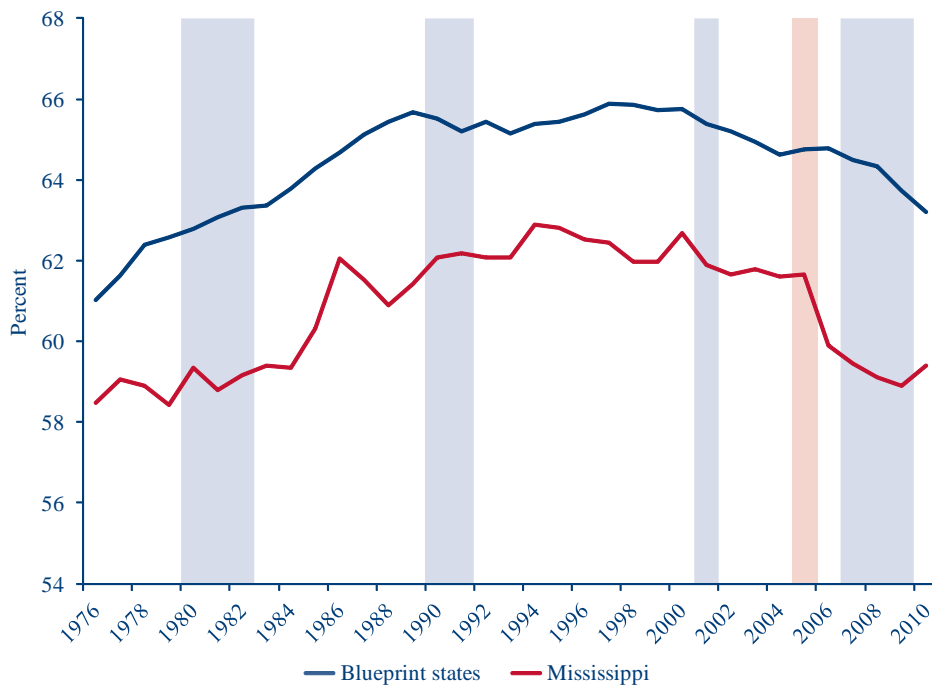
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**Of five key differences between Mississippi and the Blueprint states, the most dramatic is that nearly 60 percent of Mississippi’s residents lived in nonmetropolitan areas in 2009, compared with 19 percent in the Blueprint states.**

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Virginia) and greater than 72 percent in two (North Dakota and Minnesota). Because the state of Mississippi has historically had one of the lowest LFPRs in the United States, in August 2011, the Mississippi Governor’s Office commissioned the Upjohn Institute to study the reasons for Mississippi’s relatively low LFPR. This article summarizes the main findings of the Institute’s research. (For a complete description of the work with additional

**Figure 1 Labor Force Participation Rates in Mississippi and the Blueprint States, 1976–2010**



NOTE: Light blue bars indicate recessions as defined by the National Bureau of Economic Research. The pink bar indicates 2005, the year of Hurricane Katrina.

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics, Local Area Unemployment Statistics.

**Labor Force Participation Rates of Population Subgroups**

We follow a long tradition in the analysis of labor force participation and examine five subgroups of the civilian noninstitutional population (see Figure 2):

- 1) Men, ages 25–54, sometimes called “prime-age males,” who have traditionally been the most active labor force participants, with LFPRs approaching 90 percent in some years.
- 2) Married women, ages 25–54, who showed dramatic growth in labor force participation in the years following World War II, as they substituted work in the labor market for work at home, and whose LFPRs are now within 10–15 percentage points of prime-age males.
- 3) Single women (never married, divorced, and widowed), ages 25–54, who have long had LFPRs approaching those of prime-age men.
- 4) Older persons, ages 55 and older, who have the lowest LFPRs of the five groups because they are prone to retirement.

- 5) Younger persons, ages 16–24, who have lower LFPRs than people ages 25–54 partly because they are still in school (or other training), and partly because they have less human capital and earnings capacity than older people and have limited opportunities in the labor market.

Figure 2 shows that, except in the case of married women, the LFPRs of the Mississippi population are lower than those in the Blueprint states.

