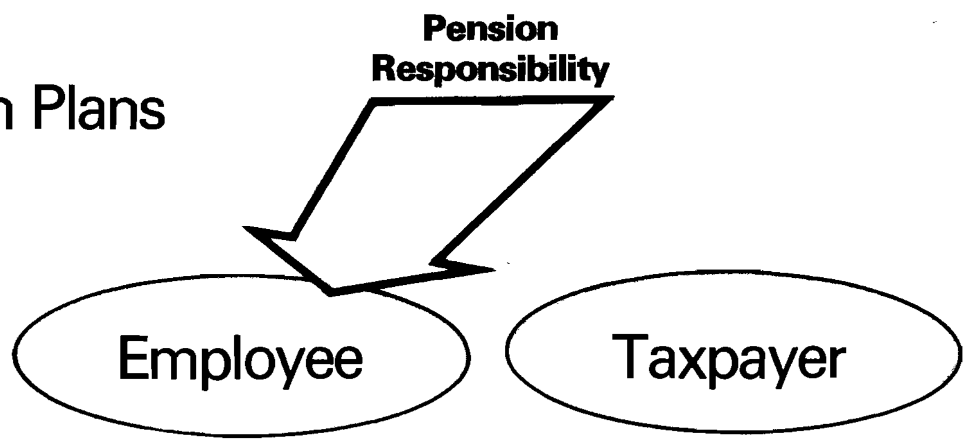
CITIZENS LEAGUE REPORT

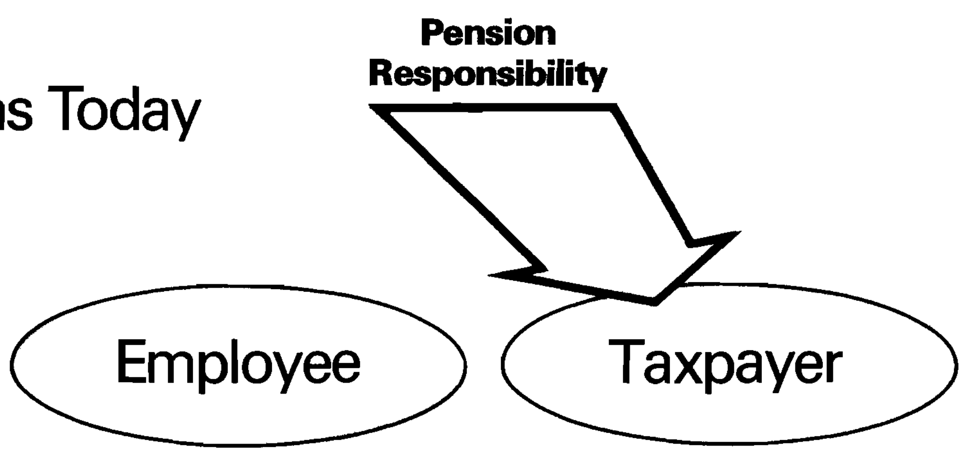
A risk-shared basis for pensions...

how taxpayers and employees
can benefit through greater sharing
of responsibility for public pensions

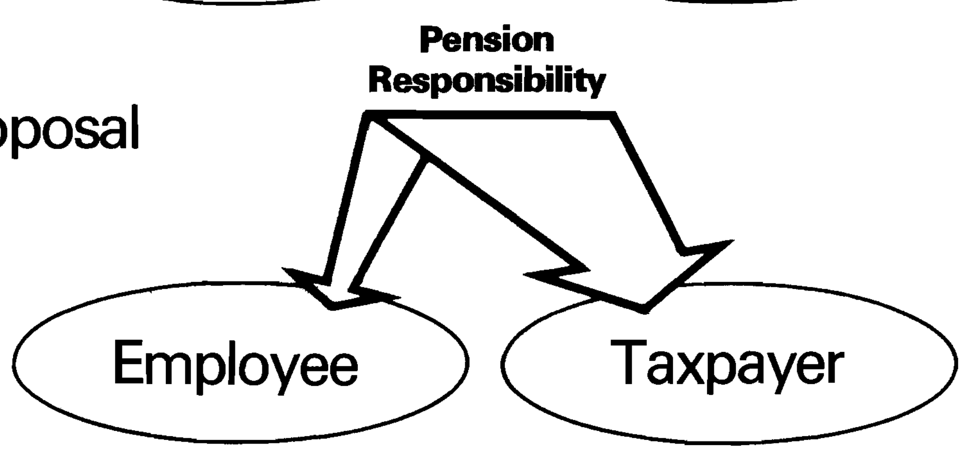
Early Public Pension Plans



Public Pension Plans Today



Citizens League Proposal



CITIZENS LEAGUE REPORT

A RISK-SHARED BASIS FOR PENSIONS.....

How Taxpayers and Employees Can Benefit Through Greater Sharing of Responsibility for Public Pensions

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December 13, 1978

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INTRODUCTION

Public pensions have not been a topic of general public discussion. And, within government, policy makers (elected and others) have not taken general interest in public employee pension plans. For example, in the Legislature, virtually all debate regarding public pensions takes place within the ten-member Legislative Commission on Pensions and Retirement.

Interest has been low largely because there has been little public realization of the cost of the plans. By contrast, employer and employee organizations are directly affected by all changes in pension plans and follow the plans closely. These conditions do not invite the policy makers' attention...especially when they can apply themselves to issues that will produce more tangible benefits for the general public.

The situation is changing...public interest is on the increase, mainly because the costs of many pension plans are rising and government's resources are limited now. Policy makers may now have their best opportunity in twenty years to make major changes in Minnesota's public pension plans.

Pension plans are complex. But, they are not incomprehensible...not to policy makers and not to most taxpayers. Like other policy areas, pension plans are built around some basic concepts. These seem no more or less complex than those for transportation, health care, or taxation. However, the "basics" are rarely discussed. Instead, specific features (e.g., deferred annuities augmentation, buy-back privileges, and reduction factors) appear to receive most of the attention.

Our report tries to describe the basic concepts. And, as the Legislative Commission did in the late 1950s, it examines the way these concepts are now being applied. The discussion and recommendations are divided into five parts:

- How pension plans work.

- The purpose of public pension plans.

- The benefits provided by public pension plans.

- Funding public pensions.

- Public pension policy making and administration.

As we examined public pension plans, it was clear that they had changed a good deal since the early 1950s, particularly with respect to benefits and funding. In these two areas, concepts at one end of the spectrum have been abandoned for those at the other end.

While Minnesota's pension plans are healthy by comparison with those in many other states, it is important for the changes to be evaluated. Have the changes been fair to employees and have they been affordable for taxpayers? Have our policies on benefits and funding moved too far in one direction? Are there concepts not now in use that should be?

Taxpayers and employees will be better-off through greater sharing of responsibilities for public pensions. Sharing has been a part of Minnesota's public pension plans for many years. Employees and taxpayers share the cost of pension plans...more equally today than at any time in the past. The concept of "sharing" should now be incorporated into other aspects of public pensions...into benefits, by sharing some of the risk for future benefits between taxpayers and employees; into funding, by sharing costs equally between generations of taxpayers; and, into governance, through more active roles for the Governor and public employers.

The problem of paying the bill for public pensions is now the focus of public debate. Until recently, the complexity of pension plans kept this policy area out of the limelight. However, growing concern about the cost of state and local government has brought attention to the cost of public pensions. In Minneapolis, for example, pension costs account for approximately one third of the city's property tax levy. At the same time, the chairman of the Legislative Commission on Pensions and Retirement has proposed that the state match all local government contributions to public employee pension plans.

Adequate attention is not being given to the causes for increasing costs. To date, policy discussion has focused on plans for cost relief and not cost control. The Legislature, mainly by creating deadlines for the full funding of all pension costs, has focused debate on methods for meeting the deadline. And, as a result, little attention has been given to the forces which are now pushing costs up.

The current level of benefits is not the problem. For most employees we found the dollar amount of benefits received at retirement to be adequate. There are some employees whose benefits may be too low, mainly those who retired before 1973. And, there are some whose benefits may be too high. But, for most employees a public pension in combination with social security provides an adequate pension at retirement.

And, there is no crisis with respect to funding. Except for local police and fire plans, Minnesota's public pensions seem to have sufficient reserves. With the exception of the Teachers Retirement Association, reserves are growing, approaching 100% funding in some cases.

To control costs, the format for benefits must be changed. Virtually all Minnesota public pension plans now work on a defined benefit basis. With the exception of public safety employees, pension benefits are based on an employee's years of service and his wages during his last five years of employment. Because benefits are based on salary during these final years, it is possible that benefits paid may be substantially greater than the contributions that were put aside during the employee's work life. If the rate of inflation is high, the problem intensifies. By increasing employee contributions, some of the additional cost can be paid. However, the bulk of this largely inflationary and open-ended expense is left to the taxpayers.

Benefits can also be based on "defined contributions." This approach does not guarantee a benefit; rather it guarantees that a certain amount will be placed in each employee's retirement fund on a regular basis. When the employee retires, his pension benefit is determined by the amount that is in his individual account. University of Minnesota faculty members have this kind of plan. Current contributions to the University plan are earning interest at a rate of 8.25%.

In the past, the retirement plans for teachers and Minneapolis municipal employees worked on the defined contribution method. This approach was dropped because it was not providing an adequate benefit. It failed to do so because the contribution rates were low and not because of any inherent defects with the defined contribution method.

Risk for future benefits can be shared without jeopardizing employees' basic benefits. The basic difference between the defined benefit and the defined contribution approach is in the distribution of risk for future benefits. The former places all of the risk on the taxpayers and the latter puts it on the employee. We feel that, for higher-salaried employees, the risk can and should be shared. The defined benefit approach should be used to provide every employee with a certain basic benefit. For lower and middle-salaried employees, the basic benefit could be their entire pension. Higher-salaried employees should receive part of their pension benefit from the defined contribution plan and part from a defined benefit plan. These employees can afford the risk.

Employees and taxpayers will both be better-off if benefits are restructured using both the defined benefit and defined contribution approach. The benefit system we propose will improve cost control. From the employee's perspective, this is desirable because it adds assurance that promised benefits will be paid. From the taxpayer's perspective, controlling pension costs is desirable because this will help stabilize state and local taxes.

Public safety employees need special attention. Other than permitting public safety employees an earlier retirement age (55), their pensions should be the same as other public employees. The same benefit formula should be used, including coordination with social security. Post-retirement benefit adjustments should come (as they do in other plans) through increases in social security and as a result of investment earnings.

The cost of public pensions to the taxpayers must be divided evenly among different generations of taxpayers. To do this, employer contributions should be made at a constant per cent of payroll, including social security payments. This approach will divide pension costs evenly among different generations of taxpayers. It will also show clearly the impact of any change in benefits on pension costs. By contrast, the current funding policy tends to load costs unfairly onto current taxpayers. And, at times, it will hide the cost of benefit increases.

Governance of public pensions must also be shared...for policy purposes, between the Legislature and the Governor, and for administrative purposes, between public employers and employees. As the state's chief executive officer, the Governor should be a major actor in pension policy debate. He should propose policy changes as well as review those proposed by the Legislature. Currently, responsibility for making proposals and reviewing them rests almost entirely with the Legislative Commission on Pensions and Retirement. While the Commission has done an excellent job, participation by the Governor is essential to insure adequate checks and balances.

The composition of the boards of directors of pension plans should reflect the financial responsibility that both the public and the employees have for current and future benefits. Currently, the public is not adequately represented. While these boards cannot change pension benefits, they do play a major role in plan administration and policy discussion at the Legislature. As such, fair representation by both the public and the employees is essential.

Part I - HOW A PENSION PLAN WORKS

For all pension plans there are two major decisions that must be made: First, a decision must be made on what an appropriate pension should be. And, second, a decision must be made on how to reach this goal.

Several factors are taken into account in deciding what should be an appropriate pension. Among the most important factors to be considered are:

- The goal of the pension system.
- Other income sources of each retiree (such as social security, savings, other family income, part-time work).
- The tax situation of each retiree.
- The condition of the economy with respect to, for example, inflation and purchasing power, both when a person retires and in the future during retirement years.

Different employees and employers will attach different weights to these four major factors. Employers often place greatest emphasis on the overall goal, while employees are more concerned with their particular situation.

Once an appropriate pension has been defined, a decision must be made on how to provide the pension. There are two basic alternatives from which to choose. The first alternative is built around a "<u>defined contribution</u>." Employers and/or employees contribute a fixed amount of money every year that the employee is working. Whatever this sum of money will buy at the time of the employee's retirement is the pension amount. Each employee has his own "bank account." The contributions are invested and, as such, the employee is at risk for any unanticipated changes in the economy. Insurance companies which handle this kind of account will often offer the employee the choice of a "fixed return" or a "variable return" account. The fixed return account assures the employee of getting back what he contributes, plus any accumulated interest. The variable account provides no such guarantee. The employee's risk is considerable. He may have a considerable profit or loss.

The second major alternative is a "<u>defined benefit</u>." Here, the retiree's benefit is usually determined by applying a formula to his salary. In many cases his average salary during the last five years of service is used. In this method, the employer and, to a much lesser extent, the employees are at risk for any unanticipated changes in the economy and the work force. A sudden depression may mean that the employer cannot meet pension costs or that money put aside by the employer for pension benefits may be used for other purposes. Federal law protects private employees to a certain extent from these kinds of losses, but there is no similar protection for public employees.

In a defined benefit plan, a decision must be made on how to pay the benefits that will come due when people begin retiring. Once again, there are two alternatives: "Pay-as-you-go," where the employer simply pays the amount of benefits as they are due; and "advance funding," where the employer and employees estimate future benefits and then put money aside to pay them. The major differences between these two alternatives are:

-"Pay-as-you-go" allows the general public the use of the money until it is paid. With "advance funding," the money is held by the pension plan.

-Any investment earnings for the former accrue to the general public, and, for the latter, to the pension plan.

-The risk involved is different. For "pay-as-you-go," contributions to the pension plan may be erratic—higher one year and lower the next, but generally increasing. For "advance funding," too much money may be put aside or too little.

At any time, there is also the possibility that a decision will be made to change what is meant by an adequate pension. This means that pension benefits could be either increased or decreased. Benefit increases may apply to both working and retired employees. And, other changes may apply only to people who are still working.

Changes for people who are already retired (post-retirement adjustments) may take any of the following forms:

-An adjustment may come through social security benefits. Currently, social security benefits change with increases in the consumer price index.

-The employer may put a provision in the pension plan allowing automatic increases under certain specified conditions. For example, there may be a pension benefit increase following every increase in the wages of current employees.

-Ad hoc benefit increases may be granted by the employer.

People who are still working may have their benefits changed by a change in any provisions of the pension plan. For example, if the number of years of service required in order to be eligible for a pension are decreased, then this will change the benefits for qualifying active employees. Some employees who might not have been eligible for a pension under the old provisions may now be eligible. Employees who are just beginning work will qualify for a pension sooner than they would have under the old provisions. Another example would be a change related to the age at which an employee can begin collecting pension benefits. If this age is decreased for all present employees, then employees will be able to collect benefits over a longer period of time, presuming that there is also no decrease in their life expectancy.

Under a "pay-as-you-go" system, changes in pension benefits for either retirees or active employees can be paid for along with other pension expenses. Under an "advanced funding" system, the employer's regular contributions to the plan could be increased. Or, the employer could set up a separate payment schedule to pay for the additional benefits.

Part II - THE PURPOSE OF PUBLIC PENSION PLANS

Findings

Pension plans have traditionally been used to provide career employees with some income during retirement.

Minnesota's first public pension plan, the Minneapolis Firemen's Relief Association, was begun in 1868. At first, the Association provided only a disability pension. Soon after the Spanish-American War, a regular pension (one that all employees could get after a career of service) was added. These two kinds of benefits, disability and service pensions, coupled with incentives for a career of service are now common to most governmental and non-governmental pension systems.

It was not until the early 1900s that pension plans were established for non-public-safety government employees. The St. Paul and Minneapolis teachers retirement associations were started in 1909; Duluth teachers in 1910; Minneapolis Municipal Employees Retirement Fund (MMERF) in 1919; Minnesota State Retirement System (MSRS) in 1929; Teachers Retirement Association (TRA) in 1931*; University of Minnesota faculty plan in 1935; and Public Employees Retirement Association (PERA) in 1936.

Initially, the non-public safety pension plans provided only a pension benefit. It was common for plans to work on a defined contribution basis. Two of the state's three largest plans (MSRS and PERA) worked on a defined benefit principle from their inception. The third (TRA) had a defined contribution plan. The initial and sole objective in all cases (regardless of the method used to reach it) was to provide a pension. In this respect they were similar to the public safety plans. While the length of service required to qualify for a pension was shorter than that in public safety jobs, it was still designed as an incentive for a career of service. Survivor benefits, disability benefits, special provisions for early retirement, and post-retirement adjustments did not become standard provisions of the non-public safety pension plans until the late 1950s.**

Even at the start, the purpose of a pension plan was not clear. Today, there is even less clarity.

Clarity is lacking for three major reasons:

- We can no longer be sure that pension benefits are a significant factor in attracting and retaining employees.

- There is growing controversy over what constitutes an adequate public pension.

- Their size alone suggests that public pension plans impact on many public and private activities; however, no one is sure how.

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* The first statewide teachers retirement pension plan was established as the Teacher Retirement Law, 1915. This law and the plan was replaced by the Teachers Retirement Association, 1931.

** A disability benefit was added to MSRS employees in 1951.

Salaries for state and local public employees are no longer lower than those for similar employees in the private sector (see Table 1). Thus, pensions and other fringe benefits no longer play such a large role in recruitment of employees.

Table 1

GOVERNMENT EARNINGS AS A PER CENT OF PRIVATE INDUSTRY EARNINGS

	1955	1960	1965	1970	1973	1977
Total non-military public employment	99.5%	102.4%	106.4%	112.2%	113.4%	114.5%
Federal	118.2	123.9	133.4	140.8	145.9	159.7
State and local	91.8	95.2	98.7	105.0	106.2	104.2
Public education	92.9	99.9	102.4	109.0	108.1	102.8
Non-school	90.8	90.9	94.7	100.5	103.9	105.7

SOURCES: 1955-1973, Advisory Commission on Intergovernmental Relations staff compilations based on Department of Commerce Survey of Current Business, published in the National Journal, August 21, 1975, p. 1199. 1977 based on employment and earnings October, 1977, as reported by U. S. Department of Labor, Employment and Earnings, Table C-1. And, the Census of Governments.

In testimony to our committee, the director of personnel for the State Department of Transportation reported that pensions are often not a major concern with prospective employees.

> "Retirement benefits mean different things to different people. If the department is recruiting a manager or similar-level person, that person may look at several things, and retirement may be very important. However, the first concern is normally the challenge of the job and the overall compensation for the job."*

"Adequacy" has always been a concern with respect to public pensions. It has often been resolved by aiming toward a public pension which would replace about one half of an employee's average salary after about 30 years of service.** The remainder of an employee's retirement income was assumed to come from personal savings. Together, the public pension and personal savings are intended to provide an "adequate" income.

"Adequacy" is more difficult to address in the case where public employees have social security benefits in addition to their savings and public pension. This is particularly true because of the fact that public employers do not have complete information about their employees' social security benefits.

The increasing number of two-income families may, in the future, make "adequacy" more difficult to judge. More couples are likely to have two pensions. There may also be a regular income due to a spouse's employment in households where there was previously only a pension and social security.

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*Comments by Don Wicklund, Director of Personnel, Minnesota Department of Transportation, to the Citizens League Committee on Public Pensions May 8, 1978.

**Some formulas were based on an employee's highest five salary years rather than a career average. For example, MSRS had a "high five" formula from 1929 to 1955.

