

Leaving Money on the Table: The 106 Pension Systems of Massachusetts

Public Employee Benefits Series: Part 2



BY **KEN ARDON**

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Executive Summary

The Public Employee Retirement System of Massachusetts consists of 106 separate retirement systems. Each of these systems is governed by Chapter 32 of the Massachusetts General Laws but has a separate board with the power to rule on eligibility issues and supervise investments. The two largest systems cover state employees and teachers; together these account for approximately \$35 billion of the \$50 billion in pension funds for public employees. The other 104 systems hold \$15 billion on behalf of a variety of municipal, county, district, and public authority employee groups.

These local systems vary tremendously in size, ranging from Boston, with more than \$3 billion in its pension fund and 34,000 employees and retirees, down to Blue Hills Vocational District with \$5 million in assets and fewer than 100 employees and retirees. The median local retirement system fund holds approximately \$75 million and covers 1,000 employees and retirees, and the average local retirement system holds \$150 million in assets and covers 2,200 employees and retirees.¹

The two state-funded pension funds, which serve state employees and teachers, invest through the Pension Reserve Investment Trust (PRIT), which is managed by the Pension Reserves Investment Management board (PRIM). Local retirement boards² have the choice of whether to manage their investments on their own or to invest all or a portion of their assets in PRIT. Most local boards choose to retain control of their investments. In 2004, 55 out of the 104 local systems invested entirely on their own, 29 had some assets invested in PRIT or the PRIT segmentation program,³ and only 20 invested entirely with PRIT.⁴

While local control may be warranted for rulings on eligibility, it is less obvious whether local control of investment decisions is justified. Local independence comes at great cost. A review of 10-year and 20-year return histories demonstrates that the vast majority of local boards underperform PRIT by significant margins, imposing a significant burden on the municipalities that must make up the shortfall. Only six of the 104 local systems have earned an annual return as high as PRIT. The estimated cumulative loss from the lower returns that local retirement funds earned by controlling their own investments over the last ten years was \$1.6 billion. Massachusetts' taxpayers are in the process of paying an additional \$3 billion in taxes to make up for the poor investment performance since 1995.

There are several possible explanations for this underperformance—higher costs, a lack of access to high quality investment managers, a dearth of investment expertise, or poor oversight of board activities.

This is the second in a four-part series on the Public Employee Retirement System from Pioneer Institute. The first paper focuses on the core of the system, the defined benefit pension plan, and explore whether the system is fair to employees and taxpayers. This paper examines the inefficiency of operating 106 separate retirements systems within the state and highlight the costs of these practices. The third will examine the incentives in the current system and alternatives. The final paper will consider the provision of health care to retirees.

The current structure of the state pension system, with its proliferation of boards and poor oversight, costs municipal taxpayers millions of dollars per year. This problem should be addressed in two ways:

1. **Centralization:** The pension system should capture economies of scale and provide access to the highest quality managers by putting all assets in a single pension fund, of which PRIT is the most obvious candidate.
2. **Enhanced Oversight:** The legal and practical ability of the designated state oversight body, the Public Employee Retirement Administration Commission (PERAC), should also be expanded by putting local pension boards under the state's Uniform Procurement Act, setting state-wide standards for travel expenses and conflict of interest, and conducting audits more frequently.

The cost to taxpayers, in the form of underperformance and poor oversight, outweighs any benefits of such a fragmented system.

Introduction

The Public Employee Retirement System of Massachusetts consists of 106 separate retirement systems. Every system has a separate board that has the power to rule on eligibility issues and supervise investments. The 106 separate systems break down into two groups: the two state-funded pension funds, which serve state employees and teachers, and the other 104 systems, which serve a variety of municipal, county, district, and public authority employee groups.

The two state-funded pension funds consist of approximately \$35 billion in assets and invest through the Pension Reserve Investment Trust (PRIT), which is managed by the Pension Reserves Investment Management board (PRIM). The other 104 systems oversee \$15 billion in assets. They vary greatly in size, ranging from Boston, with more than \$3 billion in its pension fund and 34,000 employees and retirees, to Blue Hills Vocational District with \$5 million in assets and fewer than 100 employees and retirees. The median local retirement system fund holds approximately \$75 million and covers 1,000 employees and retirees.