**Key Differences between Mississippi and the Blueprint States**

The LFPR differences between residents of Mississippi and the Blueprint states may be attributable to a range of factors, some measurable, others difficult to quantify. We focus on five key differences between Mississippi and the Blueprint states:

- 1) Nonmetropolitan residence

Of the five potentially relevant differences, the most dramatic is that

nearly 60 percent of Mississippi’s residents lived in nonmetropolitan areas in 2009, compared with 19 percent in the Blueprint states (see Figure 3). This difference may be important because residents of nonmetropolitan areas have significantly lower LFPRs than do residents of metropolitan areas—about 65 percent in metropolitan areas versus 57 percent in nonmetropolitan areas. Accordingly, Mississippi’s mix of metropolitan and nonmetropolitan residents—which is skewed toward nonmetropolitan residents—is one likely explanation of the LFPR gap between Mississippi and the Blueprint states.

2) Race

The Mississippi population has a significantly higher percentage of black residents (36 percent) than the Blueprint states (18.5 percent). This difference matters because most groups of the black population have lower LFPRs than their white counterparts. For example, the LFPR of black men 25–54 in the Blueprint states is nearly 77 percent, compared with nearly 89 percent for white men. (The LFPR gap between black and white men in Mississippi is even larger.) Only for married women 25–54 is the LFPR of blacks greater than that of whites.

3) Incidence of health problems

A third set of differences between Mississippi and the Blueprint states is that Mississippi residents report a higher incidence of health problems. The American Community Survey asks questions about five types of health issues: 1) cognitive difficulties, 2) ambulatory difficulty, 3) difficulty taking care of oneself, 4) difficulty living independently, and 5) vision or hearing difficulties. In most cases, Mississippi residents are more likely to report having one or more of these health difficulties. Only in the case of younger persons are Mississippi residents and residents of the comparison states (approximately) equally likely to report having each of these health difficulties.

4) Receipt of government transfers

Mississippi and the Blueprint states differ in the percentage of individuals who receive government transfers such as Social Security, Supplemental Security Income (SSI), and Supplemental Nutrition Assistance (or Food Stamps).

- Among men 25–54, women 25–54 (both married and single), and younger persons, the incidence of income from Social Security is higher in Mississippi than in the Blueprint states, usually by about 60 percent.
- Similarly, the incidence of SSI receipt is higher in Mississippi than in the Blueprint states, usually by 50 percent or more.
- The incidence of Food Stamp receipt is higher in Mississippi than in the Blueprint states among all groups, but most notably among single women 25–54 and younger persons, for whom Food Stamp receipt is 40 percent higher in Mississippi.

Higher incidence of government transfers is usually related to lower LFPRs, either because recipients have fewer marketable skills or because the availability of nonwage income reduces the need to participate in the labor force.