In addition, life after retirement today is quite different from that for previous generations. Inflation is more serious today than at some periods in the past. Employees are retiring earlier, on the average, and are generally in better physical condition and have longer life expectancies. They can do more. In some cases this means taking another job. For others, it means travel and a variety of leisure activities. With this broader range of possibilities and the problems related to inflation, it is more difficult to reach agreement regarding the "adequacy" of a public pension.

Between 1955 and 1975, the membership in Minnesota's three major statewide plans (PERA, TRA, and MSRS) doubled, going from 90,000 to about 182,000. The assets of these plans increased about 18.5 times, going from about $70 million to about $1.3 billion. The scope of benefits has also grown. Disability and survivor benefits are now a part of almost every plan. As a result of their growth and change, it is difficult to separate the consequences of having a pension system from its basic purpose. Two examples will illustrate:

- Because pension plans accumulate large pools of capital, some people now argue that their major purpose is to provide investment capital, assuming a role once played by the savings of individuals.*

- Because pension plans now include disability benefits, some people argue that the purpose of a pension plan is to provide income for disabled workers, assuming the role of the state's workers compensation program.**

<u>Lacking a clear statement of purpose, Minnesota's public pension systems are now being used to carry out objectives that would otherwise be accomplished through separate and distinct programs</u>.

The trend can be illustrated by the following examples:

- <u>Leave of absence for teachers</u>: During the 1977 session, the Legislature created a special leave of absence program for teachers. The program allows a teacher to accumulate credit toward a pension while taking a five-year extended leave. During the leave, teachers may continue to make contributions to their pension plan. Their contributions will be matched by the state. The objective is to encourage teachers to change careers and thereby reduce the number of teachers during a period of declining enrollments. A special appropriation was made to pay for this program.

- <u>Lower retirement age for high-risk jobs</u>: Public safety employees are permitted to retire at a younger age than other public employees. This increases the cost of pensions for public safety employees. The objective is to keep this portion of the public work force young.

- <u>Disability benefits</u>: Minnesota's pension plans now provide disability benefits. In some other states (e.g., Illinois), disability benefits are financed through a direct appropriation, keeping payments for disability separate from those for pension benefits.

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*See <u>The North Will Rise Again: Pensions Policies and Power in the 1980s</u>, Jeremy Rifkin and Randy Barber, Beacon Press, Boston, 1978.

**Disability benefits are offset against workers compensation benefits. But, the result is that two programs are addressing the needs of disabled workers.

-Financing public works projects with pension fund reserves has been proposed: As the assets of public pension plans have grown, there has been an increasing number of proposals to use these funds to finance public works projects. For example, since 1974 a proposal was made to use PERA funds to construct a state office building. Other suggestions have been made, for example, that pension funds be used to purchase the general obligation bonds of state and local governments. The tax-exempt status of these bonds lowers their interest rate. Since Minnesota public pension funds are not taxed on their earnings, they would be losing by investing in general obligation bonds rather than the stocks and bonds of private corporations.

Conclusions

The purpose of a public pension plan should be to provide one source of income for employees after they reach a specified retirement age.

A public pension should not be thought of or designed to provide an employee with all of his retirement income. Rather, the pension should be a supplement to personal savings and social security.

Even with personal savings and social security, state and local governments must continue to provide a pension. Without the public pension, there would, no doubt, be many public employees without personal savings and/or sufficient social security benefits to support themselves during retirement. As a result, their retirement incomes would have to come from various income maintenance programs. We find this to be undesirable, preferring instead to supplement an employee's own savings and social security benefits with an adequate public pension.

We also recognize that standards related to "adequacy" have changed. These changes should be considered as a part of any discussion of the level of public pension benefits. But, changes in our concept of "adequacy" should not affect the general purpose of a public pension.

Two criteria should be used to judge how adequately Minnesota's public pensions meet the stated purpose:

-Do they guarantee adequate income for retirees, and, secondary to this guarantee, do the plans give employees a choice regarding their pension program?

-Are the plans' costs to the public affordable and predictable?

The first test of a pension plan should be its ability to provide retirement income. The question of "adequacy" is primary. Employee choice is also important but secondary. Since the pension is a part of an employee's compensation, he should have some choice in the way he receives this compensation. However, the amount of choice must be limited, so that the risk of an employee's losing his pension benefits because of a "bad decision" is minimized. This limit on choice is also necessary in order to protect the general public against large future claims for additional benefits from employees who (unknowingly or otherwise) made poor decisions regarding their retirement income.

The second test is necessary from the employee's point of view to assure that benefits will be paid, and from the taxpayer's point of view to assure that pension costs will not be excessive or unexpected. As is true for other public programs, the public's purse is limited. The ability to predict future costs is important in planning the use of these resources.

<u>Public pensions should *not* be designed primarily to attract people to public service. At the same time, they should *not* discourage people from taking public sector jobs.</u>

Public pensions should be competitive with those in the private sector. Pensions have become a standard part of an employee compensation package. They are no longer unique to the public sector. The benefit is expected by all employees. And, the public sector must provide it. Furthermore, the benefit must be competitive with that offered by the private sector.

Because pension benefits are provided to employees as a group, they are probably not the best way to reward exceptional employees. For example, it would not be wise to raise benefits overall in order to reward a small group of employees. Rather, the public sector should look for other means of providing rewards.

<u>Public pensions should not be used as a means of implementing other public policies where added costs are involved unless separate and distinct methods are set up for this.</u>

Pension plans should not be used to implement other public policies. In some cases it might be desirable to "piggy back" a policy onto a pension plan. When this is done, the additional objective should be financed separately, as has been done with teachers who take a leave of absence to seek a new career. Other examples might be:

-Lower retirement age for police and fire employees can be permitted, but perhaps a special and separate appropriation should be made to finance this.

-A disability program could be run through the pension plan, but this should be kept separate from the regular pension. It should be financed through a separate and special appropriation.

Part III - THE BENEFITS PROVIDED BY A PUBLIC PENSION PLAN

Findings

The benefit system has changed from one built around defined benefits and defined contributions to one based almost entirely on defined benefits.

Since the 1950s, major public plans have changed from defined contributions to defined benefits. Looking at the state's major funds:

-Defined contribution plans were being used by the Minneapolis Teachers Retirement Association until 1952, by the Minneapolis Municipal Employees Retirement Fund until 1955, by the Duluth Teachers Retirement Association until 1969, and by the Teachers Retirement Association until 1969.*

The University of Minnesota faculty plan still works on the defined contribution principle.

Together, defined contribution plans covered about 35% of all Minnesota state and local public employees in 1950. Today, only about 2.4% of Minnesota's public employees are covered by defined contribution plans. These employees are either members of the University faculty plan, short-term Minneapolis municipal and school employees, or are "unclassified" state employees. The state "unclassified" service consists primarily of appointed state officials.

The Teachers Retirement Association was the only statewide plan to ever work on a defined contribution basis. This was the case until 1969. At that time, the Legislature found that benefits for teachers were lower than those of most other public employees. To insure equity, a new plan was adopted that placed most new employees in a defined benefit program and gave old employees the option of joining. The formula for the new program was almost identical to the PERA and MSRS formulas.

Defined contribution plans are often criticized because the benefits are not as predictable by the employee as those he would receive under a defined benefit plan. Under a defined contribution, benefits depend on the performance of the plan's investments during his working life. As a result, there is more uncertainty for the employee.

TRA's lower benefits, however, were not a function of poor return on investment. Rather, the problem was that contributions prior to 1957 were capped at $100 per year. Between 1957 and 1967, the cap was raised twice; however, it was never enough to bring the benefits up to a par with the other statewide plans. Compare, for example, the benefits that an employee received at retirement in 1974 after 30 years of service:

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*The Teachers Retirement Association had an "improved" defined contribution plan. For service prior to July 1, 1957, each employee's deductions were supplemented by a 25% credit.

Table 2

BENEFITS PER MONTH AND AS A PER CENT OF FINAL SALARY; 1974[1]

	DEFINED CONTRIBUTION		DEFINED BENEFIT	
FINAL SALARY:	TRA (with Soc. Sec.)	TRA (no Soc. Sec.)	PERA/MSRS/TRA (with Soc. Sec.)	PERA/TRA (no Soc. Sec.)
$10,480	TRA = $223 SS = 300 Total = 523 (60%)	$313 - 313 (36%)	SS SS = $300 PERA/MSRS = 323 Total = 623 (69%)	- $565 565 (63%)
$19,213	TRA = $257 SS = 328 Total = 585 (37%)	$382 - 382 (24%)	SS = $328 PERA/MSRS = 592 Total = 920 (56%)	- $1036 1036 (63%)
$36,679	TRA = $314 SS = 328 Total = 642 (21%)	$495 - 495 (16%)	SS = $328 PERA/MSRS = 1130 Total 1458 (46%)	- $1977 1977 (63%)

[1]See Appendix B for assumptions and calculations.

In the last few years there has been new interest in the defined contribution plans. The Legislative Commission on Pensions and Retirement's 1969 report described variable annuity plans, one form of defined contribution plan, as an effective means of protecting employees and retirees against inflation.* And, when the Legislature adopted a strategy for providing post-retirement adjustments, it used this principle. The Minnesota Adjustable Fixed Benefit Fund (MAFBF) provides post-retirement adjustments based on the performance of investment of this fund which is composed of the contributions for all retired employees. A form of defined contribution plan has also recently been given some consideration by at least one member of the Legislative Commission. A memo from the Commission staff to this member reaches the following conclusion:

> "The conclusion which can be drawn then is that the universal money purchase plan (defined contribution plan) will only reach dollar equivalency with the present formula when the rate of salary increase is relatively modest and the rate of guaranteed interest is in the neighborhood of 7.5%.** . . . The disadvantages of the proposal from a policy point of view are few. The chief disadvantage would be that this proposal would be a radical change in the pension system, making it initially difficult to understand, explain and manage."***

*Report to the 1969 Legislative Session of the State of Minnesota, Legislative Commission on Pensions and Retirement, p. 14.

**Recent experience for such plans shows an average return of 7.25% over the last nine years. The University of Minnesota faculty plan, which is a defined contribution plan, has paid a return of 8.25% since October, 1976, for funds contributed to its "fixed" return program.

***Legislative Commission on Pensions and Retirement staff memo, 5/25/78. The memo called for a "no risk" plan, one that guaranteed at least a specified return on investment.

Defined benefit plans have a long history in the public safety area. They go back to the early part of this century in both Minneapolis and St. Paul. Two of the major statewide funds, the Minnesota State Retirement System (MSRS) and Public Employees Retirement Association (PERA), have had defined benefits since their beginnings.

The early defined benefit plans had fairly restricted formulas. The PERA and MSRS formulas placed a ceiling on the amount of salary that could be used in computing an employee's pension. For example, in 1955, it was the first $4,800. These plans also placed a $200 per month maximum on benefits until 1956. The initial defined benefit plan for the St. Paul Teachers Retirement Association was based on a "flat payment" for each year of service.

The public safety plans have never been restricted in the same way. In both Minneapolis and St. Paul, pensions have been computed as a per cent of the salary of a first class patrolman or firefighter. Not only have there been no maximums on these benefits, but the formulas have also included special provisions providing for benefits to increase or decrease benefits after retirement at the same rate as salary changes for a first class patrolman or firefighter.

Defined benefit plans have several major advantages relative to defined contribution plans. Among the most important are:

- Employees are not at risk for their pension benefits. The risk is with the employer. This may be appropriate because the employer's resources are greater and its life is usually not limited. For an employee in a defined contribution plan, a down-turn in the economy can cut benefits. But, the employer has the resources and the time to "ride it out."

- Benefits may be more predictable. If an employee can project his salary changes and knows how long he will work before retirement, then he can easily determine the exact amount of his public pension.

- Employers can be more certain that the pension plan will replace the amount of income it was designed to replace. A defined contribution plan provides less assurance.

- Defined benefits may be more equitable. By changing the formulas, all employees with the same salary and length of service will have the same public pension. With defined contribution plans there will always be the chance that benefits will be different. Employees may make different decisions regarding investments. And, while the money they contribute may be equal, the timing may vary and with it the investment earnings and the pension benefits.

There are also disadvantages. Among them are:

- The employer's costs are not as predictable. Our formulas now base the pension benefit on the average salary during an employee's highest five salary years. As a result, any sudden and unexpected increase in wages will increase the cost of benefits significantly.

-Employers and, in some cases, future employees bear all the risk. If costs do go up unexpectedly, the employer will have to pay most, if not all, of the increase. The only exceptions are those plans where employees and employers shall all costs equally. For these, future employees may also be at risk.

-Administrative costs are high relative to a defined contribution plan. There is greater need for sophisticated actuarial and cash flow analysis.

Benefit formulas are no longer as restricted. They offer employees better benefits and more options for getting these benefits.

For a defined benefit plan, the pension is based on length of service and the employee's salary. Pension benefits are often accumulated at a specified rate per year of service. The rate is usually some fixed per cent of an employee's salary during a specified period of time. In the case of most Minnesota public pensions, it is the average salary during an employee's highest five successive salary years.

Since the mid-1950s, the internal workings of the defined benefit plans have changed, resulting in increased benefits at retirement. The following are some of the major changes:

-1957, 1973, and 1978 changes in rate at which an employee covered by MSRS or PERA accumulates credit toward his pension. In 1957, four different rates were used: 1% per year for the first 10 years of service; 1-2/3% per year for the second 10 years; 2-1/3% per year for the third 10 years, and 3% per year for any years beyond 30.

In 1973, the formulas were changed so that only two rates are now used: 2% per year for the first 10 years, and 2½% per year for each year of service thereafter.* In 1978, a limit of 40 years was placed on the total number of years for which an employee could accumulate pension credit, making the maximum pension benefit 95% of the highest five successive salary years.

-1957 for MSRS, 1959 for TRA, 1967 for PERA, and 1978 for MMER and the local school funds...coordination with social security. Prior to these changes, state and local employees were not eligible for social security benefits through that employment.

-1961 for MSRS and TRA, 1963 for PERA changes allowed employees to apply their service, for some purposes, from one state or local government job toward a pension while working in another state or local government job that had a different pension plan. This is known as "portability."

-1967 elimination of the ceiling on salaries used to compute PERA, MSRS, and TRA benefits.

-1973 change from a "career average" salary to the average of salary of the "highest five" successive years for PERA, MSRS, and TRA. This average salary is used to compute the pension benefit.**

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*These rates are for employers not covered by social security. Employees under both social security and the public pension plan accumulate credit at a rate of 1% for the first 10 years and 1½% per year thereafter. In 1978 a 40-year limit was placed on the total number of years benefits could be accumulated.

**MSRS was on a high five formula from 1929 to 1955. The Minneapolis Municipal Employees plan went to a high five formula in the 1950s.

In all cases, the impact of these changes has been to increase the benefits provided by public pensions. Compare, for example, an employee retiring in the mid-1950s with one retiring today. In each case our sample employee has worked in state and local government for a total of 30 years. Over that time, he has two different jobs: the first for 22 years with the state, and the sscond for 8 years with a local government. Comparing public pension benefits we find:

Retiring in mid-1950s	Retiring in 1978
-Pension would be about 31% of his career average salary up to $4,800.	-Pension would be 70% of his average salary during his high five salary years.
-The employee would have no social security coverage through his public service.	-The employee would have had the option of getting social security coverage. If he elected to receive social security, his public pension would be 40% of his average salary during his high five salary years.
-Pension would apply only to the first job. Service in the second was not long enough to qualify for a pension.	-Pension would apply to all 30 years of service.

The University's faculty plan, the only large remaining defined contribution plan, also provides better benefits. The plan underwent major revisions in 1963. Employees were given the option of choosing an investment program which provided a fixed return or one that provided a variable return. Before, they had only a fixed return program. And, the rate of employer contributions was increased from 7.5% of total salary to 2.5% for the first $5,000 in annual salary and 13% for all salary over $5,000.

Public pension benefits at retirement have stayed competitive with those offered by major local corporations. Comparing benefits of the three statewide public pension plans with those of two large local corporations, we find:

Table 3

COMPARISON OF PUBLIC AND PRIVATE PENSION BENEFITS AT RETIREMENT - INCLUDING SOCIAL SECURITY BENEFITS

Average Salary During Last Five Years of Employment	Corporation "A"[1]	Corporation "B"[2]	PERA,[3] MSRS, TRA[4]
$ 8,400	$ 7,300 (87%)	—[5]	$ 7,512 (89%)
12,000	9,300 (77%)	$ 9,960 (83%)	10,098 (84%)
25,000	15,750 (63%)	15,250 (61%)	15,500 (62%)

[1]All benefits based on 30 years of service and retirement at age 65. It is assumed that the employee retired on January 1, 1978.

[2]Ibid.

[3]PERA employees were not permitted to be covered by social security until 1967. As such, employees retiring in 1967 might be slightly lower.

[4]Ibid.

[5]Data not comparable.

A broader sample of private employers suggests that Minnesota's public employee pension benefits at retirement and those offered by the two private companies may be relatively high. A 1975 study by Bankers Trust* shows that for a final salary of about:

$9,000, the average pension and social security benefits were $6,210 (69%).
$12,000, the average pension and social security benefits were $9,300 (58%).
$25,000, the average pension and social security benefits were $12,750 (51%).

Unlike public pensions, most private sector employees do not make contributions to their pension plans. Rather, the plans are supported entirely through employer contributions. As a result, public and private plans may not be comparable in terms of cost. This, however, assumes that public employees are not compensated higher to make up for the salary they contribute. Regardless, the concern here is total benefits for retirees and in this regard the comparison seems valid.

Social security benefits have also been added; however, there are no provisions to allow pension benefits to change as social security benefits change.

At present, about 80% of Minnesota state and local public employees are covered by social security through their jobs in state and local government. Most of the remainder have social security coverage through either a second job or through their spouse. A person (born after 1929) may qualify for the minimum social security benefits (including medicare coverage) after 40 quarters of work in a job covered by social security. A quarter of work is defined by earnings over three months. The current requirement is $250 per quarter or an annual average of $250 per quarter.

Public safety employees are the only employees of state and local government who are not permitted to participate in social security. Most current Minneapolis municipal employees are also not covered by social security, but legislation adopted in 1978 makes this option available to these employees and requires that all new city employees after July 1, 1978, be covered by social security.

When social security benefits were added, the public pension plans' benefit formulas were adjusted (see Graph 1). For the most part, the rate at which pension benefits accumulate was cut by almost half. In this respect, public employee pensions are described as "coordinated" with social security.

Under a coordinated system, the public pension benefit is not affected by increases or decreases in social security. The initial change in the formula is all that is done. Regular adjustments are not made to take into account the increases or decreases in social security benefits.

Many private plans work differently. These plans use social security as the base for their pension benefits....That is, the private employer's pension benefits are added on top of social security benefits or a portion of social security benefits. These plans are described as "integrated" with social security. The objective of a totally integrated plan is to have an employee's total retirement income at the time of retirement equal a specified per cent of final salary. The mix of social security benefits and pension changes with the rise and fall of social security benefits. But, the total retirement income for similar employees is not affected by these changes. Employees after retirement do not have their private pensions decreased due to increases in their social security benefit.

