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In this issue . . .

Marta Lachowska and Michał Myck
What Is the Relation
between Public Pensions
and Private Savings?

Carolyn J. Heinrich
The Role of Performance
Management in Good
Governance and Its Application
in Public Education

New and Noteworthy Books

Upcoming Conference

Vol. 22, No. 3

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What Is the Relation between Public Pensions and Private Savings?

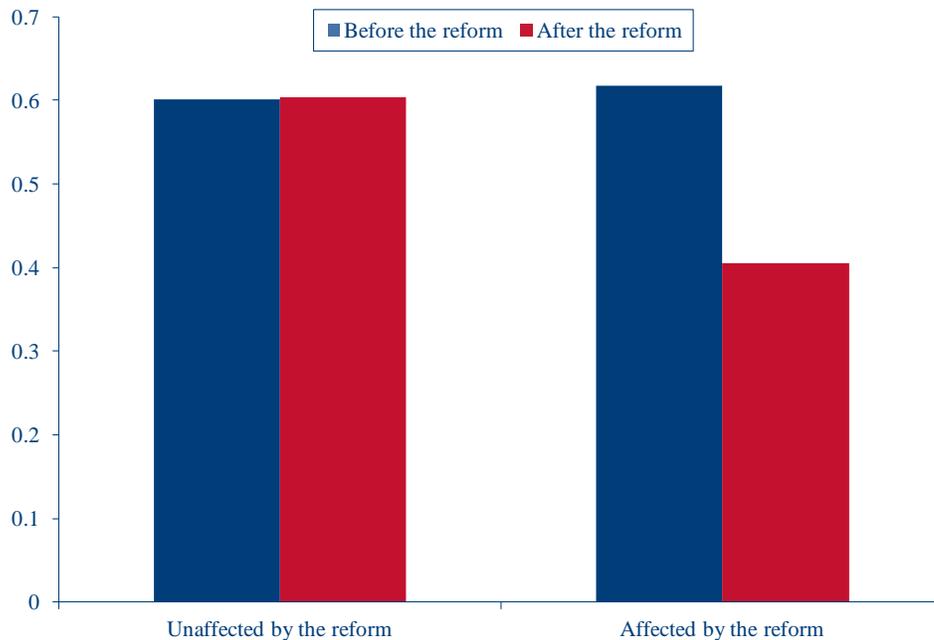
Pension systems where current pension benefits are financed by current revenues, also known as pay-as-you-go systems, are vulnerable to demographic changes such as increased longevity and declining fertility. In part because of lower birth rates in the United States, a 2014 Social Security Board of Trustees report projects that by 2033, the costs of Social Security programs will increase so that revenues will pay for only about 77 percent of scheduled benefits (U.S. Government Printing Office 2014).

To deal with such demographic changes, over the past 20 years many European countries, including Italy, Poland, Sweden, and Germany, have reformed their pension systems (see, for example, Szczepański and Turner [2014]). A common theme of pension reforms has been to change the design of future pensions in order to encourage people to work longer and save more for retirement. Such reforms provide an opportunity to estimate whether, in response to lower future pensions, people save more on their own, or, equivalently, to answer whether pay-as-you-go public pensions crowd out private saving. The public pension crowd-out is an important policy parameter, because it tells us how much people would save on their own if Social Security benefits were lowered.

The 1999 Pension Reform

To answer whether public pensions crowd out private saving, in a recent Upjohn Institute working paper, Lachowska and Myck (2015) study Poland's 1999 pension reform, which created a setting similar to a "quasi-experiment." The reform lowered future pension benefits but had a different impact on individuals, depending on their year of birth. Individuals who were older than 50 at the time of the reform were not directly affected. However, those who were between 30 and 50 years old at the time of the reform will receive pension benefits computed according to a less generous postreform pension formula.