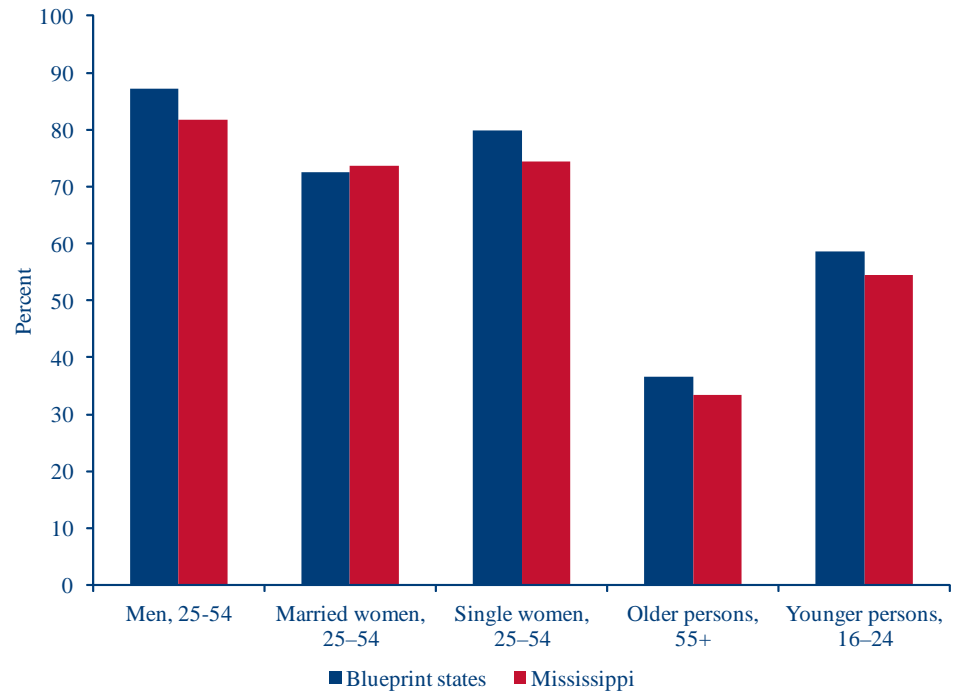
5) Educational attainment

Compared with the Blueprint states, a higher percentage of Mississippi residents had not completed high school, and a lower percentage were college graduates. These differences are potentially important because LFPRs tend to be higher for individuals with higher educational attainment: The LFPR of high school dropouts in Mississippi was only 35 percent in 2009, whereas the LFPR of high school graduates was nearly 60 percent, and the LFPR of those with some postsecondary education was 70 percent or more.

**Accounting for LFPR Gaps between Mississippi and Other States**

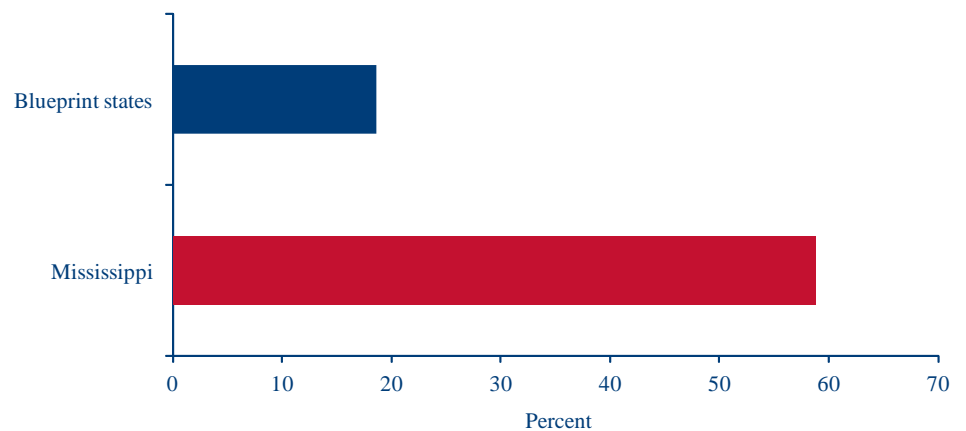
To what extent do the LFPR gaps between Mississippi and the Blueprint states reflect the interstate differences just discussed? We answer this question using the well-known Blinder-Oaxaca

**Figure 2 Labor Force Participation Rates of Population Subgroups in Mississippi and the Blueprint States, 2009**



SOURCE: Authors' calculations from the 2009 American Community Survey, Integrated Public Use Microdata Series (ACS-IPUMS).

**Figure 3 Differences between Mississippi and the Blueprint States in the Percentage of Residents Living Outside of Metropolitan Areas, 2009**



SOURCE: Authors' calculations from the 2009 ACS-IPUMS.

technique, which decomposes the total LFPR gap between Mississippi and the Blueprint states into components attributable to (or “explained by”) various factors.

Table 1 summarizes the findings. The Total LFPR Gap column shows the LFPR gap (in percentage points) between Mississippi and the Blueprint states in

2009. For example, for men 25–54, the LFPR in Mississippi was 5.3 percentage points less than in the Blueprint states. Of this 5.3 point gap, 2.1 points can be attributed to the fact that a higher percentage of men 25–54 in Mississippi lived in nonmetropolitan areas, another 1.2 points occurred because a higher percentage of Mississippi men are black,

**Table 1 Percentage Point LFPR Gaps Explained by Five Key Differences between Mississippi and the Blueprint States, by Population Subgroup**

Demographic group	Total LFPR gap	Percentage points attributable to differences in:				
		Nonmetropolitan residence	Percentage black	Health problems	Government transfer receipt	Educational attainment
Men 25–54	-5.3	-2.1	-1.2	-1.0	-0.9	—
Married women 25–54	+1.1	—	+1.2 <sup>a</sup>	-0.7	—	+0.3
Single women 25–54	-5.5	-1.7	—	-0.8	-1.6	-0.9
Older persons	-3.1	-1.2	—	-1.1	—	-0.7
Younger persons	-4.1	-0.8	-1.2	—	—	-0.4

<sup>a</sup>Mississippi's higher percentage of blacks among married women increases the LFPR of Mississippi's married women because the LFPR of black married women exceeds that of white married women.