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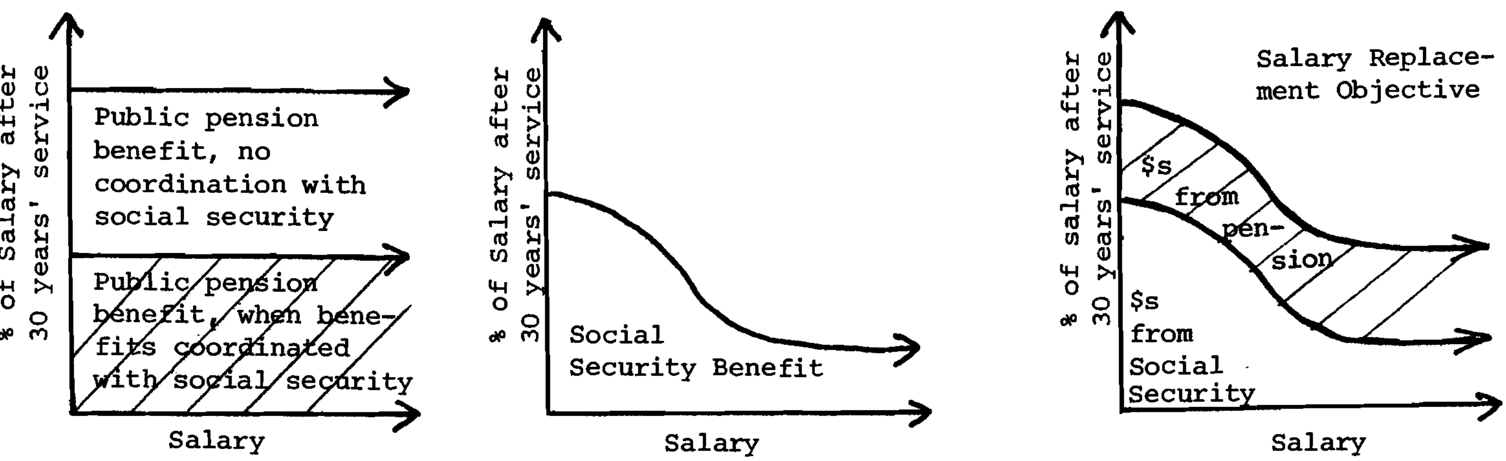
*1975 Study of Corporate Pension Plans, Bankers Trust Co., New York, New York.

Graph 1

TWO APPROACHES TO PENSION PLAN DESIGN:
COORDINATION WITH SOCIAL SECURITY AND
INTEGRATION WITH SOCIAL SECURITY

COORDINATED PLANS | INTEGRATED PLAN



<u>The public pension benefits do not distinguish between higher and lower paid employees.</u>

None of the formulas distinguish between higher and lower paid employees. Pension benefits are accrued at the same rate by all employees.

Table 4

RELATIONSHIP BETWEEN FINAL AVERAGE SALARY AND THE
SIZE OF PUBLIC PENSION AND SOCIAL SECURITY BENEFITS

Average Salary During Last Five Years of Employment	Public Pension (Excluding Social Security)[1]	Social Security Benefit Only[2]	Total
$ 8,400	$ 3,360 (40%)	$4,152 (49%)	$ 7,512 (89%)
$12,000	4,800 (40%)	5,298 (44%)	10,098 (84%)
$25,000	10,000 (40%)	5,500 (22%)	15,500 (66%)

[1]All benefits based on 30 years of service. Retirement on January 1, 1978, at age 65. Public pension based on formula used by major statewide plans.
[2]Ibid.

By contrast, both social security benefits and those provided by many private pension plans are set up to replace a larger portion of final salary for lower paid employees and a smaller portion for higher paid employees. In Table 4, social security benefits as a per cent of final average salary fall as the final average income increases. As a result, the total retirement benefit as a per cent of salary decreases, but this would not be the case if the benefit were based on the public pension alone.

Public safety employees in local plans now receive benefits that are significantly better in some respects than those of other public employees.

The major differences between most local public safety plans and those of other public employees (including those public safety employees in the statewide pension funds) are:

-All service pensions are based on the salary of a top grade patrolman or firefighter, irrespective of an employee's final average salary.*

-Employees are not eligible for a service pension until they have completed 20 years of service. At that time, the pension is set at 40% of the salary of a top grade patrolman or firefighter. Between 20 and 25 years, they accumulate service at a rate of 2% per year. In most local plans, after 25 years, no more service may be accumulated for pension purposes...the maximum being 50% of the salary of a top grade patrolman or firefighter.

-All employees contribute at the same rate...6% of the salary of a top grade patrolman or firefighter in Minneapolis and St. Paul. Employees with more than 25 years of service continue to contribute even though their benefits have stopped accumulating.

-For the Minneapolis and St. Paul police and fire plans, employee contributions are not refundable.

-Every time the salary for a top grade patrolman or firefighter is increased, the service pensions for all retirees are increased at the same rate. The plans are said to be "fully escalated."**

In addition, like all other public safety employees, but unlike most other public employees:

-Local police and fire employees are not covered by social security. Federal law prohibits this in Minnesota.***

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*In some local public safety plans, benefits escalate with rank. Among these plans are: Albert Lea Police, Albert Lea Fire, Faribault Police, Hibbing Police, Mankato Police, South St. Paul Police, Virginia Police.

**Some local plans are only partially escalated, for example the police and fire plans in Chisholm and Rochester. Pension benefits for retired members go up at some specified fraction of the rate of salary increases. In one case (Red Wing), pension benefits change with the Consumer Price Index.

***Social Security Act, Section 218 (d)(5)(A), (d)(8)(D) and (p). The law specifically prohibits social security coverage for police officers in Minnesota and 25 other states. The federal law allows coverage for firemen upon certification by the governor that all participants will get a better pension as a result.

-Local public safety employees may start drawing a service pension at age 50 in most cases. Some plans have 55 as the minimum age.*

These differences raise serious questions regarding both the cost and equity of the local public safety plans as compared with plans for other public employees.

The local public safety plans treat all members the same. A fire chief or police chief makes the same contributions and gets the same pension as a patrolman or firefighter covered by the same plan. And, they are relatively simple for employees to understand.

But, by comparison with the pension plans for other employees, the plans are quite generous. Two of the exceptionally generous provisions of the local plans are:

-the right to retire and draw full benefits at age 50 or 55.

-the automatic increases in the pension benefits.

With the exception of Minneapolis city employees, Minneapolis teachers, and member of TRA, no others can draw benefits at age 50 or 55. And, no other group of public employees has provision in their plan for automatic increases in their pension. They must rely instead on:

-ad hoc increases granted by the Legislature.

-investment earnings from a special fund for retired public employees known as the Minnesota Adjustable Fixed Benefit Fund (MAFBF).

-increases in social security benefits, if they have these benefits.

Local public safety benefits at retirement are generally lower than those of other plans. However, for local public safety employees retiring in 1975 as top grade patrolmen or firefighters, within one year their pensions were greater than those of public safety employees with similar salaries and length of service who are in PERA Police and Fire (see Table 5). For higher salaries employees, the number of years necessary for the benefits of the local plan to reach and/or exceed those of PERA Police and Fire will be greater...the exact number depending on the rate of salary increase (see Table 5).

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*For the Crookston Fire plan, the minimum age is 60.

Table 5

PENSION BENEFITS FOR LOCAL PUBLIC SAFETY PLANS[1]
COMPARED WITH PERA POLICE AND FIRE

	LOCAL POLICE AND FIRE		PERA POLICE AND FIRE		
Year	Age	FINAL SALARY = $12,840	Age	FINAL SALARY = $12,840	FINAL SALARY = $22,000
1974	50	$ 579/month (54%)[2]	55	$ 563/month (53%)[3]	$1,034/month (56%)[4]
1975	51	708/month (61%)	56	563/month (53%)	1,034/month (56%)
1976	52	759/month (66%)	57	574/month (54%)[5]	1,045/month (57%)[6]
1977	53	807/month (70%)	58	574/month (54%)	1,045/month (57%)
1978	54	864/month (75%)	59	597/month (56%)[7]	1,087/month (59%)
1980[10]	56	989/month (85%)	61	621/month (58%)[8]	1,130/month (62%)
1982[11]	58	1,132/month (98%)	63	646/month (60%)[9]	1,175/month (64%)

[1]Retirement on December 31, 1973; 25 years of service. Each retiree is single and drawing the maximum benefit with no joint or survivor benefits.

For local police and fire, the pension benefit is 50% of the pay of a top grade firefighter or patrolman. In 1974 there was a pay increase. Since the plan is fully escalated, the pension (even in the first year of retirement) is greater than 50% of the final year's salary.

[2]Per cent of final salary.

[3]Ibid.

[4]Ibid.

[5]$.75/month increase for each year of retirement and $3.75/month for each year of contribution to the fund...July, 1976. Special increase granted by Legislature.

[6]Ibid.

[7]4% increase, January 1978, from MAFBF.

[8]Ibid.

[9]Ibid.

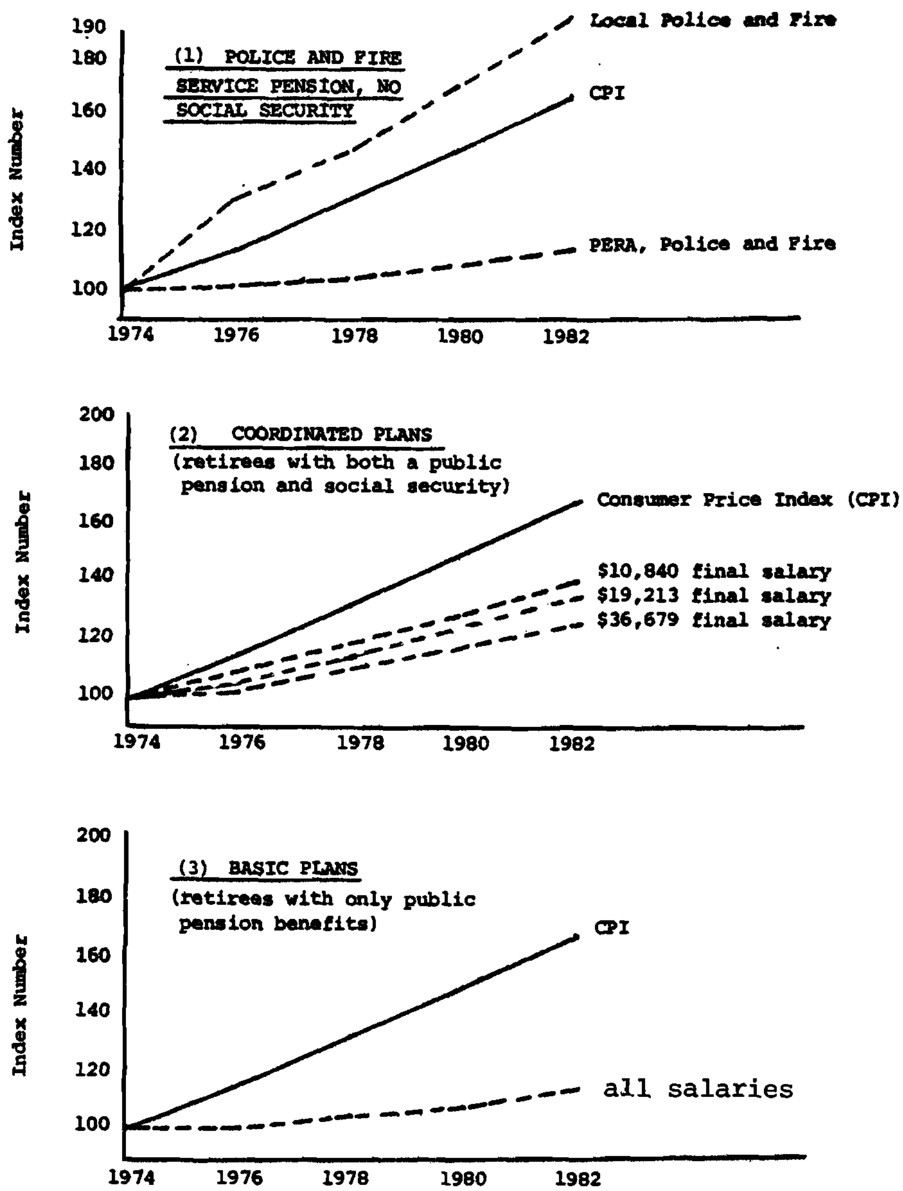
[10]For 1978, 1982, it was assumed that salaries would increase at a rate of 7% per year.

[11]Ibid.

The local public safety plans are the only Minnesota pension plans whose benefits after retirement grow faster than the consumer price index (CPI). All others lag behind the CPI (see Graph 2).

Graph 2

COMPARISON OF INCREASES IN PENSION BENEFITS AFTER RETIREMENT WITH THE CHANGES IN THE CONSUMER PRICE INDEX[1]



[1] For a 65-year-old retiring on January 1, 1974. For full description of the assumptions and methodology, see Appendix B.

The provision requiring 20 years of service before becoming eligible for a pension is also unique, but results in lower costs for these pension systems. The cost of training a police or fire employee is high. Cities like Minneapolis have been concerned that, without this provision, the employees they pay to train will be lured away by other communities. While this may be true, the lengthy service requirement may keep people in jobs they no longer want. The combination of the future benefits and the fact that most of what an employee has contributed will not be refunded may make it "too" difficult for the employee to quit. Furthermore, because service in one local plan cannot be credited toward a pension in any other public plan, including other public safety plans, an employee's career potential in public safety is extremely limited.

On balance, these special provisions have made the cost to the taxpayers of public safety pension benefits extremely high (see Table 6).

The pension plans for municipal employees in Minneapolis also have had some special provisions...which have made their pensions more expensive than those for employees in statewide plans. Among the most significant differences have been:

-Retirement with full benefits at any age after 30 years of service. New employees as of July 1, 1978, cannot collect full benefits until age 65 regardless of their length of service.

-Employees with 10 years of service may begin drawing their full benefits at age 60. In most other funds they must wait until age 65 to draw full benefits.* Current elected officials may begin drawing their pensions as soon as they leave office, regardless of age and provided they have 10 years of service covered by MMER. 1978 legislation will require officials elected after 1978 to wait until they are 60 before drawing pension benefits.

-If an employee works for at least four months of the first year of his service, or receives at least $200 during the year, he is credited with a full year. Also, an employee may retire at any time of year and still receive a full year of credit. The major statewide plans credit a year of service on the anniversary of the date an employee began work.

The employer costs for benefits now being accrued for Minneapolis employees are higher than those for the statewide plans. In 1976, it was 10.85% of payroll.

Other public pension plans also have special provisions which make their benefits, in varying degrees, better than those for most other public employees with similar salary history and length of service. Of particular concern are some special features of TRA, the University faculty plan, and the Legislators' plans:

-Regarding TRA: The Teachers Retirement Association has a supplemental benefit for faculty members in the State University System. An additional contribution is made by both employee and employer on salary between $6,000 and $15,000. The funds are placed in a defined contribution plan. Employees can draw on this part of their pension benefit at any time, even while they are still employed by the University System. This benefit was added in 1965. It was done in lieu of an increase in the salary on which regular contributions could be made.

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*MSRS and PERA will permit any employee with 10 years of service to draw reduced benefits at age 62...or with 20 years of service at age 58. New City of Minneapolis employees after July 1, 1978, come under the same provision. TRA members and members of the Minneapolis and St. Paul Teachers plans may draw reduced benefits at age 55 with 10 years of service.

Table 6

TOTAL PUBLIC CONTRIBUTIONS FOR BENEFITS NOW BEING ACCRUED[1]
AS A PER CENT OF PAYROLL, 1976

	Mpls. Police	Mpls. Fire	St. Paul Police	St. Paul Fire	PERA Police & Fire	PERA	MSRS
Total employer contribution from local government revenues for pension benefits now being accrued (normal cost):	13.1%	10.0%	12.3%	9.3%	12.0[2]	4%-8%[3]	4%[4]
State contribution from dedicated funds:[5]	2.2%	6.9%	2.2%	4.9%	1.4%	-	-
Total public contribution for normal cost:	15.3%	16.9%	13.5%	13.8%	12.00	4%-8%[6]	4%[7]

SOURCE: Minneapolis/St. Paul Study, Municipal Expenditures Employee Compensation, Minnesota State Planning Agency, 1978, p. 56 and p. 62.

[1]Total public contribution for benefits now being accrued = employer contribution from local revenues and state contribution from dedicated funds. Excluded are employee contributions and employer contributions for benefits already accrued but for which no money has been put aside and social security costs where applicable.

[2]"Normal cost" is not broken out as a separate cost in 1976...12% includes both the cost for benefits now accruing and other pension costs.

[3]In PERA, some employees are not covered by social security. For these employees, the employer's contribution for the public pension is 8%. For employees covered by social security, the employer paid 4% for the public pension and then 5.85% of the first $15,300 salary for social security.

[4]All MSRS members are also covered by social security, except correctional employees.

[5]The state contribution comes from a tax on insurance premiums. Here, we assume that the contribution is split equally between normal costs and other pension costs.

[6]In both cases the employer was also contributing for social security (5.85% of the $15,300 salary).

[7]Ibid.

Employees can retire with reduced benefits at any age with 30 years of service, or as young as 55 with 10 years of service. For the other statewide plans, the minimum age is 58 with 20 years of service or 60 with 10 years of service.

The rate at which benefits are reduced for early retirement is lower for TRA than for the other statewide plans.

-The University faculty plan is a defined contribution plan. It covers University of Minnesota faculty members and between 175 and 200 non-faculty University employees. Employees are eligible for a pension as soon as they begin work; however, the amount of that pension depends exclusively on the value of contributions at the time of retirement.

The University plan is designed to be competitive with other major universities. The defined contribution approach allows a faculty member to change jobs without losing pension benefits, and his new employer can continue putting money into his defined contribution account. This kind of system makes it easier for one University to attract faculty from another.

The University's current plan was begun in 1963. According to the University's director of employee benefits, it is difficult at this time to say if its benefits will be adequate. However, two aspects of the plan are worth noting at this time.

Employer contributions are higher than those for the statewide plans, including TRA. The employer contributes 2½% of an employee's first $5,000 salary and 13% for all salary above $5,000. And, compared to other public plans, the employer's share of cost for benefits now accruing is high (see Table 10).

Employee contributions are relatively low...2.5% of salary. University faculty members are covered also by social security. Employees in the statewide plans receiving social security, contribute to their public pension at 4%.