Figure 1 shows the median replacement rate, defined as the ratio of the first pension benefit of the head of household to his or her last preretirement salary, before and after the reform for the cohorts affected and unaffected by the reform. Prior to the reform, many could expect a replacement rate of about 60 percent. After the reform, the replacement rate for the cohorts unaffected directly by the reform remained the same; however, the replacement rate for the cohorts affected by the reform fell by about 20 percentage points. We use the arbitrarily set cutoff at age 50 to identify whether this drop in pension generosity led to an increase in the private saving rate.

Figure 1 Median Replacement Rate Before and After the Pension Reform

NOTE: Replacement rate is defined as the ratio of first gross pension benefit to last gross salary of the head of the household.

SOURCE: Authors' calculations using BBGD 1998 and 1999.

We want to stress that this quasi-experimental variation is valuable because a person's future pension benefits depend on one's earnings, and the determinants of earnings are in turn likely to be correlated with how much one saves. Hence, because of unaccounted-for confounding factors that affect both earnings and savings, simply comparing the savings of somebody with a high future pension to the savings of somebody with a low future pension may not isolate the effect of pension on saving. However, by comparing the saving rate before and after the reform and across similarly aged people—some of whom were affected by the reform and some of whom were not—we can identify the effect of the change in pension generosity on the saving rate.

Methods

To estimate the responsiveness of private savings to pensions, we use data from the Polish Household Budget Surveys for years 1997–2003. We begin by estimating multiyear “difference-in-differences” regressions comparing

household saving before and after the 1999 reform for the cohorts affected and unaffected by the reform. These comparisons tell us how much the saving rate changed because of the reform. In a second step, we estimate the change in PLN (Poland's currency) of the private saving rate for a change of 1 PLN in pension wealth—that is, the public pension crowd-out. To do this, we compute what the pension wealth would have been under the prereform and postreform legislation and relate this variable to saving. As before, we use the fact that the 1999 pension reform changed the amount that similarly aged people could expect to receive in public pensions.

Figure 2 shows the point estimates from a multiyear difference-in-differences regression using the saving rate as the dependent variable. The point estimates show the difference in the saving rate of the households affected by the reform relative to the saving rate of households unaffected by the reform and relative to year 1998—the year preceding the pension reform. In order to interpret the point estimates

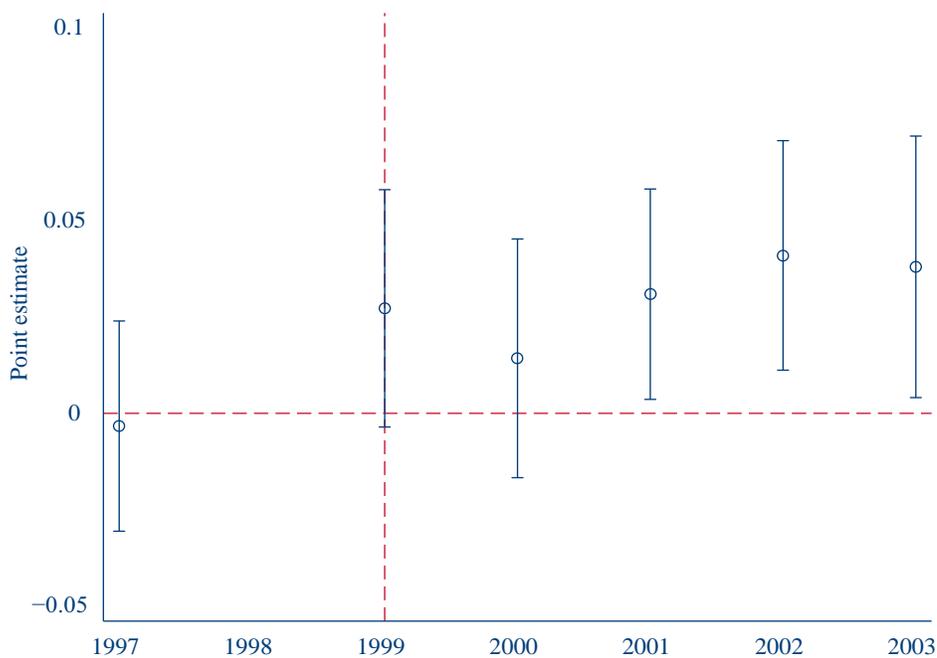
as effects of the reform on the saving rate, we should not see any statistically significant differences in the rate between the households affected or unaffected by the reform in the years preceding the reform. If we do, we would worry about preexisting group and time trends in saving rates that would confound the estimated effect of the reform. However, in the years following the reform, we expect to see an increase in the saving rate of the households whose expected pensions were reduced by the reform.