The focus of this paper is the choice that local retirement boards have of managing their own investors or investing all or a portion of their assets in PRIT. Most local boards choose to retain control of their investments. In 2004, 55 out of the 104 local systems invested entirely on their own, 29 had some assets invested in PRIT or the PRIT segmentation program, and only 20 invested entirely with PRIT.

High Costs and Lower Return on Investment

Smaller pension systems face diseconomies of scale in their administration and management that often result in higher costs. Most of the 104 local pension systems are dwarfed by the state employee and teacher's pension funds. Figure 1 shows the distribution of local pension funds by asset valuation. There are 26 systems with less than \$50 million in assets and only one with more than \$750 million.⁵

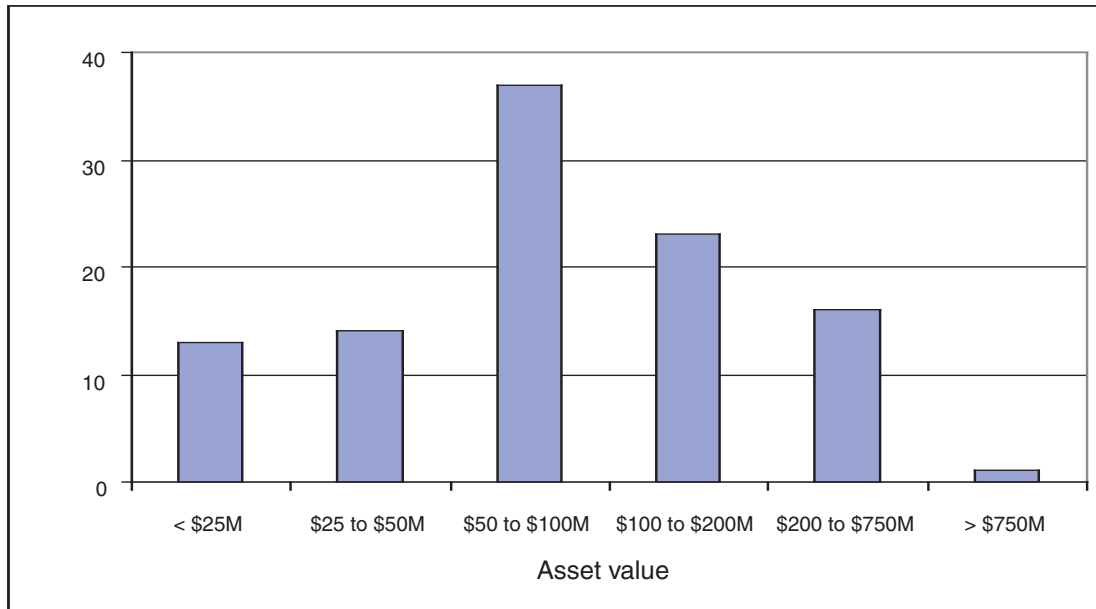


Figure 1: Distribution of Local Pension Funds by Size

Each of the local boards must hire administrators and staff, as well as investment advisors and consultants, and the boards also pay management fees. According to data provided by PERAC, administrative costs are generally lower at larger funds. Although there is not an exact relationship, the ten smallest boards had administrative costs equal to 0.44% of assets, or roughly two and a half times as high as the ten largest boards.⁶ Total expenses at the ten smallest boards equal 0.78% of assets, while they are only 0.68% at the ten largest boards.⁷

Even a small difference in expenses can compound over many years to negatively affect returns; in a fund with \$10 million, an extra 0.25% in costs each year would result in a loss of \$2 million after 20 years.

Pension systems pay administrative and management costs from fund assets, so these expenses do not immediately affect a city or town's budget. Nevertheless, every dollar drawn from a pension fund leaves it with less to pay retirement benefits and will ultimately require more funding from taxpayers.

High expenses could be offset by strong investment performance, but performance data shows that this is not the case. Across the local retirement systems, high expenses are correlated with lower net returns. The ten systems that had the best returns over the past twenty years currently have administrative expenses only half as high as those with the worst returns, at 0.16% compared to 0.32%. The ten systems with the highest administrative expenses have 20-year annual returns almost a full percentage point below the ten systems with the lowest costs.

There are two additional reasons why small, local funds may have trouble generating a strong return on investment. First, small funds may have trouble attracting the best money managers because the funds generate relatively low management fees. Additionally, the small funds may not have the ability to invest in some assets. Hedge funds and other investment vehicles are often only open to large investors; smaller

retirement boards may miss these opportunities. These factors may give PRIT an advantage over local pension systems that manage their own investments.