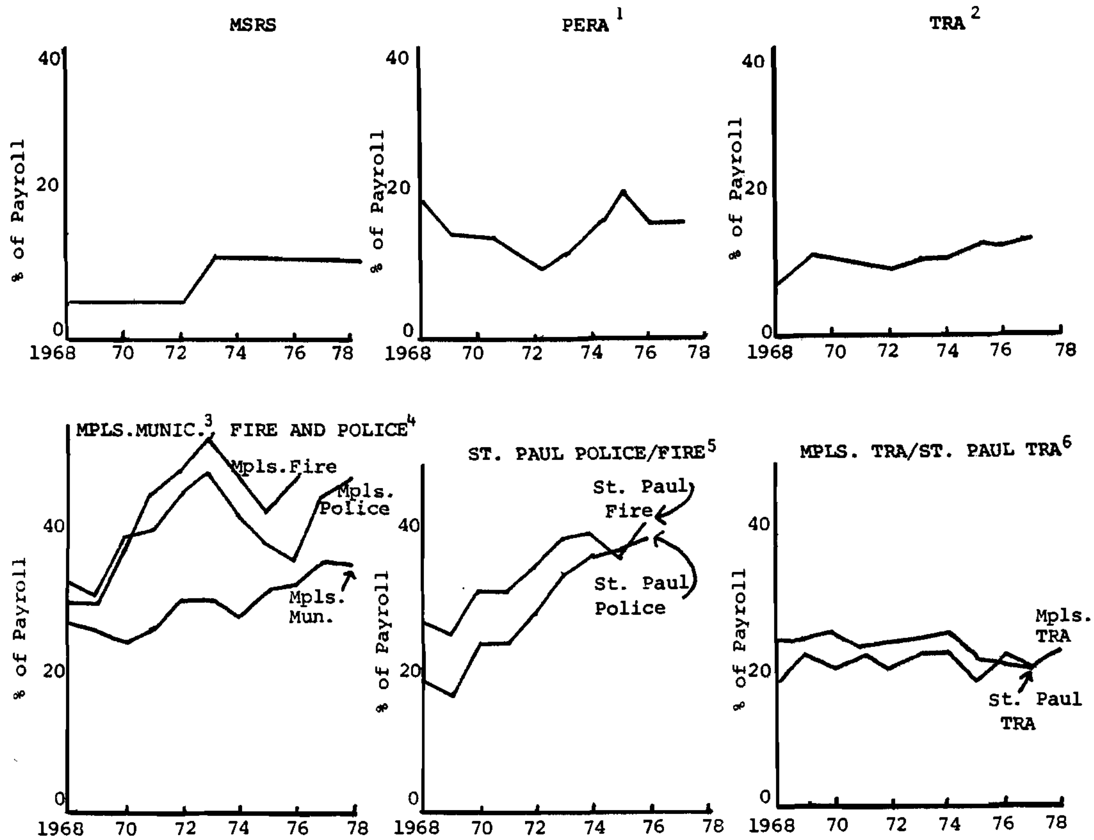
-The Legislators' plan allows a member of the Legislature to be eligible for a pension after only six years of service. Most public employees must have ten years of service. This change was made in 1978. At the same time, the Legislature took other action which decreased their pension and its total cost. Its actions included: raising contribution rates for legislators from 8% to 9%; raising the retirement age from 60 to 62, and reducing from 5% to 3% the rate at which interest is applied to required reserves for the former legislator's benefits between the time he leaves office and begins collecting his pension. Relative to most other public employees, legislators still have younger retirement age; however, their contribution rate is higher than all other public employees.

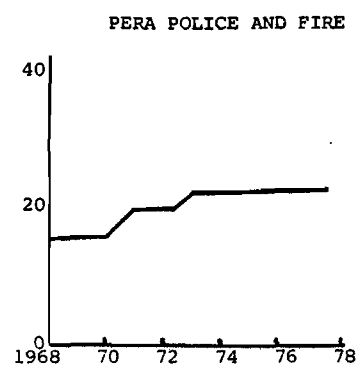
There are other differences between benefits (see Appendix C). However, none is as significant as those mentioned above. And, looking at all public pension benefits in Minnesota, we find that in most cases employees with similar salary histories and lengths of service get equal benefits.

<u>The cost of public pensions has gone up faster than total payroll in many cases (see Graph 3).</u>

Graph 3

<u>TOTAL EMPLOYEE AND EMPLOYER CONTRIBUTIONS TO PUBLIC PENSION PLANS AS A PER CENT OF COVERED PAYROLL, 1968-1978</u>





[1]Excludes PERA Police and Fire.
[2]Weighted average including basic and coordinated plans.
[3]In 1977 the funding requirements for MMERF were changed, giving the city 20 additional years to fund any unfunded benefits. This reduced the funding requirements of the plan.
[4]Based on the Minneapolis-St. Paul Study, State Planning Agency. 1976 data is from the actuarial reports of that year. 1977 and 1978 data for Minneapolis Police Relief Association from the city budget. Data includes receipts from the state's tax on automobile and fire insurance premiums.
Total payroll was estimated by dividing the employees' contribution by .06 (the statutory employee contribution rate for the period). As a result, the estimate is probably low. While this distorts each contribution rate, it does not affect the trend that the graphs show.
[5]Ibid.
[6]Since 1967, the state has paid a portion of the employer's contribution. In 1975, the local levies were dropped and the state became the sole source of employer contributions.

Pension funds involve large sums of money. For example, in 1975, total contributions to all state and local public pension plans were almost $300 million on a payroll of $2.05 billion. If the contribution rate changes by even .5% of payroll, then about $10.3 million in additional revenue would have to be raised. Between 1973 and 1974, the contribution rate for PERA rose from about 11% to 13% of payroll. In dollars this meant collecting an additional $17.7 million.

Since the dollar amount of contributions varies widely with the slightest change in contribution rates, a major objective of the Legislature and plan administrators has been to keep the contribution rates stable. The graphs above show only limited success, primarily with respect to MSRS.

<u>The cost of public employee pensions is difficult to predict. The consequence is greater risk for the taxpayer for future benefits.</u>

The existing benefit formulas place all of the risk for future benefits on the taxpayers. This is particularly true because they compute benefits on the basis of years of service and final salary, both of which may have little relation to the amount that has been contributed during an employee's work life by himself or his employer.

At any point in an employee's career his wages may be pushed up by inflation. If this comes at the end of his career, most of his contributions have been based on the expectation of a lower pension benefit. The switch in 1973 from a formula which used an employee's career average salary to one that used the average of his highest five years created this problem, making all of the contributions to all affected plans deficient by about $743 million.

Recent rates of inflation make the risk even greater for the general public. Any increase in wages now, even if it lasts for only one or two years, will change the amount of benefits that the public must pay.

The situation is particularly critical for public safety employees who are members of local pension plans. When these plans are fully escalated, any increase in wages not only increases the benefits that must be paid at retirement, but also automatically grants a benefit increase to retirees.

Additional uncertainty is added to the system by social security and by the way employee contracts are negotiated. Social security benefits are now "tuned" to changes in the cost of living: As it goes up or down, the benefits change. The number of social security recipients will also affect costs. With any change, the cost to both employees and employers must also eventually change. Pension benefits are not a matter for collective bargaining, nor can information on their cost be included in contract negotiations. Therefore, employers and employees are not likely to consider the implications of their negotiations for future pension benefit costs. This is particularly true for school boards. Since the Legislature appropriates money directly for the employer contributions to the statewide teachers plan and the local teachers plans in Minneapolis, St. Paul and Duluth, school board members may not even know the amount of the employers' contributions.

Under the current formulas, the State of Minnesota and local governments must bear all of the risk for future benefits. This makes some sense, especially if we think about employees as individuals rather than as a group. After all, the State of Minnesota or the City of Minneapolis does not have a finite existence. It can handle risk better than an employee whose years are very limited. Under defined contribution plans the risk would be with the employee. Employees retiring after or during a period of economic boom would probably have good pensions. And those retiring after or during a recession would probably not have enough. The quality of an employee's retirement life could be left to chance.

Public employers have acted in the last two decades to assume the risk. Like private employers, they want to give their employers some assurance that their pension benefits will be "adequate." However, public employers must examine the amount of insurance that they are now providing. Perhaps a defined benefit program provides too much insurance? Perhaps the cost of this assurance is taking money away from other public concerns? And, perhaps some employees should be asked to bear part of the risk?

Conclusions

Generally speaking, current benefits provided by public pensions in Minnesota seem appropriate, at least at the point of retirement.

With the exception of some provisions in local plans, TRA and the Legislators' plan, we are generally satisfied with the level and cost of benefits now being provided. They seem to provide an adequate pension. And, they seem to be quite competitive with those benefits provided by private employers.

Our major concern relates to the predictability of future benefits and the impact that this has on the risk for future benefits that taxpayers must bear. It is with this in mind that we reconsider the general structure of public pension benefits and not because of special provisions in some plans.

To limit the public's obligation for future benefits and to increase employee choice regarding these benefits, the following principles should be incorporated into the present benefit structures:

- With respect to public pensions: A maximum should be placed on the salary used in computing defined pension benefits. For any income above the maximum, employee participation should be optional. The optional portion of the pension plan should work on a defined contribution basis. It should offer employees a number of investment options, each with a different degree of financial risk for the employee. None of the options should involve any additional financial obligation for the public beyond the promised contribution.

- With respect to post-retirement adjustments: Increases should come through social security, through investment earnings, or through "one-time" grants given by the Legislature. No automatic escalators should be allowed.

- With respect to public pensions for elected officials: Elected officials should have their entire public pensions based on a defined contribution plan.

The current benefit system is in many respects the opposite of the defined contribution plans of the past....Benefits are guaranteed and not contributions. While we recognize the need for a defined benefit plan, we do not feel this need applies equally to all persons in the public service.

The current pension system places too much risk for future benefits on the general public. This risk should be shared between the general public and those public employees able to bear the risk. Thus, a "two-tiered" benefit system is needed. The first tier should be a defined benefit plan with formulas that are similar to the current ones. Its purpose should be to provide every employee with a benefit sufficient to provide a reasonable portion of an employee's income needs during retirement. For employees whose salaries are above a certain minimum, there should be an optional defined contribution plan. Together, the defined benefit and defined contribution plan should provide roughly the same retirement income that employees now receive.

The essential difference for the general public between this two-tiered system and the current one is that the obligation of taxpayers for future benefits will be more limited. Part of it will be taken care of with each contribution to the defined contribution plan.

Those employees affected at all by the two-tiered system will have more choice. Participation in the defined contribution plan should be optional.

And, once in the plan, an employee should have the right to make investment decisions. Employees who wish a higher rate of return should be free to choose an option with that potential. Those who are most concerned about security could choose an investment with a "fixed" return.

This plan will not put undue risk on the employees. Their basic pension benefit will still be guaranteed through the defined benefit plan. And, past performance suggests that the defined contribution plan could provide the rest. In recent years, defined contribution plans have paid interest on contributions at a higher rate than that used by the state in calculating the growth of contributions to its defined benefit plan. Table 7 compares the investment assumption used by the state with the actual rate of interest applied to funds contributed to the "fixed" annuity plan for University of Minnesota faculty members.

Table 7

COMPARISON OF THE "FIXED" RATE OF RETURN ON CONTRIBUTIONS TO THE UNIVERSITY OF MINNESOTA FACULTY PLAN WITH THE ASSUMED RATE OF RETURN AS SET IN THE MINNESOTA STATUTES

Date	University of Minnesota Faculty Plan, "fixed" annuity:	Assumed rate of return, Minnesota Statutes:
1968	7/1/68-5%	3.0%
1969	5.0%	3.0% and 3.5%
1970	1/1/70-5.25%	3.0% and 3.5%
1971	1/1/71-6.0%	3.5%
1972	7/1/72-6.5%	3.5%
1973	7/1/73-7.0%	5.0%
1974	7/1/74-7.25%	5.0%
1975	7.25%	5.0%
1976	10/1/76-8.25%	5.0%
1977	8.25%	5.0%
1978	8.25%	5.0%

SOURCE: University of Minnesota, Director of Employee Benefits, and Legislative Commission on Pensions and Retirement.

The public cannot afford automatic increases in benefits for retirees. Even the slightest post-retirement adjustment is costly. For example, one local company reported to us that even a cost-of-living provision with a 3% annual cap would increase the cost of that company's pension plan by about 38%.* Yet, we recognize the need that retirees have for increases in their pensions. They are not immune to the effects of inflation. Post-retirement adjustments should be provided through:

- -Increases in social security. Social security is now "tuned" to the consumer price index. As it increases, so will benefits. This gives public employees covered by social security protection against inflation for about one half of their retirement income.

- -Investment earnings. Retirees' contributions and whatever interests they have earned are now invested by the Minnesota Adjustable Fixed Benefit Fund. This fund should not be used for any purpose other than providing benefits for retirees.

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*Assumes a 15-year amortization period for the full cost of the increase.

-"One-time" grants by the Legislature. If the first two options do not provide sufficient protection against inflation, the Legislature should consider increases on a class-by-class basis.

Legislators and other elected officials who make decisions regarding public employee pensions should have their own pension plan. Otherwise, conflict of interest is more likely. Elected officials must be free to make changes in the plan for public employees in general, without also changing their own pension benefits. In our judgment, the only way to do this is through a separate plan for elected officials.

The plan for elected officials should be, above all, extremely easy to understand and have a clearly visible cost associated with it. A 100% defined contribution plan most clearly meets these objectives.

University of Minnesota faculty members should continue under their current defined contribution pension plan. To date, the University has had to compete nationally for personnel more than other public employers. Its pension plan must be competitive with that provided by other major universities.

<u>The cost of pension benefit packages for public employees with similar salaries and length of service should be equal.</u>

The differences that now exist between the provisions of public employee pensions should be changed such that the cost of plans is more likely to be similar.* For example, the Minneapolis Municipal Employees Retirement Fund uses a definition for "year of service" which is more liberal than that used by other plans. This makes the MMERF plan more expensive. If there are reasons for continuing this practice, then some other feature of the plan should be changed so that the cost of this plan will be comparable with others. We can find no differences between the work of public employees in Minneapolis and those employed by the state or in any other municipality. And, therefore, we see no justification for having a higher-cost pension plan.

With the exception of the cost required to allow a lower retirement age, pension benefits for public safety employees should be no more or less costly than those for public employees in general. Of major concern is the provision in local police and fire plans for automatic increases in pension benefits. To a certain extent, this provision makes up for a benefit at retirement which is low by comparison with the major statewide plans. However, over an employee's retirement years, the automatic increases result in a pension which is substantially better than that provided by any other public plan. We can see no reason for this type of preferential treatment. Public safety jobs do involve more risk than most types of public service. However, this would more appropriately be rewarded through higher salaries and/or better disability benefits than through a better pension.

The younger retirement age is justifiable. Public safety employees must be in good physical condition. To help insure this, a younger work force is desirable. By allowing public safety employees to draw benefits at a younger age, there is incentive for them to leave their public safety job before they are no longer physically capable of handling it.

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*Age and life expectancy characteristics may also account for differences in cost between employee groups. Beyond them, costs should be similar.

While staying within our objective that costs should be equal, employees should have a choice of different types of benefits. For example, one option would be to start retirement with a reduced benefit and then have it increased over time. Another might be to defer the entire pension to some time in the future...taking a larger benefit at that time.

All employees (except local police and fire) drawing benefits before the specified retirement age (which should be younger for public service employees) should have their benefits reduced so that the total cost of their pension benefits will not exceed that of a benefit commencing at the specified retirement age...usually 65. Employees working past the normal ages should continue to accrue benefits in the same way as younger employees; however, no special adjustments should be made to their pension benefits in anticipation that they will draw benefits for fewer years than a person retiring at normal age.

<u>Participation in social security should be universal.</u>

Social security participation should be universal. Public employees not now covered by social security in their public employment will receive social security benefits through part-time or short-term work. When they do, their contributions are not likely to cover as much of the cost of the benefits they will receive as is the case for employees working full time under social security. Therefore, we believe that it is in the general public interest to have all employees covered by social security. With this, all employees will be paying their full share of the cost.

Social security benefits accumulate for an employee in almost every possible job. Accumulation is not interrupted or reduced by a job change. No other plan offers as broad an opportunity to qualify for benefits. And, to insure that all employees will have retirement income, participation should be universal.

<u>And, public pension benefits should be integrated with social security.</u>

Public pension benefits should be integrated with social security. By this, we mean that public pension benefits should have social security as their base. The public benefit should be added to that base in whatever amount necessary to bring the employee's benefits to the level deemed adequate. Currently, public pensions and social security are separate. The public pension benefits do take into account the presence of social security, but this is not done on a regular basis. Benefits are not adjusted regularly as a result of changes in social security. Discussions of pension benefit adequacy often only relate to the public pension.

A more useful way to think about pensions might be to first reach agreement on the portion of an employee's final earnings that should be replaced by pension and social security benefits together. Then, at retirement, the basis for determining the pension plan's portion of an employee's retirement income should be the difference between projected social security benefits and the total amount of retirement income that the employee is supposed to have.

<u>The qualification for a pension should be fashioned in a way that does not pressure employees to keep jobs they no longer want, nor limit their prospects for promotion.</u>

It is not in the public interest to have employees continue their work in the public sector simply to qualify for a pension. Of particular concern are the local public safety plans where an employee must work for 20 years before being eligible for any pension benefit. This may put undue pressure on an employee to keep a job that is relatively dangerous and that he no longer wants.

Pension plans should not be a limiting factor on an employee's career potential. They should not make it difficult for an employee to advance in his profession. If they do, they will discourage employees from improving their performance. The local public safety plans again are of special concern in this regard. Currently, a public safety employee who is a member of a local plan cannot switch jobs without losing all of the credit that he has accumulated toward a service pension. While we understand that this provision protects communities from losing employees that they have paid to train, we feel that its impact on employee performance is more significant. In addition, since a growing portion of the cost of training employees is being paid for by the state, this provision is less necessary.

In a more limited way, all other public employees have their career potential limited by current public pension plans. None of the plans allows service in a private sector job to be credited toward a public pension, or vice versa. While we recognize that the mechanics of a system permitting service to be credited back and forth would be quite complex, we feel that it is worth considering.

<u>Total pension benefits (including social security) for low-income employees should be higher relative to pre-retirement earnings than for high-income employees.</u>

The per cent of an employee's income replaced by total pension benefits should be higher for lower income employees. This is necessary in order to assure that these employees have an adequate retirement income. Designing pension plans to replace the same portion of salary at all salary levels assumes that this per cent will always produce an adequate dollar amount. We do not think that this is the case... for example, while a pension replacing 60% of a $25,000 salary may be adequate, one that replaces 60% of a $10,000 salary may not be.

For the purposes of computing pension benefits, an employee's normal salary should be used, excluding overtime.

<u>Recommendations</u>

<u>During its 1979 session, the Minnesota Legislature should establish a new benefit system for public employees...one which places a limit on salary covered by defined benefit formulas, and above that limit provides benefits through a defined contribution plan.</u>

1. The following modifications should be made by the 1979 Legislature to the current system of benefits for all public employees, except elected officials and unclassified employees:

   a. The new benefit program should apply to all new state and local government employees as of July 1, 1979.

      Current state and local government employees should be given the option of receiving benefits under the new program. If they choose to do so, their contributions should be redistributed, as necessary, between the defined benefit and defined contribution plans.

   b. A limit should be placed on the salary covered by the formula now used to compute defined benefits.

      For income below the limit, employers and employees should contribute at the same rate as a per cent of payroll.

      For income above the limit, employee contributions should be optional and should be put in a defined contribution plan. Employers should be required to make contributions for income above the limit. As a guide in determining the contribution rate, employers should use the same rate they use for the long-term expected normal cost below it. Employees should vest in the defined contribution plan after a total of ten years of service.

c. Initially, the salary limit should be set at about $20,000. The Legislature should review the limit biennially, taking into account such factors as changes in median family income, price levels, average wages (in both public and private employment), the poverty level, the savings, investment and other income of public employees after retirement, as well as the degree of success which the Legislature believes the plan has had, and the costs the public is willing to pay.

Every time the salary limit is adjusted upward, there will be some increase in the total liability of each plan affected by the change. This happens because contributions for the defined benefit portion of the plans have been based on only part of the salary that will actually be used to calculate an employee's benefits. The Legislature should address this problem by requiring each plan's actuary to include an assumption for changes in the salary limit as a part of his calculations for annual employer and employee contributions. As a guide in making this assumption, the actuary might use the consumer price index or some similar indicator.

When an employee exceeds the limit, that salary becomes the employee's ceiling for the purposes of determining the defined benefit part of his pension. However, every time the Legislature increases the limit, employees should have the option of transferring employee and employer contributions to buy into the increased defined benefits that will now be possible as a result of raising the limit.

d. There are several alternatives from which to choose for making public pension benefits progressive. We did not study these carefully enough to make specific recommendations. However, among the alternatives that might be considered are: Special benefit credits for low salary employees, the creation of a set of income replacement "targets," and lowering the rate at which an employee accrues benefits above a certain salary. Each proposal would have significant impact on both the level and cost of benefits. None should be implemented without careful study.

e. The benefits for all employees of state and local government should be at least 50% and perhaps 100% integrated with the social security benefit earned while working for state and local government.