NOTE: Compared with the Blueprint states, a higher percentage of Mississippi residents live in a nonmetropolitan area, are black, report health problems, and receive government transfers. The educational attainment of Mississippi residents is on average lower than in the Blueprint states. SOURCE: Lachowska and Woodbury (2012a,b).

another 1.0 point is due to a higher incidence of health problems among Mississippi men, and 0.9 point is related to a higher incidence of government transfers.

Table 1 suggests that the main reasons for Mississippi's LFPR gap differ among the five population groups:

1) The relatively high concentration of Mississippi residents in nonmetropolitan areas is the most consistent reason for Mississippi's lower LFPR.

2) Mississippi's relatively high percentage of black residents has a mixed impact on its LFPR. For men and younger persons, it tends to reduce the LFPR. For married women, it raises the LFPR because the LFPR of black married women exceeds that of white married women.

3) Higher incidence of health problems helps explain the lower LFPR of Mississippi's men, women (both single and married), and older persons.

4) Higher incidence of government transfer receipt helps explain the lower LFPR of Mississippi's men and single women.

5) Lower educational attainment reduces the LFPR of Mississippi's single women, older persons, and younger persons.

For all but younger persons, the five key measurable differences between Mississippi and the Blueprint states account for (or "explain") most of the gap between Mississippi and

the Blueprint states. However, for younger persons more than half of the gap must be attributed to cultural, historical, and institutional factors that are difficult to measure and quantify. The legacy of racial discrimination, the connection of Mississippi residents to rural communities, and an agricultural sector that is in long-term decline are all possible contributors.

### Policy Implications

The findings may have three implications for policy. First, the connection between low LFPRs and nonmetropolitan residence provides a rationale for targeting regional economic development toward nonmetropolitan areas of Mississippi (see also Range [2011]). Such efforts at regional development could be augmented with efforts to connect workers in nonmetropolitan areas with job opportunities in urban areas that are relatively nearby, for example, through inexpensive and accessible transportation.

Second, the connection between educational attainment and labor force participation provides a rationale for improving the quality of education generally and, more specifically, for creating opportunities for vocational and technical training in occupation-specific skills that employers indicate they demand.

Third, for young persons culture and institutions play a large role in explaining the LFPR gap between Mississippi and other states. This suggests that special efforts may be needed to create employment opportunities for high school students in Mississippi, so that young people see the relevance of schooling to job opportunities and to gaining a foothold in the labor market. Policies that could be helpful include cooperative programs connecting school to work, and direct employer subsidies to encourage the hiring of young people.

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*Nancy Mohan and Ting Zhang*

# What Determines Public Pension Investment Risk-Taking Policy?

*See p. 7 for new and recent books on pension policy published by the Upjohn Institute.*

**S**tate public pension plans, mostly defined benefit plans, cover pension benefits for 12.8 million active public employees and 5.9 million retirees and other annuitants.<sup>1</sup> However, by the end of 2009, public pension plans had accumulated a total funding deficit of \$697 billion (measured by the difference between actuarial pension assets and liabilities). On average, public pension funds cover 75 percent of their liabilities, but individual state results vary greatly. The 2008 stock market crash strongly affected pension asset value in that equity allocation on average accounted for 56 percent of invested assets. The average 2009 pension asset beta of 0.63 suggests that if the market fell 35 percent (the drop experienced during the 2008 financial crisis), public plans would lose 22 percent of their total fund value.<sup>2</sup>

Therefore, an important yet largely overlooked issue related to pension underfunding is the investment risk level assumed by public pension plans. As shown in Figure 1, the state pension funds equity allocation varied greatly at the end of 2009, from 11 percent (South Carolina) to 69 percent (Nebraska and Mississippi). The current funding gap prompts the question of whether the pension fund managers will adopt riskier investment positions in hopes of raising returns and lowering the shortfall.<sup>3</sup>

This article summarizes our research that is reported in our Upjohn Institute working paper (Mohan and Zhang 2012). In it, we examine the determinants of pension risk-taking policy during the period 2001–2009 after taking into consideration state government incentives, political pressure, fiscal

constraints, public union presence, and workforce features.