Lack of Oversight

With 104 local boards each making hiring, spending and investment decisions, significant opportunities for favoritism or corruption exist. Although the same can be said of PRIM's decisions, it is easier to provide oversight for one statewide board rather than 104 local boards.

Legal restrictions on retirement system boards are relatively weak. Chapter 130B of the Massachusetts General Laws contains the Uniform Procurement Act that governs government purchases of goods and services. **However, the law specifically exempts services for retirement boards from the act, leaving local boards free to purchase services without competitive bidding. In addition, there are no uniform statewide restrictions on travel expenses or business relationships with related parties.**

PERAC audits regularly report on the lax financial controls of many of the boards. In a particularly glaring example, the Middlesex County Board has recently been accused of rigging bids for construction contracts, falsifying documents, steering contracts towards a board member's in-laws, and firing a contractor who did not hire favored subcontractors. The State Inspector General described the board's actions as "a profound breach of public trust and a misuse of beneficiaries' money."⁸

The irregularities in Middlesex are not new—earlier audits uncovered many problems at the board:

It regularly billed the retirement system without proper documentation and hired an auditor without a competitive bidding process. The board responded that the state law did not require competitive bidding. While this distinction may or may not be legally correct, it is ethically troubling.

It inappropriately reimbursed an attorney for travel, conferences, and lodging and provided health insurance.

It used an American Express card to bill personal expenses to the retirement system, including travel to Asia, Australia, Myrtle Beach, Florida, and Las Vegas. The expenditures included charges for liquor, limousines, groceries, and gifts. The board claimed that the personal expenses were later reimbursed as soon as practicable, but a special audit found that some expenses were not reimbursed.

It billed for food and beverages for a party at the chairperson's home without documentation.

It purchased a computer for delivery to a board member's home.

Board members across the state frequently exploit weak controls on travel to conferences, at the pension fund's expense or under the sponsorship of investment managers. Pension board members are free to use pension funds to travel to educational conferences. Among the recent examples of questionable behavior:

During 2005, the chair of the Melrose Retirement Board requested reimbursement of more than \$11,000 for seven conferences.⁹

During 2004, the Plymouth Retirement Board, which has some of the highest administrative costs in the state, spent \$26,861 on travel to conferences, a number far in excess of other retirement boards in the area.¹⁰

Similarly, the Plymouth County Retirement Board (which is separate from the Plymouth board) spent over \$7,000 in 2005 to send four of its board members to a national conference at a resort in Las Vegas.¹¹

In 2002, the Executive Director of the Massachusetts Teachers Retirement Board was fined \$5,000 for ethics violation for improper credit card charges. He had incurred these charges during \$75,000 worth of conference travel over a two-year period.¹²

Considering that retirement boards hire professional consultants and advisors to manage pension fund investments, it is not clear that these educational conferences, at hotels and resorts in locations such as Florida, Australia, Las Vegas, and Myrtle Beach, are necessary or efficient. The least that can be said is that many board members have taken advantage of these opportunities with what appears to be excessive zeal.

Even when travel does not impose costs on pension funds it opens up serious ethical issues, as evidenced by the 2001 publicity surrounding the actions of the executive director of the MBTA retirement fund. The executive director attended an April 2001 conference in New Orleans and had his airfare and hotel expenses paid for by the conference organizer. While there, his attendance and participation in conference events was found to be minimal. Fourteen investment management firms, five of which had active business with the MBTA Retirement Fund, sponsored the conference.¹³

The local retirement boards make decisions that result in more than one hundred million dollars in administrative spending and management fees each year. Control of this much public spending requires supervision to prevent abuse. Unfortunately, with 104 boards, over 400 board members, and over \$15 billion in assets, the ability to provide consistent oversight of local boards is limited not only by weak legal authority and regulations but also by limited resources. Many retirement systems have not been audited by PERAC in more than five years.

PRIT vs. Local Performance

In theory, the problems of high costs, poor access to quality investment managers, and weak oversight could cause local funds to underperform. In practice, the important metric is actual performance—whether or not the proliferation of boards has hurt taxpayers.

The full Massachusetts public employee retirement system controls \$50 billion in assets. Approximately \$35 billion of this total is in PRIT, the state employee and teachers' retirement systems. The remaining \$15 billion is managed by the local systems.