The Legislature must decide on the extent of integration. In making its decision, the Legislature should consider factors such as the likelihood that any employee might forfeit his pension contributions.

Integrating at some rate below 100% would assure every employee of getting some return for his own contributions. Under this approach, the employee's public pension would be reduced by a legislated per cent of his social security benefit. We recommend that, if the Legislature chooses this approach, the social security "offset" be not less than 50%.

The 1979 Legislature should request that the Minnesota Congressional delegation introduce and unanimously support special legislation allowing social security coverage for public safety employees.

f. All public employees whose pensions are integrated with social security should accumulate credit toward their public pensions at the same rate. If Congress does not act to allow integration of public safety plans, then these plans should credit service at a rate sufficient to produce a benefit at age 55 equal to that of integrated plans at age 65.

g. All vested employees (except public safety) should be eligible to collect their full pension benefits at age 65. Benefit payments may start at age 58. However, when payments begin before age 65, pension benefits should be reduced such that the cost of a pension for an employee drawing benefits early will not exceed that for an employee retiring at 65. Employees working past age 65 should continue to accrue benefits in the same manner that they did before reaching 65. Their benefits should not be adjusted because of the likelihood that they will draw them over a shorter period of time.

h. All public safety employees should be permitted to receive benefits at age 55. They should, however, have an option of deferring receipt of the pension to some later time. If this option is selected, funds sufficient to pay for the employee's pension benefit should be transferred to the MAFBF in the same manner as for other employees. The employee's MAFBF account should accumulate interest at the actual rate for the MAFBF in general. When the employee elects to begin receiving benefits, they should be increased according to the amount of interest credited and to life expectancy up to age 65. An employee deferring benefits beyond age 65 should get interest credited but <u>no</u> adjustment for life expectancy.

i. Portability should be extensive and uniform throughout the public sector. Local police and fire funds should be changed to permit the same portability as is now available in other public jobs. The Legislature should also initiate a study of portability between jobs in state and local government and private business. This should be carried out by the Commissioner of the Department of Personnel. The Commissioner should report and make recommendations to the Legislature by December, 1979.

j. The new system should continue the current practice of providing post-retirement adjustments through earnings on funds invested in the Minnesota Adjustable Fixed Benefit Fund, through increases in social security, and, when necessary, through ad hoc increases granted by the Legislature. This should apply to all employees. As such, the automatic escalator provision in the local police and fire plans should be eliminated. This should be achieved by placing all newly hired police and fire personnel in the affected cities in the PERA police and fire fund, and phasing out all of the local police and fire plans.

k. Disability benefits should not be a part of regular pension benefits. Rather they should be financed and managed separately.

2. Elected officials should get their pension benefits for that service only from a defined contribution plan. The Legislature should create such a plan during its 1979 session. The plan should be integrated with social security in the same manner as we suggest for regular public employees. Elected officials who are also members of another public employee pension plan should be required to choose between participating in the "elected officials" plan or continuing in their old plan.

The Legislative Commission on Pensions and Retirement and the Governor should review the University of Minnesota faculty plan and report to the Legislature on its status at the start of the 1980 session. The Commission and the Governor should make findings and conclusions regarding the benefits provided by this plan, the cost-sharing arrangement between the employer and the employees, and the need to treat University faculty members differently from other public employees.

Part IV - FUNDING PUBLIC PENSIONS

Findings

Before defined benefit plans were common, public pension plans were financed almost exclusively by public employees. Any employer share was financed on a pay-as-you-go basis.

Employees always have made contributions to their public pension plans.* In defined contribution plans their objective was to put enough money away while they were working to finance an adequate benefit at retirement. For some plans there was never any employer contribution. PERA, for example, was supported entirely by employee contributions until 1956. And, in their early years, there were few occasions when public support was necessary.

For defined benefit plans, initially the situation was not very different. For example, until 1939, if MSRS funds from employees were not sufficient to pay benefits, then an employee's pension would be reduced. However, over time, the employer committed himself to pay a certain benefit. With this commitment came regular employer contributions (see Table 8).

Table 8

PENSION PLANS: DATES ESTABLISHED COMPARED WITH INITIATION OF REGULAR EMPLOYER CONTRIBUTIONS

	MSRS	PERA	TRA	St. Paul TRA	Mpls. TRA	MMERF	Mpls. Fire	Mpls. Police	St. Paul Police	St. Paul Police
Plan Established:	1928	1936	1931	1909	1909	1919	1868	1895	1903	1903
Initial Employer Regular Contribution:	1939	1956	1957	1955	1924	1957	1969[1]	1969[2]	1969[3]	1969[4]

[1]The Guidelines Act, 1969, first required employers to make regular contributions to police and fire pensions based on the actuarial needs of the plans. Prior to 1969, state laws required a minimum levy for all local police and fire plans.
[2]Ibid
[3]Ibid
[4]Ibid

The local public safety plans were the first public pension plans where the employer made contributions to help build reserves. State law permitted the public safety plans in Minneapolis and St. Paul to keep only a limited amount of reserves. For example, the Minneapolis police fund's reserves could not exceed $1,000,000. When the reserves fell below the ceiling, the city contributed...sometimes in cash and sometimes by giving the fund bonds to be redeemed later.

*The only major exception has been the volunteer firemen's plans, and they are not considered in this report.

<u>Today, the objective is to fund immediately for pension benefits that employees are accruing now and to fund by 1997 for benefits already accrued but for which no money has been put aside.</u>

As the number of defined benefit plans and the benefit they provided increased, concern grew about the way pension costs were to be financed. The public was agreeing to pay defined benefits at some time in the future, but, for the most part, there was no plan for paying the employer's share of the cost.

In 1955, the Legislature created a Public Retirement Study Interim Commission. In 1957, this joint legislative commission proposed plans for financing pension benefits. The framework established at that time is still being followed today. Essentially, it called for public employers to pay for pension benefits in the same way as public employees...that is, by making regular contributions to the pension funds.

While the decision has been made to finance pension costs through regular contributions by both employees and employers, it is still being debated. The major arguments for and against pre-funding are as follows:

-In favor of funding:

1. The long-term expense of a plan is reduced because there are investment earnings. Without funding, there would be nothing to invest.

2. A funding policy allows costs to be spread equally over several generations of taxpayers. With "pay-as-you-go," the burden on one generation of taxpayers may be greater than that on others due to a large number of retirements and overly generous benefits granted, perhaps, by a previous generation's policymakers.

3. Prefunding benefits gives employees greater security that their benefits will be paid when they are due.

4. Paying for pension benefits ahead of time may improve the credit of state and local government.

5. A program of prefunding makes it harder to increase pension benefits because higher contributions would be necessary immediately. However, some groups seeking higher benefits also support "full funding" in the belief that it will be easier to grant increases the closer the system is to "full funding."

-Opposing funding:

1. Prefunding does not reduce the long-term cost of a plan. Rather it shifts savings and interest earnings to pension plans when they would otherwise go to individuals. The public, in aggregate, may realize a better return on this money than the small group of investment managers working for the pension plans.

2. Prefunding, particularly "full funding," does not spread the cost of pensions equally over several generations of taxpayers. Rather it concentrates the cost on the current generation.

3. Prefunding is not necessary for public pensions because the taxing power of state and local government stands behind the plans.

4. Prefunding is not desirable because it forces us to pay for future benefits with current dollars when they could be paid for at some time in the future with inflated dollars.

As Table 9 shows, most state and local public pension plans in the nation are funded.* However, there are different degrees of funding. Some policies (19% of the locally administered plans and about 10% of the state plans) are designed so that the regular employer and employee contributions will cover the cost of benefits that employees are accruing at that time. Other plans try to do more. For almost one half of the state-administered plans and about 25% of the local ones, contributions are designed to pay not only the cost of benefits that employees are earning now, but also the cost of any "unfunded" benefits...that is, benefits that employees have already accrued but for which no money was put aside.

Table 9

METHODS BEING USED BY U. S. STATE AND LOCAL PUBLIC PENSION PLANS TO FINANCE DEFINED BENEFITS

Type of administration:	Pay-as-you-go	Employer/ employee each pays a set % of payroll	Full funding of benefits now accruing only:	Full funding of benefits now accruing and some part unfunded benefits:	Full funding of benefits now accruing and all unfunded benefits:	Unknown or other methods:
Locally administered plans	16.6%	26%	18.7%	1.3%	26.1%	11.3%
State administered plans:	23.1%	4.5%	9.6%	3.4%	47.2%	12.2%

SOURCE: Table 52, Pension Task Force Report on Public Employee Retirement Systems, Committee on Education and Labor, United States House of Representatives, March 15, 1978, p. 292.

Minnesota's policy for most public pension plans** is to fully fund all pension costs. As such, regular contributions to the pension plans have two parts:

-One part goes to pay for benefits that employees are accruing at that time.

-One part goes to pay for benefits that employees have already accrued but for which no money has been put aside.

*The data base for the table is the number of "plans." All "plans" regardless of size are given equal weight. Irrespective of this, the table does show the frequency with which one approach to funding has been chosen over another.

**The only exceptions are legislators, judges, constitutional officers, and most local police and fire plans. Employee contributions are made in all cases. But, for legislators and judges, pensions are paid for through the general fund within a lump sum payment to the Minnesota Adjustable Fixed Benefit Fund, and for constitutional officers through monthly payments to retirees. For most local police and fire plans the policy is to fully fund all benefits that employees are accruing now and to pay the interest only on the cost of benefits accrued in the past but for which no money was put aside.

The employee's contribution covers only a portion of the first part...that is, the cost of benefits that they are accruing at this time. This is usually referred to as the "normal cost." In computing this amount, the objective is to divide the reserves required to support an employee's future benefits equally over each year of his expected work life, reducing the required reserves to take into account interest that will be earned through the investment of the accumulated contributions.

The Legislature's policy has been for the employer and employee to split normal cost equally, except for local policy and fire plans where the employer/employee split is 60%/40%. This has been done with mixed success. Looking at the contributions for normal cost in 1975, we find the following distribution:

Table 10

EMPLOYEE'S AND EMPLOYER'S SHARE OF THE COST FOR BENEFITS NOW ACCRUING (NORMAL COST)

Fund	Employee contribution as a % of normal cost	Employer contribution as a % of normal cost
PERA (no Social Security)	57.12%	42.88
TRA (no Social Security)	51.09	48.91
MMERF	36.97	63.03
MINNEAPOLIS TRA	49.35	50.65
ST. PAUL TRA	71.09	28.91
CONSTITUTIONAL OFFICERS	41.74	58.26
LEGISLATORS	36.91	63.09
PERA, POLICE AND FIRE	51.78	41.22
LOCAL POLICE	27.30	72.70
LOCAL FIRE	27.49	72.51
PERA (with Social Security)	54.61	45.39
TRA (with Social Security)	48.54	51.46
MSRS	56.74	43.26
UNIVERSITY FACULTY	19.64	80.13

SOURCE: Report to the 1977-1978 Minnesota State Legislature, Legislative Commission on Pensions and Retirement, p. 28.

For the major statewide plans (TRA, MSRS, and PERA) the Commission's policy has been implemented, at least approximately. But, for many of the other plans, the employee and employer costs are not even close to being equal. In some cases the employees are paying more, and in others it is the employer (see Table 10).

Table 11 shows per cent of payroll which was necessary in 1975 to fund benefits that employees were accruing at that time. In many cases, the contribution was not sufficient to meet normal cost. As a result, part of normal cost must now be paid for with the second part of the contribution. And, progress towards paying for unfunded benefits slows. In those cases where the contribution for normal cost was greater than what was required, the "surplus" can be used to pay any existing unfunded benefits.

The second portion of the contribution is now paid almost exclusively by the employer. It is often referred to as the "employer's additional" or the payment for the "unfunded liability" or "deficit." As the name implies, this part of the total contribution is intended to pay the cost of benefits already accrued by employees but for which insufficient or no contributions have been made.

According to the current policy of the Legislative Commission on Pensions and Retirement, the employee and employer should share the cost for any new unfunded benefits attributable to benefit increases after January, 1977.* However, there have been no major benefit increases since January 1, 1977.

Three factors account for the unfunded benefits that exist today:

-First, the employers, as noted above, did not start contributing to the plans until many years after they started. And, when they did, it was often at rates less than required. And, the employee contributions alone were not sufficient to cover the full cost of the benefits they were accruing.

-Second, through the years, benefits have been increased. Many of these increases have been retroactive, applying to the pension benefits that an employee accrued in the past as well as what he might accrue in the future. The result is that employees have credit for benefits for which no money has been put aside. For example, in 1969, PERA and MSRS proposed that pension benefits be calculated using the average salary for an employee's "high five" salary years rather than one using a career average salary. This change would have applied to all members regardless of their length of service. Actuaries for the plans estimated that this increase would add about $230 million** worth of "unfunded" benefits, that is, benefits which have been accrued but for which no contributions have been made.

-Third, to fund a pension benefit, estimates must be made for the cost of future benefits. The estimates are based on assumptions regarding the rate at which wages will increase or decrease, the rate of return on investments, and the average life expectancy of employees. Other assumptions are also made, but these are the most significant. If these assumptions are not accurate, then the contributions will be too high or too low. If the latter is the case, then the amount of unfunded benefits will grow.

Even small changes in the assumptions can have a significant impact on the contributions which are made. For example, Table 12 shows the impact of changes in the salary and interest assumptions on the value of unfunded benefits for the Teachers Retirement Association:

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*Report to the 1977-1978 Minnesota State Legislature, Legislative Commission on Pensions and Retirement, p. 2.

**Report to the 1969 Minnesota State Legislature, Legislative Commission on Pensions and Retirement, p. 51 and p. 58.

Table 11

REQUIRED CONTRIBUTION FOR 1975 NORMAL COST
COMPARED WITH ACTUAL CONTRIBUTIONS

Plan	% of Payroll Needed To Cover Normal Cost	Employee and Employer contribution for Normal Cost	Difference
PERA (no Social Security)	14.01%	16.00%	+ 1.99%
TRA (no Social Security)	15.54	16.00	+ .46
MMERF	21.64	18.77	- 2.87
MINNEAPOLIS TRA	13.17	13.00	- .17
ST. PAUL TRA	11.25	19.00	+ 7.75
CONSTITUTIONAL OFFICERS	16.77	On a "pay-as-you-go basis. Employee contributions (7%) go to state's general fund.	
LEGISLATORS	21.67	Employee contributions (8%) made to general fund. On retirement, full reserves to pay pensions are appropriated from general revenue.	
PERA POLICE AND FIRE	15.45	20.00	+ 4.55
PERA (with Social Security)	7.32	8.00	+ .68
TRA (with Social Security)	8.16	8.00	- .16
MSRS	7.05	8.00	+ .95
UNIVERSITY FACULTY	Slightly less than 18%	Slightly less than 18%	0
MINNEAPOLIS POLICE	21.3	19.1	- 2.2
MINNEAPOLIS FIRE	22.9[1]	15.8	- 7.1
ST. PAUL POLICE	20.6	20.5	- .1
ST. PAUL FIRE	20.2	15.1	- 5.1

SOURCE: Report to the 1977-1978 Minnesota State Legislature, Legislative Commission on Pensions and Retirement; and Minneapolis-St. Paul Study, Municipal Expenditures/Pensions, State Planning Agency, 1978.

[1]1974 data.

Table 12

IMPACT OF ALTERNATIVE ASSUMPTION ON VALUE OF UNFUNDED BENEFITS, TRA

Interest Assumption:	5.0%[1]	5.0%	6.0%	6.0%	6.0%	6.0%	7.0%	7.0%
Salary Assumption:	3.5%[2]	7.5%	3.5%	5.0%	6.0%	7.5%	6.0%	7.0%
Total value of benefits accrued (in millions):	$1463	$2324	$1185	$1388	$1555	$1811	$1262	$1413
Total funded benefits (in millions):	822.4	822.4	822.4	822.4	822.4	822.4	822.4	822.4
Ratio of funded benefits to total benefits:	56.2%	35.4%	69.4%	59.2%	52.9%	45.4%	65.2%	58.2%

SOURCE: Staff memorandum, July 28, 1978, Legislative Commission on Pensions and Retirement.

[1]These assumptions are the ones set by the Legislature and used in the evaluation of all Minnesota state and local pension plans.

[2]Ibid.

In 1977, the total value of funded benefits for the major statewide and local plans was $2.35 billion or 59.5% of the value of all benefits accrued to date. The local police and fire plans are not included. They do not report on an annual basis. 1976 is the most current available data. At that time, the relationships of funded to unfunded benefits for the largest of these plans were as follows:

Table 13

RELATIONSHIP OF FUNDED TO UNFUNDED BENEFITS FOR MINNEAPOLIS AND ST. PAUL POLICE AND FIRE PENSION PLANS, 1976

	Value of Benefits Accrued	Funded Benefits	Unfunded Benefits	% funded
Minneapolis Firemen's Relief Ass'n	$107.1 million	$20.3 million	$ 86.8 million	18.1%
Minneapolis Policemen's Relief Ass'n	87.4 million	9.1 million	78.3 million	10.4
St. Paul Firemen's Relief Ass'n	53.7 million	8.2 million	45.5 million	15.2
St. Paul Policemen's Relief Ass'n	55.4 million	10.1 million	45.3 million	18.3

SOURCE: Municipal Expenditures: Pensions, Minneapolis/St. Paul Study, Minnesota State Planning Agency, p. 32.

Since the first report of the Legislative Commission on Pensions and Retirement in 1957, the state's policy has been to work toward full or 100% funding of state administered pension plans. To this end, state statutes require that contributions be made at a rate sufficient to reach 100% funding by 1997.

The Minneapolis Municipal Employees Retirement Fund was brought under this policy in 1967. However, in 1977, the date for 100% funding of this plan was extended to 2017. Most police and fire plans (including Minneapolis' and St. Paul's) have never been under the 100% funding requirement. And, it was not until 1969 that there was a general funding requirement at all for these plans. At that time, legislation was passed (i.e., the Guidelines Act) requiring funding at a rate sufficient to freeze the growth of unfunded benefits by no later than 1980. Unlike the other public pension plans, for most there was no requirement that the unfunded benefits be 100% funded.

Since the 100% funding policy was adopted, progress toward the goal has been relatively steady, major setbacks occurring only when benefits were increased. Table 14 and Graph 4 show the progress for the three major statewide plans*

Table 14

CHANGES IN THE PER CENT OF FUNDED BENEFITS FOR TRA, MSRS, PERA, MMERF AND THE LOCAL TEACHERS PLANS IN MINNEAPOLIS, ST. PAUL, AND DULUTH

Year	Per Cent of Benefits Funded
1958	33.0%[1]
1968	70.0 [2]
1969	59.8
1970	61.5
1971	64.4
1972	66.3
1973	53.3 [3]
1974	54.6
1975	56.9
1976	56.9
1977	59.5

SOURCE: Overview of Minnesota Public Pension Plans, Supplementary Report to the Minnesota Legislature, 1977 Session, Legislative Commission on Pensions and Retirement, p. 14-16. Report of the Public Retirement Study Commission, Public Retirement Study Commission, pp. 42, 52, 65, 97 and 103. And, the 1976 and 1977 actuarial valuations of the plans.

[1]Data for three major statewide plans only.
[2]Ibid.
[3]Funding ratio decrease due to major benefit increase for a number of the funds in 1973.