We see from Figure 2 that in 1997, relative to the unaffected households and relative to the year 1998, there was no statistical difference in the saving rate of the cohorts later affected by the reform. That the saving rate in 1997 is not different for the cohorts affected and unaffected by the 1999 reform strengthens our claim that differences in the saving rate between the cohorts observed after 1999 really are an effect of the reform. The saving rate tends to increase over time in the years following the reform for the cohorts whose pensions were reduced relative to the cohorts who were unaffected by the reform and relative to the prereform saving rate. This suggests an effect of the reform in the expected direction. The magnitude of the estimated effects on the saving rate in Figure 2 is between 0 and less than 5 percentage points, which is a large increase, given that the average saving rate in our data is about 2 percent and the median saving rate is about 9 percent.

Key Findings

How does the change in the saving rate reported in Figure 2 relate to the degree of public pension crowd-out? In our working paper (Lachowska and Myck 2015), we report the following key findings:

- Our analysis shows that public pension crowds out private saving by about 0.24 PLN for each 1 PLN.
- For older cohorts (born between 1949 and 1953), middle-aged cohorts (born between 1954 and 1968), and people with a higher education, we find a large and statistically significant crowd-out ranging between 0.45 and 1.0, which

Figure 2 Estimated Effect of the 1999 Pension Reform on Saving Rate

NOTE: The figure shows point estimates from a multiyear difference-in-differences regression of saving rate on an indicator for whether the household is affected by the reform, i.e., whether the household is “treated,” six-year dummies, and an interaction term between the year dummies and the “treated” dummy. The figure presents the interaction point estimates over time. The omitted categories are year 1998 (the year just before the reform) and the cohort born 1937–1948 (the cohort unaffected directly by the reform). The regression uses robust standard errors clustered by year of birth, and the figure presents 95 percent confidence intervals. The dashed vertical line indicates the first year of the reform.

SOURCE: Authors’ calculations using BBGD.

implies that, for these groups, private saving and pensions are close to perfect substitutes.

- Younger cohorts (born after 1968) and lower-educated households display much smaller public pension crowd-out.

Policy Implications

A crowd-out of 0.24 suggests that public pensions displace a sizable part—about one-quarter—of private savings. However, compared to other recent studies, our estimate of crowd-out is at the lower end of the range of existing estimates.¹ Also, our subsample analysis reveals that this crowd-out is not uniformly distributed in society, but rather is concentrated among certain types of households. If the goal of pension reforms is to increase private saving, policymakers should be aware of the heterogeneity in the responsiveness

of saving to pension reforms. Simply put, some households might increase their saving in response to benefit cuts, while other households might not save enough.

We speculate that the nonresponse among the younger households could be due to liquidity constraints, incomplete information, or uncertainty about how enduring the 1999 reform would be. For young people, building up a stock of wealth might simply be a question of time, and as they age they may accumulate more saving. However, the lack of a savings response observed for the less-educated households is worrisome and echoes the findings of the financial literacy literature. The concern is that by remaining passive and not adjusting their saving, these households are at risk of having a low standard of living in retirement. One policy conclusion from the passive behavior of the low-educated households is that all households do not behave according

to the predictions of the classical life-cycle model; therefore, limited financial literacy should be taken into consideration when designing pension reforms.

Note

1. For example, Attanasio and Brugiavini (2003) report a range of effects between 0.30 and 0.70; Attanasio and Rohwedder (2003) report the crowd-out to be between 0.65 and 0.75; and Bottazzi, Jappelli, and Padula (2006) estimate it to be 0.70.