PRIT has been very successful at investing the billions of dollars that it manages. From 1985 to 2004, PRIT earned a compound annual return of 11.19%, which beat the S&P 500's return of 10.5% per year and the NYSE Composite return of 10.4% per year.

PRIT's performance has consistently been well above the average of other public pension funds in the United States. According to the Wilshire Trust Universe Comparison Service, over the past ten years the median public fund with more than \$1 billion in assets returned 8.56% per year. Over this same period, PRIT earned 10.52%, which placed it at the 95th percentile. This strong performance has been consistent: PRIT ranks in the top 10% over one-year, five-year, and ten-year horizons.

The successful performance of PRIT has helped ease the (still monumental) burden that retirement costs impose on the state government. The calculations of the state's unfunded liability assume that the state will earn an 8.25% return on the retirement

fund. PRIT's ability to consistently surpass that target is the primary reason the state has been able to improve from a funding ratio of 39% in 1990 to more than 70% in 2005.

Unfortunately, as Table 1 demonstrates, almost every local board that invests on its own has not been as successful as PRIT. Over the past twenty years, while PRIT earned an annual return of 11.19%, the median local return was only 10.07%. **During that time, only six of the 104 local systems have earned an annual return as high as PRIT.** Eighty-four local funds earned at least 0.5% per year less than PRIT, and 55—or more than half the retirement systems—earned at least 1% less than PRIT. These returns compound each year, so that \$1 invested in PRIT twenty years ago would have grown to \$8.35 today, while in the median local fund it would have grown to only \$6.82.

Table 1: Historic Returns on Pension Fund Investments

	PRIT	Local (Median)
20-Year Annual Return	11.19%	10.07%
20-Year Total Return	735%	582%
10-Year Annual Return	11.59%	10.36%
10-Year Total Return	199%	168%
# Beating PRIT		
(Over 20 Years/Over 10 Years)		6/21
# 0.5% or more below PRIT		
(20-Year/10-Year)		84/74
# 1% or more below PRIT		
(20-Year/10-Year)		55/57

The results are similar over the past ten years. During that time, the median fund earned 10.4%, or roughly 1.2% below PRIT.¹⁴ The total return at PRIT during this time was roughly 200%, while at the local funds the median return was less than 170%. Once again, the returns at more than half the funds were at least a full percentage point below PRIT. Table 2 shows the returns from the ten best and the ten worst funds over the past ten years.

Table 3 presents an overview of local pension fund returns over 20 years. While a few funds have been able to beat PRIT over a 20-year time horizon, only Wellesley, Haverhill, and Weymouth have earned 0.25% per year more. The total return figures demonstrate the impact of the underperformance. The six top performers exceeded PRIT's total return by an average of 73 percentage points, but the ten bottom performers lagged PRIT by an average of 323 percentage points.

Despite low returns, local boards show little interest in placing funds with PRIT. Athol had the worst performance of any pension fund in the state over the past ten years, and the third worst over the past twenty years. However, according to a report in the *Boston Globe*, when asked about investing with the state, Athol's town accountant Gene A. Ferrari Jr. replied, "It's never been brought up."¹⁵

A 20-year history of consistent underperformance clearly demonstrates that almost all local boards are unable to match the investment return of PRIT.

Table 2: Local Pension Fund Returns Over 10 Years – Best and Worst Performers

Top Performers				Bottom Performers			
Board	Rank	Annual Return	Total Return	Board	Rank	Annual Return	Total Return
Haverhill	1	13.1%	242%	PRIT		11.6%	199%
Malden	2	12.2%	215%	Greater Lawrence S.D.	95	8.9%	134%
Weymouth	3	12.2%	215%	Lawrence	96	8.8%	133%
Beverly	4	12.1%	213%	Springfield	97	8.8%	132%
Gardner	5	12.0%	211%	Middlesex County	98	8.6%	127%
Northbridge	6	12.0%	211%	Everett	99	8.5%	126%
Wellesley	7	12.0%	209%	Natick	100	8.5%	125%
Wakefield	8	12.0%	209%	Fitchburg	101	8.5%	125%
Minuteman	9	11.9%	209%	Easthampton	102	7.9%	113%
Dedham	10	11.9%	209%	Chelsea	103	7.7%	110%
PRIT		11.6%	199%	Athol	104	7.5%	106%