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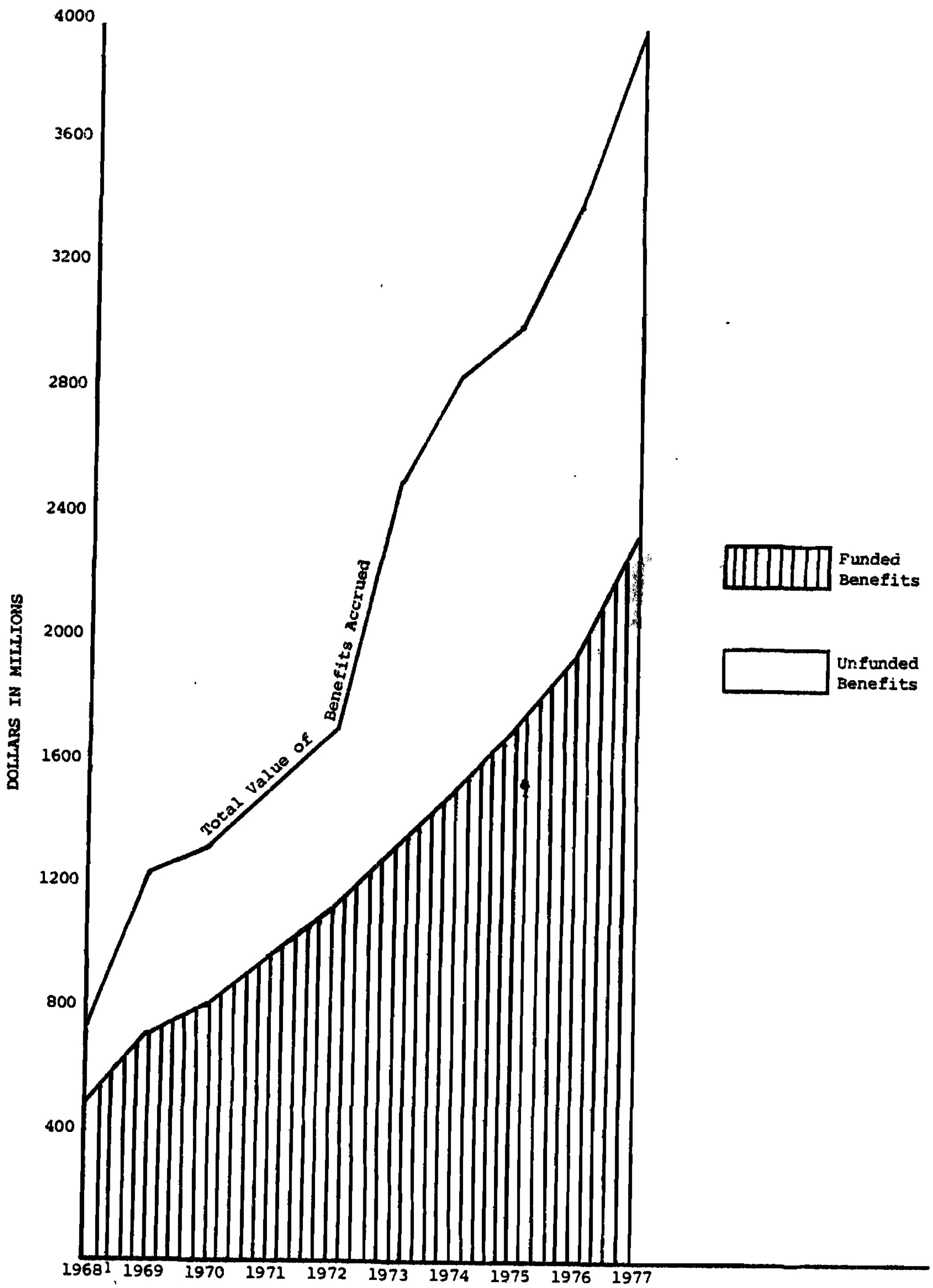
*For a detailed description of the funding of each of the major public pension plans, see Appendix D.

Graph 4

TOTAL VALUE OF ACCRUED BENEFITS FOR: MSRS, TRA, PERA, PERA POLICE AND FIRE, HIGHWAY PATROL, MMER, ST. PAUL TRA, MINNEAPOLIS TRA AND DULUTH TRA, 1968-1977



[1]Excludes MMER, Minneapolis TRA, St. Paul TRA, and Duluth TRA. These plans were not required to report annually until 1969.

A major change in the benefit formula for major funds in 1973 and for MMER in 1974 and for Minneapolis teachers in 1976 accounts for the reduction in the per cent of benefits funded in that year. The change requires that benefits be computed on the basis of an employee's "highest five successive years salary" rather than his career average salary. This increase applied to all employees covered by the three statewide plans, regardless of their length of service or date of employment. The local plans already had the provision, and the formula for local public safety plans was not changed. The change to the "high five meant that all employees would receive benefits larger than anticipated and planned for by contributions up to 1973...hence, an increase in the amount of unfunded benefits and a decrease in the per cent of funded benefits.

Current funding policy places the burden for all funding inadequacies on the current generation of taxpayers.

As the full funding target date approaches (1997 or 2017 for MMERF), the contribution rate for paying unfunded benefits will increase. There will be fewer years over which to spread the payments, and, as a result, each year's contribution may have to be larger than the last. Two conditions contribute to this situation:

-Recent benefit increases, applying to an employee's past service as well as future service.

-The use of actuarial assumptions which have not (at least in the short run) reflected actual experience.

Benefit increases occurring between now and 1997 will have to be paid for in full over 19 years or less. This is an exceptionally short period of time in which to finance a benefit increase. Typically, benefit increases are financed over 30 or 40 years. To stay within this typical schedule, any benefit increase after 1967 should have been placed on a different payoff or amortization schedule. The Legislative Commission has recognized this:

> "This target date (1997) is still in effect in spite of improvements in benefits since 1957, especially the change to the final salary formula in 1973. The Commission has recommended that this policy be changed so that a new 30-year period would be used for each new piece of deficit arising from a future benefit increase."*

With the exception of the MMERF, the Legislature has not changed the dates. In the case of MMERF, the date was changed to 2017 during the 1977 session.

The assumptions on which contributions are determined have not accurately reflected recent experiences.

In computing contribution rates for benefits that employees are accruing now and for benefits already accrued but as yet unfunded, state law requires that the following assumptions be made:

-Investment will earn at a rate of 5% per year.

-Wages will increase at a rate of 3.5% per year.

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*Report to the 1977-1978 Minnesota State Legislature, Legislative Commission on Pensions and Retirement, p. 6.

The interest assumption (5%) is designed to take into consideration the investment earnings that will accrue between the time contributions are made and benefits paid. Without this consideration, contributions would be much greater than they now are. If the assumed rate of interest were increased (say from 5% to 6%), then contributions would decrease. And, if it were decreased, then contributions would have to increase.

Since its rate was mandated in 1965, the interest assumption has been increased twice. Initially, it was set at 3.0%. From 1969-1971, two rates were used, 3.0% and 3.5%, 3.5% being used for comparison purposes only. In 1971, the 3.0% rate was dropped completely. And, in 1973, the assumption was increased from 3.5% to 5.0%. It was reported to our committee that this was done mainly to offset part of the increase in unfunded benefits that would result from the change to the "high five" formula.

Since 1975, most plans have reported earnings at or above the 5% level. Only in 1975 were there any plans reporting interest earnings of less than the assumed rate. One exception was the Minneapolis Municipal Employees Retirement Association which did not report any excess interest earnings from 1973 through 1975. Table 15 shows the interest earnings in excess of the assumed rate for the major plans:

Table 15

INTEREST EARNINGS IN EXCESS OF 5% ASSUMPTION
1973-1977 (IN $ MILLIONS)

	1973	1974	1975	1976	1977
PERA, TRA, MSRS	$16.5	$ 7.0	$ 1.6	$ 3.5	$ 7.2
MMERF	0	0	0	.1	1.0
MINNEAPOLIS TRA, ST. PAUL TRA, DULUTH TRA	$ 2.7	$ 1.0	$ .8	.9	3.1
TOTAL	$19.2	$ 8.0	$ 2.4	$ 4.5	$11.3

SOURCE: Actuarial valuations submitted to the Legislative Commission on Pensions and Retirement. There are some differences between MMERF and the other plans with respect to the treatment of unrealized gains and losses. These may limit the comparability of interest earnings.

The wage assumption is designed to take into consideration changes in salary which in turn will affect the benefits to be paid in the future. A relatively low wage assumption will tend to keep contributions low. And, one that is relatively high will cause higher contribution rates.

A specific salary assumption was not set in the statutes until 1969.* At that time it was set at 3.5%. It has not been changed. Since 1969, salary increases have exceeded the assumed rate on a regular basis. As a result, benefits have accrued faster than the funds to pay for them. Table 16 shows the unfunded benefits that have accrued since 1973 due to salaries growing faster than the assume rate.

*A salary assumption is not critical for plans that use a career average salary for computing benefits. However, for plans using the average salary of five highest successive years, it is. The Minneapolis Municipal plan started using a "high five" formula in 1969...hence the need for a salary assumption. When other plans went to the "high five" in 1973, they, too, needed the salary assumptions.

Table 16

VALUE (IN $ MILLIONS) OF UNFUNDED BENEFITS RESULTING FROM WAGES INCREASING FASTER THAN THE ASSUMED RATE, 1973-1977

	1973	1974	1975	1976	1977
PERA, TRA, MSRS	$ 34.9	$104.6	$ 52.0	$101.7	$ 83.5
MMERF	$ 3.0	$ 7.4	$ 16.3	15.8	4.5
MINNEAPOLIS TRA, ST. PAUL TRA, DULUTH TRA	$ 3.5	$ 11.4	$ 5.7	5.6	17.0
TOTAL	$ 41.4	$123.4	$ 74.0	$123.1	$105.0

SOURCE: Actuarial valuations submitted to the Legislative Commission on Pensions and Retirement.

Other assumptions such as life expectancy are also used to calculate contribution rates. However, the wage and interest assumptions are the only ones that are set by statute. The others are determined by each plan's actuary.

Actuarial assumptions are supposed to anticipate very long-term future trends. Therefore, deviations from the trend over a relatively short period of time (5 to 10 years) may not be critical if deviations in the other direction can be anticipated in the future. However, it seems clear that over the past few years the contributions for benefits that employees are now accruing (normal cost) were consistently low. And, to make up for this, the value of unfunded benefits was increased regularly. And, with it, the contribution rate for these unfunded benefits was also increased.

If it were not for the fact that public employees (unlike most private sector employees) make contributions to their pension plans, the distinction between contributions to pay for benefits now accruing (normal cost) and those to pay for benefits already accruing would be of little importance. The policy of the Legislative Commission is for employees to pay one half of normal cost and one half of the cost for any unfunded benefits attributable to new benefits granted after January, 1977. Under this policy, actuarial assumptions which keep the contribution rates low for benefits now accruing work to the advantage of the employee. This will be explored further in the next section.

<u>There is no strong evidence that the current funding policy will bring long-term discipline to the public pension system regarding benefit increases or payments.</u>

Supporters of 100% funding point out that this objective puts a constraint on the system that is beneficial to employees and employers alike. Representatives of employee groups have said that the 100% funding policy gives them assurance that their benefits will be paid. Representatives of the employers supported the policy because they said it "protected" them against requests for benefit increases. We can find little evidence to support either argument.

While having contributions "in the bank" does provide some assurance that benefits will be paid, it is by no means a guarantee that benefits will be paid. No assurance is provided that the funds will not be withdrawn and used for some other purpose. As one member of our committee put it, "If things got to the point where the government needed the revenue, it would take it...regardless of whether it was earmarked for pensions or not."

The employers' argument is suspect for the following reasons:

-Current practices with respect to assumptions tend to understate the cost for benefits now accruing. The result is an increase in unfunded benefits. Employees share the cost of the former but not the latter. As a result, until January, 1977, when the new policy for sharing the cost of unfunded benefits attributable to a new benefit took effect, there was not much of a cost deterrent to employee requests for benefit increases.

-The target date for 100% funding is likely to be changed. The Legislative Commission on Pensions and Retirement has already recommended this.* And, its recommendations to the 1979 Legislature will restate this recommendation. If the date is changed, it may no longer act (if it ever did) as a deterrent to requests for benefit increases. Public employers and employees alike will not be deterred from making requests by a goal that they know no one realistically intends to reach.

-Even if the 1997 target date is not changed, there might still be requests for benefit increases. As the cost of living continues to increase, retirees are becoming major proponents for benefit increases. They pay no contributions and can only gain through their requests. Organizations for retirees have developed alongside many of the plans; for example, the Public Employees Retirement Improvement Association is made up in part of PERA retirees.

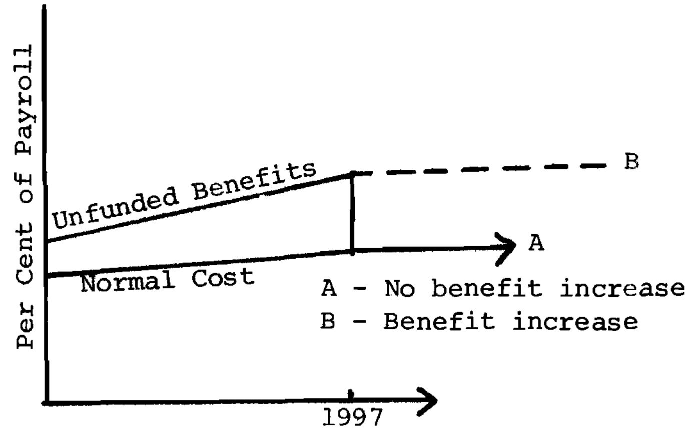
The 1973 change to the "high five" formula probably did more than anything else to bring retirees together to request benefit increases. Employees retiring just prior to the change receive benefits which are substantially lower than those of co-workers who retired after the change. The resulting inequities have brought both retirees and active employees together to request benefit increases. For example, the PERA Board has as a part of its 1979 legislative package a request for automatic post-retirement increases. The proposal calls for pensions to increase at the same rate as the consumer price index or 3%, whichever is less.

-If the 1997 date is not changed, it could lead to significant benefit increases on or shortly after that date. Graph 5 characterizes the current approach to funding. As can be seen, if the current policy is followed, the contribution rate will decline significantly in 1997 because all unfunded benefits will be funded. At this time, policymakers have two options: (a) reduce contribution rates and, as a result, taxes; or (b) increase benefits and, as a result the contribution rate will remain at its pre-1997 rate. Because the benefit increase could be granted without any apparent increase in taxes, it might be the more likely choice for policymakers.

*The Commission recommendation is for a small increase in the date for funding any unfunded benefits. This is to account for the unfunded benefits that were added in 1973. Any new unfunded benefits that might accrue after the recommendation's adoption are to be paid for over 30 years. A separate 30-year schedule is to be adopted in each case; however, for the purposes of general discussion, a single date covering all plans would also be computed.

Graph 5

ALTERNATIVE IN 1997



<u>There are other approaches to pension funding. One is being used for local police and fire plans.</u>

There are six major alternatives to be considered:

1. Pay only the cost of benefits now accruing (normal cost) and make no effort to fund those benefits which are now unfunded. This method is used by approximately 20% of the locally administered plans and about 10% of the state administered plans nationwide. If it were used in Minnesota, there would be an immediate reduction in the contribution for all of our public pension plans except the plans for judges, legislators and constitutional officers (see Table 17). The judges and legislators are funded through a lump sum payment to the Minnesota Adjustable Fixed Benefit Fund at retirement. And, the constitutional officers are on a pay-as-you-go basis.

2. Pay the cost of benefits now accruing and the interest on any unfunded benefits. This alternative is often referred to as "freezing the deficit." It is the funding policy which is required for local police and fire plans in 1980. This approach would also result in some decreases in the contribution rates; however, they would not be as large as under the "pay normal cost only" alternative (see Table 17).

   Like a home mortgage, interest charges turn out to be a significant portion of the total cost. Freezing the deficit will in the long run bring the plan very close to 100% funding.

3. Pay the cost of benefits now accruing and some portion of the principal over a specified period of time. This approach is used by about 1.3% of the locally administered plans and about 3.4% of the state administered plans nationwide. As the end of the time period approached, the plans would approach 100% funding. As is true for the "freeze the deficit" alternative, the value of unfunded benefits would be a relatively small portion of the total value of any particular plan at the end of, for example, 30 years.

4. Pay the cost of benefits now accruing and some portion of the principal over an indefinite period of time. The only difference between this and the fixed date alternative above would be that there would not be a possibility of costs escalating as the target date approached. Rather, the contribution rate would remain constant.

5. Pay a constant per cent of payroll. The rate would be set high enough to cover the cost of benefits now accruing and as much of the unfunded benefits as is deemed desirable. Nationwide, about 26% of the locally administered plans and 4.5% of the state administered plans are funded through this type of policy. The cost would depend on how high or low the rate was set.

6. Pay an amount sufficient to cover the cost of benefits for all employees who have served long enough to qualify for a pension. This is sometimes referred to as the "termination method" because contributions are sufficient to pay all benefits for employees eligible for a pension and to refund contributions to those who are not. If this plan were adopted, it would reduce the amount of unfunded benefits. The exact amount would depend on the provisions of the plan. For example, in 1975, the use of this method would have changed the proportion of funded benefits for the three statewide plans in the following way:

   -TRA could have gone from about 54% funded to between 65% and 90% funded.

   -PERA could have gone from about 62% funded to between 61% and 81% funded.

   -MSRS could have gone from about 59% funded to between 55% and 91% funded.*

None of these methods affects the value of benefits both funded and unfunded. Rather, the method chosen determines the portion of benefits that will be prefunded and the schedule for doing this. Some load payments in the early years and others push payments out into the future.**

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*Overview of Minnesota Public Pension Plans, Supplementary Report to the Minnesota Legislature, 1977 Session, Legislative Commission on Pensions and Retirement, p. 17.

**For a good discussion of pension funding see Robert Tilove, Public Employee Pension Funds, Columbia University Press, New York, 1976, Chapter 8.
Appendix G summarizes the various funding methods as discussed by Tilove.

Table 17

COMPARISON OF AVERAGE SUPPORT RATES USING TWO ALTERNATIVE FUNDING POLICIES[1]

	Average Contribution Rate for Plans Without Social Security	Average Contribution Rate for Plans Including Social Security
Pay normal cost only:	15% of payroll	8% of payroll
Pay normal cost and interest on unfunded benefits:	22% of payroll	10% of payroll
Current funding policy, pay normal cost and both interest and principal for unfunded benefits:	25% of payroll	11.5% of payroll

SOURCE: Overview of Minnesota Public Pension Plans, Supplementary Report to the Minnesota Legislature 1977 Session, Legislative Commission on Pensions and Retirement, pp. 19-21. See Appendix E for the differences in contribution rates under each alternative for each individual plan.

[1]All data as a per cent of 1975 payroll and using the statutory contribution rates.

Conclusions

The Legislature should abandon its current funding policy and adopt a new one.

The major feature of the current policy is its goal of 100% funding. The target date for this is 1997. This policy places the burden of paying for past funding inadequacies on the current generation of taxpayers. While we know that unfunded benefits must be paid (particularly those resulting from the 1973 benefit increases) we question the equity of having the current generation of taxpayers bear all of the cost, especially since it is not responsible for all of it.

One alternative would be to replace the current target date with another. While this might solve the "equity question," it might lead to unwarranted benefit increases. The impetus for establishing a target date was a feeling that it would force some "discipline" on policymakers when they were dealing with requests for benefit increases...that is, if they granted an increase, they would have to not only recognize the additional cost but also pay it in full by 1997. Changing the target date now opens up the possibility that it could be changed again and again. With these changes, all discipline might be lost.

As long as our funding policy is based around "target dates," there will be some risk that we are building automatic benefit increases into our pension system. As each target date approaches, there is the prospect of a lower contribution rate. This could result in lower taxes. However, we fear that inappropriate benefit increases would be granted instead. The cost of the increase will not be clear to the taxpayers because there may be no immediate change in the contribution rate. Rather, the new benefit increase will be paid for with funds freed-up when the target date was reached for a previous benefit increase.