## Factors Affecting Pension Funds Risk-Taking Policy

We measure pension risk as either the percentage of total plan assets invested in the equity market or pension asset beta. The more risk assumed by the fund manager (higher equity allocation or higher asset beta), the more sensitive the fund is to market volatility. So, what are the factors that could affect investment risk? One incentive may be risk management. When a pension fund is underfunded the state is obligated to increase contributions. Unexpected, required funding for pension contributions may reduce the ability to invest in schools or police, for example, because in the short run, the state/municipal budget is fixed. The implications are that, from a risk management perspective, states would prefer to have predictable pension contributions. Accordingly, asset allocation decisions would be a function of funding status—safe, well-funded plans could invest in more risky securities, while underfunded plans invest in less risky assets. Alternatively, there is a risk transfer element to consider: taxpayers are ultimately responsible for underfunded public pension plans, and governments may raise taxes to fund pension plans (Gold 2003).

Other factors may also affect risk-taking investment policy. Public pension plans have a unique set of issues to consider: politics, fiscal constraints, and public pension accounting. Political influence could pressure the fund to buy bonds issued by the state or local government or to direct funds to economically targeted investments.

And if these investments provide inefficient returns, then remaining assets may be invested in riskier securities. Furthermore, if states face fiscal limitations that restrict borrowing, pension fund debt may act as a substitute (Novy-Marx and Rauh 2009). Fiscal constraints also cause states to manipulate actuarial assumptions to lower required contributions (Eaton and Nofsinger 2004). Public pension plans are regulated by the government standard (GASB 25), which allows liabilities to be discounted at the assumed plan rate of return, which most commonly is 8 percent. Higher assumed returns reduce the discounted liabilities, which in turn reduces the required contributions. Accordingly, we label these factors political influence, fiscal constraint, and accounting effect.

Finally, we consider union membership, demographic make-up of employees, and follow-the-leader investment behavior. If union membership is associated with higher pension obligations, investment policy could become riskier in order to chase higher returns. From a demographic perspective, age and gender of plan participants may affect the risk-taking policy of the fund. In addition, investment managers tend to mimic each other. According to Park (2009), managers of public pension funds tend to follow peer group norms such that asset allocation to all equity hovers around 64–75 percent. Alternatively, public pension plan managers may follow the best performers or plans considered to be large and influential, such as CalPERS. We name these factors union effect, demographic effect, and herding effect.

## Summary of Our Results

We find that accounting standards strongly affect public fund investment risk, as higher return assumptions (used to discount pension liabilities) are associated with higher equity allocations and betas. In particular, a 100 basis point increase in pension return assumption is associated with a 1.72–4.51 percent increase in equity allocation. The corresponding increase in pension asset

beta given a same magnitude increase in the return assumption is 0.04–0.06, suggesting that an important incentive for the fund manager is justifying the liabilities discount rate.

Our results also suggest that public funds assume more risk if they are underfunded or have lower investment returns in the previous year, evidence consistent with risk transfer or intent to pass underfunded pension obligations to future taxpayers. This risk-taking policy is not necessarily in the plan participants' best interest. Taxpayers might ultimately be called upon to close the funding gap.

When states are constrained from issuing additional debt, underfunding pension funds may substitute for borrowing. And because states can justify a higher discount rate for liabilities through the assumed rate of return, states facing financial constraints may subsequently invest in riskier assets, resulting in higher pension plan betas and/or larger equity allocations. We find that pension funds in states facing financial constraints are more likely to take higher risk in their pension fund investment.

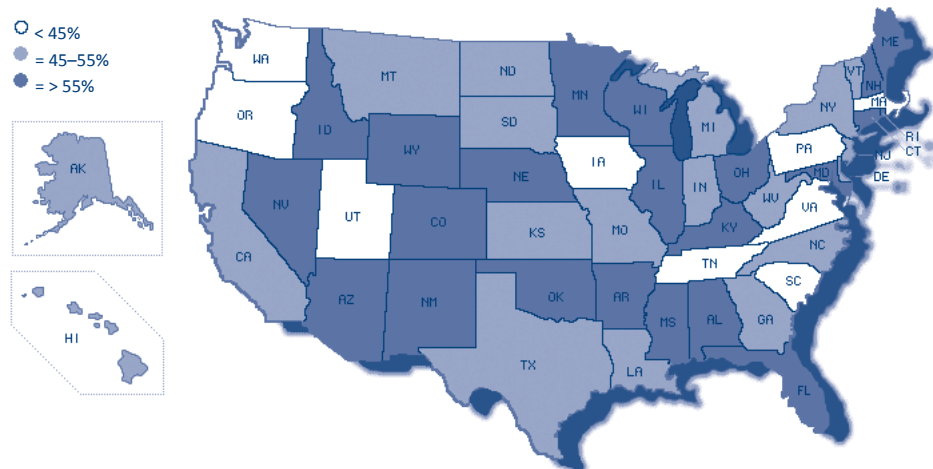
Our results suggest a degree of follow-the-leader in that plan managers tend to follow the risk-investing policy of large and high-profile plans (such as CalPERS). Furthermore, we report a mild public union effect; that is, in order to provide larger retirement benefits for unionized public employees, fund managers pursue a riskier investment allocation. Finally, limited evidence suggests that economically targeted investment policies are associated with lower pension investment risk.