Table 3: Local Pension Fund Returns Over 20 Years – Best and Worst Performers

Top Performers				Bottom Performers			
Board	Rank	Annual Return	Total Return	Board	Rank	Annual Return	Total Return
Haverhill	1	13.1%	242%	PRIT		11.6%	199%
Wellesley	1	12.2%	891%	PRIT		11.2%	735%
Haverhill	2	11.9%	844%	Clinton	95	8.9%	447%
Weymouth	3	11.8%	834%	Fitchburg	96	8.8%	443%
Needham	4	11.4%	763%	MHFA	97	8.8%	435%
Taunton	5	11.4%	759%	Chelsea	98	8.7%	431%
Wakefield	6	11.3%	754%	Hull	99	8.6%	417%
PRIT		11.2%	735%	MWRA	100	8.4%	404%
Minuteman	7	11.1%	720%	Barnstable County	101	8.4%	403%
Dedham	8	11.1%	720%	Athol	102	8.2%	384%
Holyoke	9	11.0%	705%	Dukes County	103	8.2%	379%
Milton	10	11.0%	705%	Greater Lawrence S. D.	104	8.1%	373%

Impact of Underperformance

The cost of this underperformance is significant and severe. Because the local pension funds hold assets of more than \$15 billion, every 1% drop in return equates to \$150 million in lost annual income. In 2003 and 2004 alone, the local systems earned 4.7% and 2.9% less than PRIT. **Over the past ten years, the cumulative loss from the lower returns the local retirement funds earned investing on their own was approximately \$1.6 billion.**¹⁶

The unfunded liability of local systems is difficult to estimate because each system calculates its liability and unfunded liability only every three years, resulting in asset valuations based in different years. Nevertheless, according to the most recent data provided by PERAC, local retirement boards have an unfunded liability of approximately \$9 billion, with a funding ratio of 64%.¹⁷ The \$1.6 billion in lost earnings could have significantly closed that gap.

This loss has to be made up by taxpayers or by cuts in local services; it would require annual payments of approximately \$166 million every year until 2028 to pay down the additional unfunded liability created because the local systems did not earn as much as they could have by simply putting their assets into PRIT. **Massachusetts' taxpayers are in the process of paying an additional \$3 billion in taxes to make up for the poor investment performance since 1995.**

While the \$1.6 billion represents the overall impact on the 104 systems across the state, some have obviously fared worse than others. Table 4 shows the costs for the ten systems with the lowest 10-year returns from Table 2.

Table 4: The cost of poor performance in the worst performing funds

Board	Rank	10-Year Annual Return	Loss (\$ millions)	Loss (% assets)	Loss (% UAL)
PRIT		11.6%	NA	NA	NA
Greater Lawrence S.D.	95	8.9%	-1.7	-22%	NA*
Lawrence	96	8.8%	-25.8	-24%	-19%
Springfield	97	8.8%	-66.8	-25%	-21%
Middlesex County	98	8.6%	-158.6	-27%	-26%
Everett	99	8.5%	-16.3	-36%	-21%
Natick	100	8.5%	-20.0	-30%	-52%
Fitchburg	101	8.5%	-18.7	-25%	-29%
Easthampton	102	7.9%	-5.3	-25%	-35%
Chelsea	103	7.7%	-14.2	-31%	-22%
Athol	104	7.5%	-4.2	-32%	-30%

* The Greater Lawrence Sanitary District does not have an unfunded liability.

As an example, Lawrence has posted an average annual return of 8.8%; 2.8% worse than PRIT. This has resulted in foregone investment income of \$25.8 million, which is equivalent to slightly less than 25% of the current assets of their fund and would have made up almost a fifth of their unfunded liabilities.

Table 5: The cost of poor performance in selected cities

Board	Rank	10-Year Annual Return	Loss (\$ millions)	Loss (% assets)	Loss (% UAL)
PRIT		11.6%			
Boston	61	10.1%	-402.6	-11%	-20%
Fall River	84	9.3%	-42.7	-21%	-30%
Fitchburg	101	8.5%	-18.7	-25%	-29%
New Bedford	49	10.4%	-15.4	-8%	-8%
Salem	66	10.0%	-11.4	-15%	-15%
Springfield	97	8.8%	-66.8	-25%	-21%
Worcester	32	11.0%	-18.3	-3%	-11%

Table 5 shows the costs of underperformance for selected cities across Massachusetts. The City of Worcester merits attention for an additional reason. In 1999, the City borrowed \$220 million to pay off its unfunded liability using “pension obligation bonds” or POBs. Since Worcester invested the proceeds of the POBs, the system’s return has lagged PRIT by about 1% per year. Had Worcester invested the \$220 million with PRIT in 1999, the pension system would have an additional \$15 million today.