We also question the 100% funding policy because of the number and type of assumptions that must be made in arriving at the amount to be funded. 100% funding is a relatively easy and well-accepted rule on which to fall back. It may even be an over-simplification. Policymakers and citizens may forget that the amount described as "necessary for 100% funding" is an estimate. And, like other estimates, it must be reviewed and adjusted on a regular basis.

The Legislature should adopt a new funding policy...one which will place highest priority on keeping pension costs at a constant per cent of payroll.

One alternative would be to drop funding altogether and go to a "pay-as-you-go" system. We reject this alternative, because it is not likely to keep pension expenditures at a constant per cent of payroll. The number of people retiring will fluctuate from year to year, and, with this, pension expenditures will change. With no funds put aside, the only way to deal with these changes will be to increase or decrease appropriations for pensions. Taxpayers who happen to live at a time when the public work force is relatively young and growing will have relatively small expenditures for pensions. Those who happen to pay taxes when the public work force is relatively old and either stable or declining in size will face higher pension expenditures. With the right kind of funding policy, this fluctuation in expenditures and the inequities which accompany it can hopefully be avoided.

The arguments against funding are not as important to us as a policy that will keep pension expenditures at a constant per cent of payroll. For example, we recognize that state and local government has an advantage over private industry, that is, the power to tax. While this may give public employees some greater assurance that their benefits will be paid, the prospect of levying a different tax each year to pay for pensions is not attractive.

We are intrigued by the argument regarding the impact of pension funding on the availability of capital for investment. Some argue that the economy would be better off if money stayed in the hands of taxpayers as long as possible... suggesting a pay-as-you-go approach to pensions. Others argue that the economy might be better served if more money were put aside in pension plans...suggesting a 100% funding policy. We have been able to find no data suggesting a conclusion one way or the other. Still, we recognize that the impact of pension policy on private finance may be important to consider in setting policy for paying for public pensions, and we leave it to others to determine the exact impact.

The new funding policy should also show clearly the impact of benefit changes.

While we question the ability of the current funding policy to bring "discipline" to the pension system, we do not question the need for this discipline. And, a new funding policy should be designed accordingly. Discipline can be brought to the pension system without necessarily having a 100% funding policy. The combination of analysis which shows clearly the cost of a change in a pension plan and some rule for financing that cost is all that is necessary. As pointed out in the findings there are a number of rules from which to choose:

-Pay only the cost for benefits accruing now.

-Pay the cost for benefits accruing now and the interest charges on any unfunded benefits.

-Pay the cost of benefits accruing now, the interest charges, and some part of the principal.

-Make payments at some constant per cent of payroll. At a minimum, the rate should be high enough to cover normal cost.

-Pay enough to cover the cost of benefits for only those employees who have the right to collect a pension.

A distinction should be made between pension plans which are likely to continue and those which are going to be phased out. While we do not support 100% funding for the former, we do for the latter. "Phase out" means that all of the obligations of the plan will soon be due. In order to avoid a significant increase in contribution rates and perhaps a special appropriation, a 100% funding policy should be pursued as soon as the phase out decision is made. The situation is slightly different if the plan which is to be phased out will be replaced by another. Under this circumstance, contributions coming into the new plan may be used to pay for the obligations of the old one. This policy has already been used in phasing out some plans, and we see no reason why it should not be continued.

Local government's share of pension costs should come from general revenues and not from "dedicated funds" or direct categorical state aids. Local governments may choose to use their local government aids to pay pension costs, but they should not be given revenues for that purpose alone.

<u>Whatever the funding policy, the cost of any benefit increase should be shared equally by both employees and employers.</u>

The cost sharing should include both increases in normal cost and the cost of any additional unfunded benefits attributable to the benefit increase. The Legislative Commission on Pensions and Retirement has already adopted a policy calling for this kind of cost sharing. We support the Commission's policy and urge its enforcement. The Commission currently has no specific policy for cost sharing for benefit increases which apply to an employee's past service. Recent experience with the change to a "high five" formula suggests that a policy for handling the cost of retroactive benefits is necessary. This policy should address eligibility issues. For example, if a benefit increase is granted, should employees who are about to retire be eligible for it? If they are, how should the costs of this benefit be paid?

In any cost sharing program, the average employee contribution rate should reflect average benefits. That is, an employee in a less costly plan should be assessed a smaller contribution rate than an employee in a more costly plan. Employees in current pension plans may end up paying more for their benefits than employees who will be in the new plan that we have recommended. If it is necessary to accurately reflect costs, contribution rates of employees in current plans should be increased. And, at any time, employees in more costly pension plans should have the option of joining a less costly plan and thus reducing their contribution rate. These considerations are particularly relevant for the present members of local police and fire plans.

Public employees should not be taxed on their contributions until they claim them as benefits or refunds. Practically speaking, pension contributions do not become spendable income until an employee claims them as benefits or refunds. Thus, pension contributions should not be taxed. The Minnesota Legislature should ask our congressional delegation to support federal legislation exempting contributions to public employee pension plans from taxation. And, even if the Congress does not act, the Legislature should exempt employee contributions from state income taxation. Instead, benefits and refunds should be taxed.

<u>There should be more thorough analysis of the public's and the employee's contributions to pension plans.</u>

Two new procedures should be added:

- Assumptions which better reflect expected future trends should be used in computing contribution rates. In addition, and for illustrative purposes only, two alternative sets of calculations should be done. One should use conservative estimates of future investment earnings and salary increases, and the second should use liberal estimates.

- Cash flow projections should be done on a regular basis. The projections should show the relationship between the flow of revenue into and out of a fund given the proposed contribution rates. The projection should be used as one means of analyzing the contribution rates and as a check on overall funding policy.

Current laws do not prohibit the analysis suggested above; however, they also do not suggest or recommend it. Rather, the laws require (in most cases) an annual actuarial valuation and, every four years, an experience survey. No alternative assumptions are required, and the survey, covering four years, is the longest time frame for analysis. We feel that this is not adequate. Pension expenditures are so large and so sensitive to change that there must be better analysis.

Recommendations

The 1979 Legislature should adopt as its funding policy for all public pensions a plan calling for payments at a constant per cent of payroll, including social security contributions.

Unless benefits are changed, public pensions should be funded at a constant per cent of payroll. When changes occur, the per cent should be adjusted accordingly. Regardless of the strategy that is chosen to pay for unfunded benefits, payments should be at a constant per cent of payroll.

In order to assure that we can keep pension costs at a level per cent of payroll, the 1979 Legislature should no longer require funding at a rate sufficient to reach 100% funding by 1997 (2017 for Minneapolis municipal). Instead, it should require funding at a rate sufficient to:

- Pay the full cost of pension benefits that employees are currently accruing.

- Pay annual interest charges on the amount owed for benefits accrued in the past but for which no money has been put aside.

- Pay a small portion of the "principal" owed for benefits accrued in the past but for which no money has been put aside.

This funding policy is preferable to the other alternatives because:

- By covering normal cost, interest on unfunded benefits, and a small portion of the principal, employees can be reasonably sure that their benefits will be paid. In the long run, 100% funding will be approached but not reached.

- It lends itself better than the others to keeping payments at a constant per cent of payroll. And, when increases occur, they will show up immediately in both the interest and principal payment. The alternative with the target date for making principal payments would have caused this portion of the contribution rate to increase as the date approached.

- "Discipline" is assured. As pointed out above, any change in benefits will affect the normal cost and, if it adds unfunded benefits, the interest and principal payments. Furthermore, since the policy has no target dates, "changing the date" or deadline for making payments is not anticipated or suggested.

And, by comparison with the current funding policy, this proposal could result in a modest decrease in the contribution rate of public pensions. Based on 1975 covered payroll, and the current benefit plan, the statutory wage and interest assumptions, it could decrease contributions on average by between 1.5% and 2.0%, meaning between $30.8 million and $41.1 million. The exact size of the decrease, if any, will depend on population characteristics of the members of the pension plans.

With almost all public employees now covered by social security and the prospect that the remainder will be covered, it is important that social security costs be part of any funding policy. The goal of keeping pension costs at a level per cent of payroll cannot realistically be achieved without including social security costs.

The actuaries computing the level payment should take into account changes in the defined benefit limit which the Legislature is likely (but is not legally obligated) to enact in the future. When a benefit increase occurs, the employee's eligibility for the increase should be prorated according to the covered employment between the date the increase becomes effective and his retirement. In those special cases where the Legislature decides to provide an increase in the benefits that an employee has already accrued, the Legislature should provide for a "lump sum" payment covering those total costs.

All assumptions used to compute contribution rates should be reviewed at least every four years so that they more accurately reflect long-term expectations of actual future behavior. Both the Legislative Commission and the Governor should review the assumptions in use and make recommendations for potential changes. Either the Legislative Commission or the Governor may initiate a review.

The Legislature should also require that, for comparative purposes only, two other sets of calculations be made for each plan. One of the additional sets of assumptions should take a pessimistic view of future performance, and the other should take an optimistic view. The results of these calculations should be reviewed by the Legislature in determining and monitoring contribution rates.

The Legislative Commission should enforce without exception its current policy for sharing all pension costs equally between employers and employees. This includes both the normal cost and any cost that results from benefits already accrued but for which no money has been put aside. This means that the employee contributions in local fire and police plans will have to be substantially increased. In order to keep employer and employee contributions at a reasonable level, newly hired police and fire personnel in the affected cities should be placed in the PERA police and fire fund, and present employees should be offered the option of transferring to this fund.

All of the costs of public pension plans (including administrative costs) should be met by employee payroll contributions and employer contributions. To this end, the state should stop making a direct payment to TRA. Instead, the Legislature should adjust aids to school districts in amounts equal to their respective employer contributions. EAch school district should then make its own payment to TRA.

Part V - PUBLIC PENSION POLICYMAKING AND ADMINISTRATION

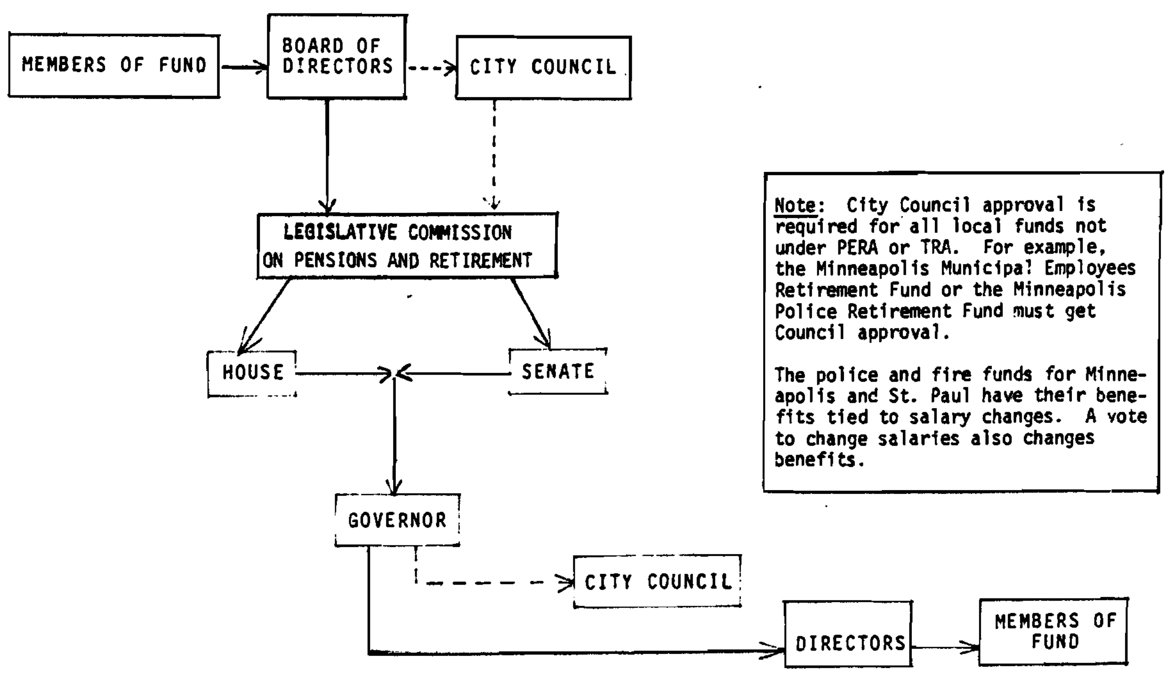
Findings

The Legislature determines virtually all pension benefits and funding policies. Yet, salaries are set mainly by each unit of government. Together salaries and pension policies determine the taxpayers' expense.

Almost 87% of the state's approximately 221,000 public employees as of 1975 are members of pension plans which are under the direct supervision of the Legislature. The remaining 13% are members of local plans. While they are under the authority of the Legislature, policy changes must also be approved by local city councils and, in some cases, by the board of directors of the plan.

The diagram below illustrates the process through which policy is set for public employee pension plans.

PUBLIC PENSIONS: HOW POLICIES ARE SET



Salaries for most public employees are set by their employer. The Legislature has determined some maximums but these affect relatively few employees. From a pensions point of view, this means that one of the two major factors affecting future pension benefits is beyond control. And, with respect to salary negotiations, this means that one major fringe benefit cannot be included in negotiations. Minnesota law adds more limits by excluding all discussion of pensions from labor contract negotiations.

Separating the process for setting wage rates from that for setting pension benefits is of major concern for PERA employers. The actions of any small group can affect the costs of the other. For TRA, the separation of wage negotiations from pension costs reaches an extreme. Since 1967, the state has paid the full employer's contribution for the school boards. The payment is made by a direct appropriation from the state's general fund to TRA. As a result, school board members are not likely to understand pension costs, or to consider the impact of their wage negotiations on these costs.

In the private sector, pensions are generally considered a part of an employee's "total compensation package." They are negotiated as a part of union contracts.

In the public sector, there is some fear that local negotiators would be too willing to trade higher pension benefits for lower salary increases. This might be attractive if local officials felt that the cost of pension benefit increases could be put off to "later generations" of taxpayers. Prior to the 1957 decision to aim toward 100% funding by 1997, this was a likely possibility for all plans. Today, the concern is still valid for TRA where the local school boards have no responsibility for pension costs. And, to the extent that the current funding policy allows costs to be shifted to the future, it may still be valid for other public employers.

From a practical point-of-view negotiating pensions locally would be difficult to do and still keep viable statewide plans. For both TRA and PERA, there are numerous independent bargaining units. This makes bargaining fragmented. And, if pensions were included, benefits might fluctuate between communities, destroying the integrity of the statewide plans.

<u>The Legislative Commission on Pensions and Retirement initially concentrated on statewide plans. Regular legislative oversight for local plans is relatively new.</u>

The Legislative Commission on Pensions and Retirement was established by the Legislature in 1955. Initially, it was an interim commission and remained as such until 1966 when it was made a permanent commission. The commission has ten members... five members from the state Senate and five from the House of Representatives.

The Commission's initial charge was to, "analyze and report as to the condition of public employee pension funds as now constituted,...set forth fair and workable alternatives in present pension funds...set forth the most workable basis on which social security could be incorporated into public employee pension provisions.*" Early in its history, the Commission was also charged to develop reporting uniform standards for public pensions.

The Commission has successfully prodded the Legislature to improve the uniformity of public pension plans, make them more equitable, and insure sound financial management. The Legislature has come to rely on the Commission's judgement regarding virtually all matters related to public employee pensions.

The Commission concentrated mainly on the state's major pension plans during its first decade of operation. However, in 1969 the Commission made major recommendations to the Legislature regarding funding for local public safety plans and the Minneapolis Municipal Employees Retirement Fund.

-The Guidelines Act that it proposed in 1969 required funding for local public safety plans sufficient to "freeze" the growth of unfunded benefits by 1980. Prior to its actions, employees were making regular contributions to these plans but employers were paying their share on essentially a "pay-as-you-go" basis.

-1969 legislation brought MMERF under the 1997 target date for 100% funding. It also recodified provisions of a number of the smaller plans, among the MMERF and the three local teachers plans. In each case, provisions were brought under a single statute.

Since 1969, the Commission has similar objectives for both statewide and local plans. Early in its work, the Commission began phasing-out plans which offered no social security coverage, replacing them with plans coordinated with social security. As of July 1, 1978, similar phase-outs began for MMERF and the local teachers plans in Minneapolis and St. Paul. Another early objective of the Commission was to work toward benefit uniformity between statewide plans. Local plans are now subject to the same objective. For example, effective July 1, 1978, new Minneapolis employees will have the same retirement age requirement as most PERA and MSRS employees.

<u>Differences remain between the various public pension plans. They are often used to support requests for benefit increases.</u>

One plan will use the benefits of another to help justify its request for similar treatment. For example, when the change to a defined benefit formula based on the "high five" salary years was being debated, the fact that MMERF and local teachers plans already had this kind of formula was used as one argument in support of the request. As uniformity of pension plans has increased, there has been less of this "benefit leapfrogging." But, it is still the basis for some requests for change. For example:

-St. Paul TRA has, relative to TRA, a wider range of provisions for allowing employees to buy additional credit toward future benefits. TRA would like similar treatment.

-The reduction in benefits for early retirement is greater for certain ages in PERA and MSRS than in TRA. PERA and MSRS would like similar treatment.

A reduction in the number of independent pension plans might further cut the occurrence of benefit leapfrogging. Another option would be to phase out provisions or plans which are different from the standard that the Commission wants to achieve. The Commission has used both approaches...consolidation generally for smaller plans (e.g., three separate plans for judges were merged into one; the St. Paul Bureau of Health Fund was merged into PERA) and phase-out for the larger ones (e.g., PERA, TRA, MSRS, and MMERF basic plans, no social security, are being phased out and replaced by plans coordinated with social security.)

Major concern is now focused on the local police and fire plans. Twenty local plans are now being phased out...replaced by PERA Police and Fire. Six have merged with PERA Police and Fire. Fifty-six remain independent. Table 18 describes the advantages and disadvantages of merger and/or phase out of local public safety plans.

Table 18

ADVANTAGES AND DISADVANTAGES OF MERGER OF LOCAL PUBLIC SAFETY PENSION PLANS: THREE PERSPECTIVES

I. STATEWIDE PUBLIC PENSION POLICY PERSPECTIVE

Advantages

(1) Statewide and systemwide, retirement benefits will be more uniform and consistent, avoiding the potential of "leapfrogging" (each fund attempting to outdo the other).

(2) PERA-P&F provides portability and earlier vesting, eliminating numerous individual hardship cases and benefit forfeitures.

(3) Pension laws administered by one fund tend to be interpreted more consistently and more accurately in conformance with legislative intent.

(4) The larger PERA-P&F fund exhibits greater efficiency and less administrative cost per member by realizing certain economics of scale.

(5) The actuarial assumptions used in police and fire will tend to be more accurate when spread over a greater membership.

(6) Pension legislation in the area of local police and fire pensions will be greatly simplified and modernized.

Disadvantages

(1) Loss of local funds means a loss in the ability to recognize special or unique local needs.

(2) Loss of local funds means a reduced sense of autonomy and local identity.

II. LOCAL EMPLOYER PERSPECTIVE

Advantages

(1) Uniform pension benefits will allow better comparisons of the total compensation package between cities.

(2) Portability and earlier vesting will aid in recruitment of all ranks.

(3) The employer, who already deals with PERA for municipal employees, would have fewer pension funds to deal with.

(4) The allocation of the burden of financing pension costs between the employer and the employee is more even and is standardized statewide.

(5) PERA's slightly later retirement age, provision of service credit for long service, and calculation of the benefit on full salary will encourage longer police and fire careers, thereby reducing personnel training costs as well as pension costs.