Overall, our findings suggest that the risk levels of public pension funds are determined by various factors: incentives to justify the accounting discount rate choice, shifting pension risk to future tax payers, and substituting underfunded pension liabilities for borrowing. A first step towards addressing the problem would be to appropriately discount future liabilities.

### Notes

1. These figures are from November, 2011. The most current figures, as of February 2012, are 13.2 million active and 7.1 million

**Figure 1 State Pension Plans Equity Allocation as of Fiscal Year 2009**



SOURCE: Center for Retirement Research at Boston College (2011).

retirees and other annuitants. Data available from <http://www.publicfundsurvey.org/publicfundsurvey/scorecard.asp> (accessed March 6, 2012).

2. Beta measures the sensitivity of financial asset returns to the overall stock market change (i.e., using the S&P 500 index as a proxy). Pension asset beta captures the risk of a pension plan's exposure to alternative investments, including private equity, venture capital, hedge funds, and other alternative assets. It was first proposed by Jin, Merton, and Bodie (2006).

3. Allocation to private equity funds increased to 11 percent as of September 2011 (Corkery 2012).

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- Nancy Mohan is an associate professor of finance and Ting Zhang is an assistant professor of finance, both at the University of Dayton.*

## New Book

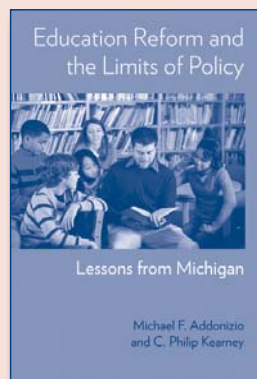
### Education Reform and the Limits of Policy Lessons from Michigan

Michael F. Addonizio  
and C. Philip Kearney

Addonizio and Kearney use Michigan as a laboratory to examine a set of commonly implemented educational reforms in an attempt to answer three key questions:

- 1) What is the nature of these reforms?
- 2) What do they hope to accomplish? and
- 3) How successful have they been?

The authors begin by examining one of the most contentious issues facing



education—money and schools. Does more money make schools better? Next, they examine accountability systems for Michigan's schools and whether they meet the federal

directives of the No Child Left Behind Act. The authors also address the growing trend of school choice, both the options for parents to select charter schools for their children to attend or to send them out-of-district via a "schools of choice" program.

Finally, possibly no other school district in the country has suffered the decline that the Detroit Public Schools has. The authors discuss the many reasons for the district's problems, efforts—including state oversight—to right the ship, and where they see the district headed as it adapts to the splintering of the city's neighborhoods and loss of population to the suburbs.

The book concludes with a discussion of what has been gleaned from the successes and failures of various reform efforts, and, based on the authors' observations and analysis, their thoughts and ideas for the future of education reform.

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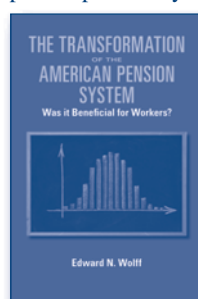
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## Recent Books on Pensions

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improving pension outcomes."—*Journal of Pensions, Economics, and Finance*

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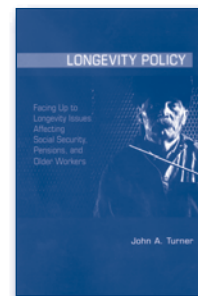
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John A. Turner

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#### International Perspectives

Dana M. Muir and John A. Turner, eds.

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pension experts from 10 countries gathered in September 2010 to propose what they view as the ideal pension systems for their countries.

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reveal how and why the image of an ideal pension system differs across countries and recognize the various long-term goals that different actors have for pension systems.

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phone \_\_\_\_\_