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Carolyn J. Heinrich

The Role of Performance Management in Good Governance and Its Application in Public Education

This article draws from the author's chapter in The Political Economy of Good Governance (Asefa and Huang, eds.), which was recently published by the Upjohn Institute. To order the book, visit www.upjohn.org/up_press, or see p. 7 for more details.

Governance—laws, rules, judicial decisions, and administrative practices that prescribe and enable the provision of publicly supported goods and services—determines government performance (Lynn, Heinrich, and Hill 2001). The role of performance management, in turn, is to shape how public sector agencies, programs, and activities are organized and managed to achieve public purposes and desired outcomes.

The origins of performance management lie in a basic agency-theory framework, where an owner hires managers and workers to generate profits (with the owner or manager acting as principal, and the workers as agents). The principal's main objective is to design a contract that aligns principal and agent incentives and achieves the principal's production objectives. This is made challenging, however, by the fact that these relationships are frequently typified by conflicts in goals and values, as well as privately held information or information asymmetries.

It is here that a role for performance management enters in, in monitoring worker actions, outputs, and outcomes, and in developing an incentive scheme that aligns principal and agent interests—essentially, a contractual relationship with performance expectations and

credible provisions for enforcing it. However, even in a simple production system—where organizational goals and production tasks are known, a linear relationship exists between efforts and outputs, and there are relatively few variables for managers to control—an enforceable contract is difficult to achieve.

One well-known problem is adverse selection, where employees' true motivations or capabilities for producing a desired outcome are unknown. The second is moral hazard and unobservability, in which employees'

Effective performance management demands clarity of goals and their translation into empirical measures that adequately characterize our intended outcomes.

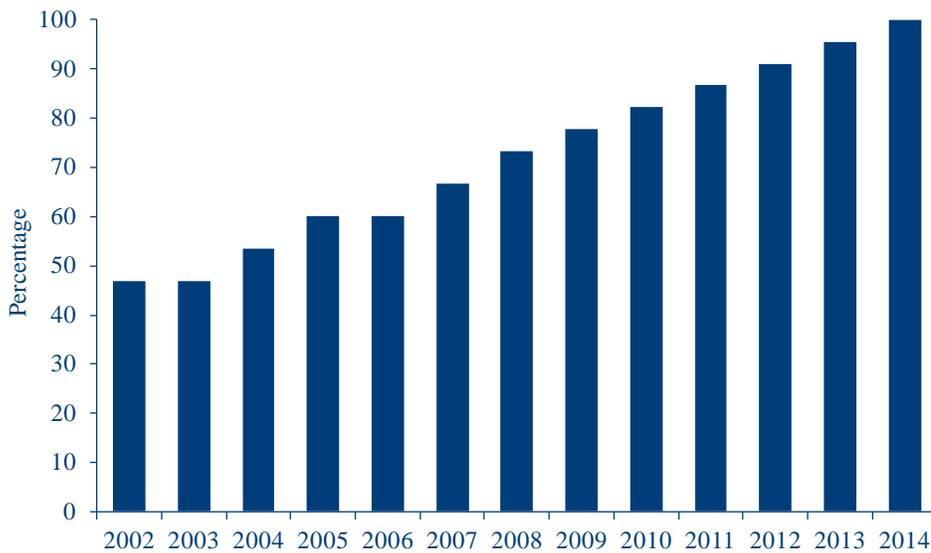
efforts or actions are not observable or readily measured, creating conditions that encourage shirking or distorted results. Recent headlines reporting cheating scandals in K–12 schools—under pressure to meet performance targets on standardized tests set by the No Child Left Behind (NCLB) Act—are just one example of how these problems can undermine performance management efforts (Rich 2013).

Yet many contracts and performance management systems still incorporate basic linear (or “straight-line”) incentive schemes, largely because of their perceived simplicity and the significant

costs of establishing a more intricate contract or system of incentives. A straight-line approach typically defines a required (linear) rate of performance improvement from an initial score or target and may also specify an ending value corresponding to a maximum performance level, such as NCLB's goal of 100 percent proficiency in reading and mathematics for public school students (see Figure 1). NCLB also provides an example of an important shortcoming of straight-line models for establishing performance expectations: they are seldom constructed using empirical data that would generate realistic expectations for performance (Koretz and Hamilton 2006). In fact, Secretary of Education Arne Duncan acknowledged that the performance management system under NCLB evolved “from an instrument of reform into a barrier to reform” (U.S. Department of Education 2013, p. 1).