Conclusion

Taxpayers are currently in the process of shouldering a \$3 billion burden caused by underperformance in local pension funds. For the worst performing funds, underperformance accounts for between 19% and 52% of the total unfunded liability of these funds. The cumulative loss from the underperformance of local retirement funds investing their own funds was approximately \$1.6 billion. This costly problem is exacerbated by the related issues of poor access to quality managers and high administrative expenses and management fees.

PRIT has outperformed all but six local pension funds over the last twenty years. Given the magnitude of the problem and the looming unfunded liabilities associated with public employee healthcare, a solution is needed in the near-term. The simplest and most practical solution would be to centralize the assets of the Massachusetts public employee pension system in PRIT. An exception could be made for the six local funds that have outperformed PRIT over the past twenty years.

In addition, the oversight of local funds by PERAC should be enhanced and expanded. The Uniform State Procurement act should be expanded to include all public employee pension systems in the state to ensure transparent and competitive bidding. Uniform standards for travel expenses and conflict-of-interest issues should be implemented to avoid excessive travel and questionable interactions with entities that have business before local boards. The state should also expand PERAC’s ability to perform audits more frequently to ensure regular and timely audits.

The underperformance of local pension funds is a costly problem that has an obvious and easily accessible solution, in the form of PRIT.

Notes

1. Figures based on data provided by PERAC. Funds were valued at different dates, and some values may have changed considerably since the last official valuation.
2. The term local in this context refers to all retirement systems other than the state employee retirement system and teachers' retirement systems.
3. The segmentation program allows locals to choose a specific asset class within PRIT rather than investing in the broader PRIT fund.
4. The local boards that invest with PRIT tend to be smaller than average; only three hold assets of over \$100 million.
5. Funds were valued at different dates, and some values may have changed considerably since the last official valuation.
6. Data was not available for 13 systems.
7. Total expenses are drawn from the most recent audit reports for each retirement system. The audits were not performed in the same years; audit dates ranged from 1999 to 2004.
8. Inspector General Gregory W. Sullivan's Letter to PERAC Executive Director Joseph E. Connarton, April 25, 2006, <http://www.mass.gov/ig/publ/peracltr.pdf>, last accessed on May 16, 2006.
9. Caroline Louise Cole, *Boston Globe*, "Board Fired Up Over Ban on Travel," April 20, 2006, north supplement.
10. Matt Carroll, *Boston Globe*, "Retirees Group Urges New Reins on Travel," November 17, 2005, south supplement.
11. Matt Carroll, *Boston Globe*, "Retirement Board Spent \$7,000 on Vegas Forum," July 3, 2005, south supplement.
12. Ellen J. Silberman, *Boston Herald*, "Teachers pension boss hit with \$5,000 fine for spree," July 3, 2002.
13. Jack Meyers, *Boston Herald*, "Easy livin' – Embattled T pension boss took junket to Big Easy," May 24, 2001.
14. The weighted average return among local funds was also 10.4%.
15. Steve Bailey, "1 State System, 106 Systems," *Boston Globe*, October 21, 2005.
16. This figure was calculated by multiplying the difference in returns between the local systems and PRIT for each year by the asset value at the end of the prior year, and summing the differences over ten years. For example, if a fund with assets of \$100 million earned 10% in a year when PRIT earned 11%, the fund "lost" 1% or \$1 million.
17. These figures have a substantial margin of error. Investment gains or losses and actuarial adjustments may have changed the asset value and unfunded liability considerably for some systems.

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Charter Schools: Fears and Facts, June 1995

About the Author

Ken Ardon received a PhD in economics from the University of California at Santa Barbara in 1999, where he coauthored a book on school spending and student achievement. He taught economics at Pomona College before moving to Massachusetts, and, from 2000 to 2004, Dr. Ardon worked for the state of Massachusetts in the Executive Office of Administration and Finance. Since 2004, he has been an assistant professor of economics at Salem State College.



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