From the start, the application of agency theory to the design of performance management systems in the public sector has been complex. First, just *who* is the principal in a given governance setting? Governance in the public sector is multilayered and dynamic. In addition, consensus or clarity on goals is often lacking among citizens, and sometimes in originating legislation as well. The public sector is also distinctive in that its primary work typically involves complex, nonmanual work, characterized by multilevel interactions and public-private sector partnerships. Nonstandardized outputs make the accurate measurement of performance and construction of performance benchmarks more challenging and more costly. Finally, the public sector is also distinct from the private sector in the extent to which political influences may be brought to bear at many different levels. Goals and priorities can change swiftly, and entire agencies or authority structures can be reorganized, as well as the foci of primary work. There is great potential for unintended consequences as performance management and the use of performance-based contracts expand into uncharted public-sector territory (Koning and Heinrich 2013).

Figure 2.1 Annual Expectations Set by the No Child Left Behind Act for Increased Performance among Students in Grades K–8 Tested in Math, 2002–2014 (% that must be met of students testing at the “proficient” level)



NOTE: The figure shows the expected percentage of students each year that should achieve a rating of “proficient” in testing for math under the legislation. The bar for 2002, the first year the law was in effect, shows the actual percentage of students who tested as proficient in math that year, and no improvement was required for the first year following that. But thereafter, increasing percentages of proficiency were set for each year, culminating in 2014, when 100 percent of kindergarteners through eighth graders were expected to be proficient in math. (The exception was 2006, when the expectations were not raised from 2005.)

SOURCE: Author’s compilation.

Applying Performance Management Bluntly in Public Education

We spend close to \$600 billion annually on our public elementary and secondary school system, and the public is demanding greater accountability and results. Furthermore, public education today is characterized by elaborate governing structures with deeply layered and overlapping levels of decision making, widely varying views on appropriate means and ends for improving education, an increasingly complex technology with diverse outputs (which we subject to standardized measures of outcomes), and political influences that interject at many levels. Could the use of performance management potentially bring some clarity and coherence to K–12 education governance?

We have proceeded full speed ahead with regimes for performance management and accountability in education that include strong incentives and high-stakes consequences for

many stakeholders. NCLB marked the beginning of an assertive federal role in directing state and local practices to meet student performance standards. The federal government holds states, districts, and schools accountable for a comprehensive set of standards, including annual academic progress, teacher quality, and achievement gaps, and for developing assessments of student performance relative to those standards. NCLB defines educational success primarily based on standardized tests of students’ performance, and current funding and accountability systems presume “same-age cohorts of students proceeding in lockstep” (Wilson 2013, p. 96). Consistent with the origins of performance management, Darling-Hammond (2002, p. 6) describes how our test-based accountability system reflects a “factory-model approach” to education, in which schools are organized “to process large batches of students in assembly-line fashion rather than to ensure that students are well-known

by their teachers and treated as serious learners.”

Recently, recognition of the limitations of proficiency measures under NCLB has propelled alternative approaches to measuring educational performance, particularly value-added measures. A basic value-added model compares the individual growth of a group of students (e.g., in a given classroom or school) to average growth of the population of interest (e.g., growth among all students in the state). Some value-added models are also constructed to account for factors outside the control of schools in estimating growth in student achievement over time. Although these are (arguably) better measures of performance than proficiency levels, should society be ratcheting up the stakes that it attaches to them, as we have recently seen in some large, urban school districts?

One of the most controversial recent developments in performance management in education has been the high-profile, public dissemination of value-added measures of teacher performance in large school districts, including in Los Angeles and New York. Calculated by third parties (outside the district), the value-added measures associated with specific teachers were published in the *Los Angeles Times* and by the New York City Department of Education.¹ The objective was to get the performance information directly to citizen stakeholders, who could use this information and their political power to drive public-sector performance improvements.

However, in New York City, the margin of error in value-added measures was so wide that the average confidence interval around each rating spanned 35 percentiles in math and 53 percentiles in English, the city said. Some teachers were judged on as few as 10 students. In publishing the Los Angeles numbers, the *L.A. Times* acknowledged that value-added measures “do not capture everything about a teacher or school’s performance” (see Note 1). A study by Mathematica Policy Research (Schochet and Chiang 2010) finds that the error rate for value-added scores (based on three years of data) was 25 percent. Therefore, a three-year model would rate one out

of every four teachers incorrectly, and with only one year of data, the error rate jumped to 35 percent.

Lessons for Improving the Effectiveness of Performance Management

What have we learned about the role of performance management in contributing to good governance and improving government outcomes?

- The effective use of performance management demands clarity of goals and their translation into empirical measures that accurately and adequately characterize our intended outcomes.

Where we fail on either of these components, the performance management system may risk doing more harm than good. In many cases, the data available simply are not up to the task.

In light of these limitations, and recognizing that performance management often grapples with multiple goals and complex production, we may be better off with multidimensional measures of performance to guide our work. A number of school districts and states are now developing these types of multipurpose, multiple-indicator performance management systems for K–12 education (New York City Department of Education 2014). A potential trade-off, of course, is that a more intricate or complicated system and set of incentives would likely place a greater demand on public capacities for managing such a system.

- Caution should be exercised in attaching high stakes to performance results, given the known challenges and imperfections of our performance measures.

The awarding of performance bonuses, “naming and shaming” (as in the publication of teacher value-added), termination of contracts, or retractions of program funding would best be backed or verified by multiple sources of quantitative and qualitative evidence before going forward. A counterargument frequently offered against eliminating high stakes altogether is that the performance management and incentive systems will lose their “teeth” and purpose. Evidence to date,

however, suggests that individuals and organizations are highly responsive to performance standards, even when the rewards are minimal, such as peer recognition (Bevan and Hood 2006; Heinrich 2007).

- Performance management systems are likely to be more effective tools of governance if we focus more on their use for *diagnostic* purposes.

That is, resources and rewards should follow their *effective use* in improving government and program outcomes, rather than for hitting performance targets. In the public education example, schools or teachers would be rewarded for using information on students’ performance to help increase their learning, ideally measured in terms of their individual growth that is not based solely on test score levels or gains. This would be a more appropriate outcome to report publicly (for the sake of transparency), and, if measured sufficiently, would also reward the right types of efforts to increase performance, that is, not success in increasing test-taking skills but rather effective use of performance information to help students succeed academically.

Note

1. See <http://projects.latimes.com/value-added/> and <http://www.schoolbook.org/2012/02/24/teacher-data-reports-are-released/> (accessed June 10, 2015).

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New and Noteworthy Books

NEW

The Political Economy of Good Governance

Sisay Asefa and Wei-Chiao Huang, Eds.

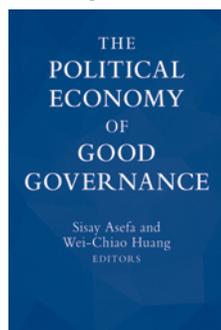
Governance refers to the process of governing and includes the actions of all the stakeholders involved, including formal governmental bodies, citizens,

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What Does the Minimum Wage Do?

Dale Belman and Paul J. Wolfson

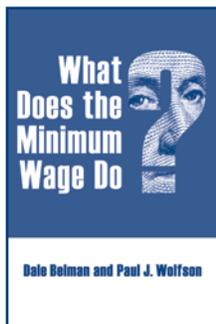
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The summit is hosted by the W.E. Upjohn Institute for Employment Research, the Initiative for a Competitive Inner City, and the Federal Reserve Bank of Chicago.

For an agenda and details on how to register, please visit <http://www.icic.org/urban-economic-development/2014-inner-city-economic-summit>, or contact Claudette Robey, Economic Development Quarterly, robey@upjohn.org or (269) 385-0469.

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