(6) PERA provides better control over the ultimate cost of post retirement adjustments when compared to an escalated fund.

Disadvantages

(1) Loss of local funds will restrict the ability of the city to tailor its pension program to meet any special or unique needs.

(2) Loss of the local funds means a loss of local control, especially over the invested assets of the fund.

(3) Either consolidation or phase-out will require a short term increase in employer contributions in order to amortize existing unfunded accrued liabilities.

III. LOCAL EMPLOYEE PERSPECTIVE

Advantages

(1) PERA-P&F provides pension portability to ease job mobility.

(2) PERA-P&F provides shorter vesting than most local funds, resulting in less chance of retirement benefit forfeiture.

(3) PERA-P&F provides earlier retirement than some of the existing local funds.

(4) PERA-P&F provides post retirement adjustments where some existing local funds do not.

(5) PERA-P&F provides a benefit as a percentage of full salary rather than limited salary as most of the local funds.

(6) Economics of scale and greater efficiency maximizes the amount of contribution dollars used for employee benefits.

(7) The laws governing pension benefits would be simplified and modernized under PERA-P&F.

(8) PERA P&F would provide the increased security of being a member of a more soundly funded retirement plan than most local funds.

Disadvantages

(1) Loss of local funds means less recognition of differing local needs.

(2) Loss of local funds will reduce the sense of local autonomy.

(3) PERA-P&F has a higher retirement age than many of the local funds.

(4) PERA-P&F does not provide escalator post retirement adjustments, unlike a number of local funds.

(5) Disability and survivor benefits under a local fund are frequently greater than those provided by PERA-P&F.

(6) Phasing out or consolidation may give rise to antagonism between active personnel or between active personnel and retirees.

(7) PERA-P&F typically requires a higher employee contribution.

SOURCE: Comments by Rep. Al Patton to the Citizens League Committee on Public Pensions, June 19, 1978.

Within the Legislature, and state and local government in general, the field of people participating in decisions related to public pensions is limited.

As described earlier, the Legislature depends extensively on the Retirement Commission for policy recommendations and oversight with respect to pensions. This is largely due to:

-The complexity of the subject. As with many other issues, a legislator must be willing to invest a substantial portion of his time learning about public pension and then overseeing the state's system.

-The politics of pension policy. Pensions are extremely important to employees. Active and retired employees are well organized and available to help support or oppose pension legislation. For example, members of local police plans actively opposed the reelection of one member of the Commission because of, among other things, his support for merger of local plans with PERA Police and Fire.

Compounding the political problems is the relative lack of general public knowledge regarding pensions and pension problems. As a result, an elected official cannot expect strong public backing for taking tough stands on pension policy.

Unlike other policy areas, leadership on pension policy has not come from the executive branch of state government. Instead, the Commission has been responsible for initiating and then debating its own proposals. While the three major statewide plans are technically a part of the executive branch of state government, the Governor, either directly or through any state agency, has not taken a leadership role. The Department of Finance does review budget requests...but this has seldom generated any proposals for policy change.

The Governor appoints three members of the MSRS nine-person board. And, the Commissioner of Education, Finance, and Insurance serve on the eight-person TRA Board. However, their participation has not been coordinated and used by the executive as a means of providing leadership on public pension issues.

At the local level, public officials have not participated actively in the affairs of local plans. A recent series in the Minneapolis Tribune* on Minneapolis' public pension plans reported that city officials, including the Mayor and City Attorney, were not aware that they were ex officio members of the boards of trustees of local plans. Other factors may also account for the lack of interest:

-As is true with the Legislators...the complexity of the subject and the politics that surround it are deterrents.

-Jurisdictional lines for pension plans do not coincide with jurisdictional lines for local governments...most communities do not have their own funds or their own representatives to the statewide plans. To a certain extent, their access to the statewide plans must be through a local Legislator or Commission member.

-Employer representation on the Boards of Directors of the various pension plans is limited. And, in the case of the St. Paul Firemen's plan, there is no employer representative on the Board (see Appendix F).

* Minneapolis Tribune, 9/20/78
p. 1

The major responsibility of the board of directors of a public pension plan in Minnesota is to oversee the administration of the plan...for example, most boards hire an executive director who is responsible for day-to-day operation. Except in granting disability pensions, the boards have no formal policy responsibility. However, they can and do act as lobbyists for benefit increases. Some boards adopt a legislative package prior to each session of the Legislature.

Information on Minneapolis public pension funds is limited. Little has been done to assess the future impact of pension policies and decisions.

The readily available information on public pensions is out of date. For example, the last report of the Legislative Commission to the Legislature was issued in November, 1977, but contained data for 1975 and, in the case of local police and fire plans, for 1972. More current data is available on plans individually. This data is awkward to use and does not give a picture of the system overall.

For all except the local police and fire plans, annual reports on the status of each plan are required by state law. A more extensive report is required every four years. These reports are filed either at the end of the year or around mid-year. They provide an up-to-date picture of the plan; however, they are not compiled into a picture of the system as a whole...except in the report of the Commission to the Legislature. The most recent editions of this report cam out with almost a three year lag.

The annual "actuarial report" and quadrennial "experience study" are the only reports required by statute. Both provide a relatively short-term view of the plans. No long term cash flow analysis has been done except by special request. And, on those occassions, the actuaries for the plans seem reluctant to do it. For example, in response to a recent request by the Department of Finance for 40 year cash flow projections for TRA, the fund's actuary responded as follows:

"...because a number of indeterminate variables we are not able to formulate a satisfactory program for generating these cash flow estimates.*"

Others disagree...the City of Minneapolis had cash flow projections done for its police and fire plans. A major metropolitan corporations has recently had cash flow projections done for its plan which covers over 25,000 employees. A November 20, 1978 advertisement in the Wall Street Journal offers customers a model for projecting pension costs over the next twenty years. Any projections that are done would have to be updated regularly. As a result, this form of analysis could become quite expensive.

The Commission's ability to do its own analysis is limited. Its staff is small... an executive secretary, an assistant, a secretary, and a consulting actuary. The Commission must rely on the funds and their actuaries for a good deal of its information and analysis.

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*June 15, 1978 letter from Robert F. Flott, Brown and Flott Consulting Actuaries, to Harvey Schmidt, Executive Secretary, Minnesota Teachers Retirement Association.

Conclusions

The composition of boards of directors of pension plans should reflect the financial responsibility that both the public and the employees have for current and future benefits.

The idea that the employer and employee share responsibility for public pension is developing better and better, particularly with respect to sharing costs. However, little progress has been made in sharing responsibility for overseeing administration. Employees, through representation on boards of directors, have assumed much of the responsibility. It is now time for the employer to assume part of the responsibility.

The division of responsibility should reflect the employer's and employee's financial responsibility. The administration of the plan affects its cost. As a result it is appropriate to base board representation on financial responsibility.

Over the years, boards have played a role in the development of the pension system...until recently, the Commission's report to the Legislature summarized the legislative proposals of each of the major plans. Today, the boards still make proposals; however, they do so through their own means. Since these proposals, if adopted, would affected both the employer and employees, the employer should be represented.

The focus of the work of the Legislative Commission on Pensions and Retirement should be long-range planning for the system. As much as possible, it should be freed from direct supervision of pension plans.

At its start, the Commission had to rethink the state's public pension system... its focus was on developing a basic direction for public policy. Over the last twenty years, it has developed the legislation that was necessary to implement many of the original objectives. The Commission should be commended for its diligence.

While its oversight activities are important, the Commission also must move ahead on its original purpose by rethinking basic policies. It must act as a long range planner for public penions. To do this, it must develop an appropriate data base...one that will show as best as possible the long term prospects for different plans and the system in general.

The executive branch of state government, and specifically the governor, should take an active role in policy discussion related to public employee pensions.

The governor is the state's chief executive officer. As such he is responsible for all aspects of administration...including his employee's pensions.

The concept of "checks and balances" is key to our system of government. With the Commission responsible for both developing policy proposals and reviewing them, there is little or no opportunity for the system to work. Active involvement by the Governor in pension policy would create the kind of tension that is necessary for a good system of "checks and balances."

Information on the cost of public pensions should be included in wage negotiations by state and local government.

The current policy of excluding pensions from collective bargaining should be altered. While the pension itself should not be a subject for bargaining, information about the pension and its cost should be available and included in contract discussions. With the current benefit formulas, wage rates have become the most significant factor in determining the cost of future benefits. This cost is significant. Wages should not be negotiated without full knowledge by both employers and employees of their impact on pension benefits and the cost of these benefits.

Salary increases around the state should be monitored by the Commission. Currently, all communities contribute at the same rate for PERA. While we have seen no evidence of this to date, unusually large wage increases in even a small number of communities could push up pension costs for all participating communities. And, as a result, the integrity of the plan might be threatened. As a precaution, the Commission should review salary increases on a community-by-community basis on a regular basis.

Recommendations

1. The 1979 Legislature should act to increase public employer representation on the boards of directors of public pension plans.

   The make-up of the boards should reflect the financial responsibility that both the public and the employees have for current and future benefits. The public employer representatives should be persons that can be held directly accountable by the voters.

2. The Legislature's Retirement Commission should require that a biennial study be done on each of the major funds to show what the public's commitment (in per cent of payroll and total expenditures) to the funds will be in the future.

   The studies should make explicit assumptions on rates of inflation, return on investment, wage increases, benefit increases, employee growth or decline, age breakdown of employee groups, administrative costs. The studies should indicate the sensitivity of the costs of each plan to changes in each of the above variables.

   Local plans should be subject to stringent state standards assuring clear public disclosure of fund status; administrative costs; and changing liabilities. These standards should be developed during 1979 by the Legislative Commission in consultation with the Governor. They should be submitted to the Legislature for approval in 1980.

3. The Governor, as the state's chief executive officer, should "comment" biennially to the Legislature on state and local pensions.

   The Governor should review the status of all public employee pension funds on a regular basis and should comment on their condition as a part of his "state of the state" message to the Legislature. In his comments, the Governor should make recommendations regarding benefit changes and funding.

4. All pension plans should be defined under one statute.

5. <u>The Legislature should establish a one-year waiting period for all changes in statutes related to public employee pensions.</u>

If recommendations one through four are not implemented, then the Legislature should adopt a policy delaying the effective date for one year for all changes in statutes related to public pensions. The waiting period would begin on the day that the Governor signs a bill and end 364 days later. During the waiting period, statutory changes can be reviewed and revisions suggested to the Legislature. Any revisions of the initial changes which are approved by the Legislature should go into effect at the end of the one-year waiting period which commenced with the initial changes. Decisions related to public pensions (particularly those affecting benefits) are extremely difficult to change. And, everyone concerned with public pensions should have the opportunity to study and consider the impact of new legislation in its final form before it takes effect.

BACKGROUND ON PREPARATION OF CITIZENS LEAGUE REPORTS

Each year the Citizens League Board of Directors adopts a research program with about six study topics. The Board makes its selection following a recommendation from its Program Committee, a standing committee of the Board. The Program Committee spends about four months in trimming a list of possible projects, which may have as many as 200 possibilities at the outset.

Under the League process, the Board submits an assignment to a committee made up of members of the Citizens League who have been given the opportunity to participate through an announcement in the League's semi-monthly newsletter. The Board approves membership on all committees and appoints the chairman.

The committee then goes to work and, after a period of six months to a year, submits a report with background, findings, conclusions and recommendations to the Board of Directors.

A period of time after the committee has begun meeting, but before it has reached its conclusions and recommendations, the Board of Directors names about five persons from the Board to meet with the study committee chairman and committee members to review how the committee is progressing and to raise questions which might subsequently be raised at the Board level. A five-member group from the Board may meet with the chairman about three or four times. The five-member Board panel may submit a list of questions for consideration by the Board when the committee's report is submitted.

Under the League's constitution and by-laws, the Board approves all League reports and position papers before they become official League policy and are released to the public. The Board may take whatever action on the report it deems desirable, including approval, modification or rejection. Once a report is approved by the Board, it becomes the full responsibility of the Board as official policy of the Citizens League.

The study committee officially disbands when the report is acted on by the Board. The chairman and others from the committee frequently are asked to help explain the report to the community.

COMMITTEE ACTIVITY

The Citizens League Board of Directors, in May, 1977, authorized the creation of a study committee on public employee pensions. The committee's charge from the League Board was as follows:

> Considerable concern exists in some sectors over the status and cost of public pension plans in Minnesota. For example, many questions exist relative to police and fire pension plans. How serious is the gap between assets in the funds and future benefits which will have to be paid? What is the impact of provisions in these plans which permit benefits to retirees to escalate as current salaries increase and to permit early retirement without reduction of benefits? The Legislature has required these cities to increase their tax levies substantially to stop an increase in the deficit. Other controversies relate to the funding of a separate pension plan which the City of Minneapolis maintains for its other city employees and to the public cost of statewide public employee pension plans in Minnesota.
>
> The committee shall review (a) the need to reduce pension fund deficits; (b) the proportionate relationship today between expenses for current compensation and for pension benefits and what that relationship is projected to be in coming years; (c) how the employee, the state and the localities should share in the expense of these plans; (d) factors affecting the cost of various plans, including benefit levels and retirement ages; and (e) incentives which may exist now for increasing or decreasing benefits.

A total of 74 League members signed up for the committee, but only 20 participated actively in the work of the committee. The chairman was Andrew R. Lindberg, from Bloomington. The other members of the committee were: Robert A. Chapman, H. David Crain, Norman P. Foster, Mel Hansen, Robert E. Hannon, E. Robert Hoffman, John M. Leadholm, E. Lester Levine, Daniel B. Magraw, Jim Newland, Robert E. Perkins, Fabian Pinkham, Leonard F. Ramberg, Marian Raup, Philip M. Raup, Harry L. Sutton, Jr., Clyde W. Thompson, Robert E. Wetherille, Jr., and Perry M. Wilson, Jr.

Three minority reports were submitted by members of the committee. They raised the following concerns:

-The two-tiered benefit plan as proposed by the committee would be unworkable. The committee's objectives could be accomplished by changing the current defined benefit plan so that it would provide a basic level of benefits. The new plan could be integrated with social security, and a minimal, if any, employee contribution would be required. Over and above the basic benefit, there could be a voluntary plan for capital accumulation for all employees regardless of pay level. The following committee members concurred: Chapman, Foster, Perkins, Sutton, and Thompson. Mr. Levine agreed with the nature of the dissent but not the alternative solution.

Mr. Sutton submitted an addition to this minority report. He suggested some additional alternatives for limiting the public's risk for future benefits and that current benefits are "too liberal to be supported considering the adequate nature of the current salary levels."

-The Legislature should "adopt a rational and systematic approach to fund the "principal" owed for benefits accrued in the past but for which no money has been put aside." The minority felt that any withdrawal from 100% funding would establish an undesirable precedent. It saw no reason for treating unfunded accrued pension benefits any different from other public debts. Furthermore, the minority feels that the cost differential between their proposal and the committee's is not significant. The following committee members concurred: Chapman, Foster, Hansen, Hoffman, Magraw, Pinkham.

-Mr. Magraw submitted a minority report concerning University of Minnesota faculty pensions. Mr. Magraw felt that the University plan should not be excluded from the committee's general recommendations regarding benefits and funding. He objected to "public policy which sets up two classes of public employees for pension purposes."

The full text of these minority reports is available at the Citizens League office.

During its early meetings the committee was assisted by Judith Alnes. During deliberations and report drafting, the committee was assisted by Bill Blazar. Jean Bosch arranged all meetings, kept the committee's records, and provided secretarial assistance.

The committee held a total of 39 meetings, from February 27, 1978 to November 20, 1978 . . . one a week at first, and later two per week. For the convenience of committee members and resource persons, meetings were held in both Minneapolis and St. Paul.

The committee spent the first several weeks of its work hearing from a wide range of resource persons, including legislators, pension fund administrators from both the public and private sectors, and actuaries.

Detailed minutes were prepared of each meeting of the committee, with copies being made available to members who were not present, and to a large mailing list of persons who were interested in the subject matter under study. A limited number of copies of the minutes are on file at the Citizens League office, as are copies of background articles, staff reports and surveys and other data.

After the initial orientation portion of the committee's work, several months of internal discussion resulted in a series of drafts of findings and of conclusions. Following general agreement on the findings and conclusions, the committee's discussion shifted to recommendations and, finally, to adoption of this report.

As is always the case with Citizens League reports, the work of this committee could not have been possible without the important participation of a number of resource persons. We offer our sincere thanks to persons who acted as resource persons:

<u>Sergeant Lloyd W. Berg</u>, President, Minneapolis Police Relief Association
<u>Harold J. Bernard</u>, Director of Employee Benefits, University of Minnesota
<u>Dr. Francis M. Boddy</u>, Acting Executive Secretary, Minnesota State Board of Investment
<u>Wayne Burggraaff</u>, Richfield City Manager
<u>Sergeant Dick Feider</u>, Board Member, St. Paul Police Department Relief Association
<u>Tom Fulton</u>, State Planning Agency, Office of Local & Urban Affairs
<u>Tom Gelbmann</u>, President, St. Paul Fire Department Relief Association
<u>Paul Goldberg</u>, International Representative, American Federation of State, County & Municipal Employees

Harry Groschel, Minnesota Department of Personnel
Paul Groschen, Executive Director, Minnesota State Retirement System
Katherine Gustafson, State Planning Agency
Harlan E. Johnson, Executive Secretary, Minneapolis Municipal Employees Retirement Fund
Stan Kehl, Legislative Liaison, Minneapolis City Clerk's Office
Dan Lesh, Manager of Benefit Planning, Honeywell, Inc.
Dean Lund, former Executive Director, League of Minnesota Cities
David MacIntyre, Manager, Employee Benefits, General Mills, Inc.
Gene Mammenga, Minnesota Education Association
John Mandeville, Executive Secretary to the Legislative Commission on Pensions & Retirement
Representative Donald M. Moe, Member, Legislative Commission on Pensions & Retirement
Mort Mosiman, Deferred Compensation Administrators, Inc.
Senator Harmon T. Ogdahl, Minnesota State Senate
Michael Ousdigian, Executive Director, Public Employees Retirement Association
State Representative Al Patton, former chairman, Legislative Commission on Pensions & Retirement
Stan Peskar, General Counsel, League of Minnesota Cities
Harvey Schmidt, Executive Director, Teachers Retirement Association
Mike Scully, Secretary-Treasurer, Minneapolis Police Relief Association
Franklin Smith, Stennes & Associates
Steve Wellington, Budget Analyst, Office of the Mayor, St. Paul
Gus Welter, Minnesota State Fire Departments Association
Robert E. Wetherille, Jr., Secretary, Minneapolis Fire Department Retirement Ass'n
Don Wicklund, Office of Personnel, Minnesota Department of Transportation
Beryl Wright, State Planning Agency, Office of Local & Urban Affairs

In addition, special thanks is due to the staff of the Legislative Commission on Pensions & Retirement. John Mandeville and Larry Martin followed the committee's work closely, provided valuable information and comments on committee discussion.

ACTION BY THE CITIZENS LEAGUE BOARD OF DIRECTORS

The Citizens League Board of Directors discussed this report at its regular November and December meetings. In addition to the committee's report, three minority reports were also considered.

Board discussion focused on three topics:

- The autonomy of local police and fire pension plans.
- Policy for paying the cost of benefits which have already accrued but for which no money has been put aside.
- The process for changing pension policy.

It was the consensus of the Board that the merging of the local police and fire plans was a necessary first step to making police and fire benefits more similar to those of other public employees. As independent plans, the local police and fire plans can work directly with the Legislature. If they were part of a larger system, it seems more likely that their pension needs will be balanced against those of other public employees.

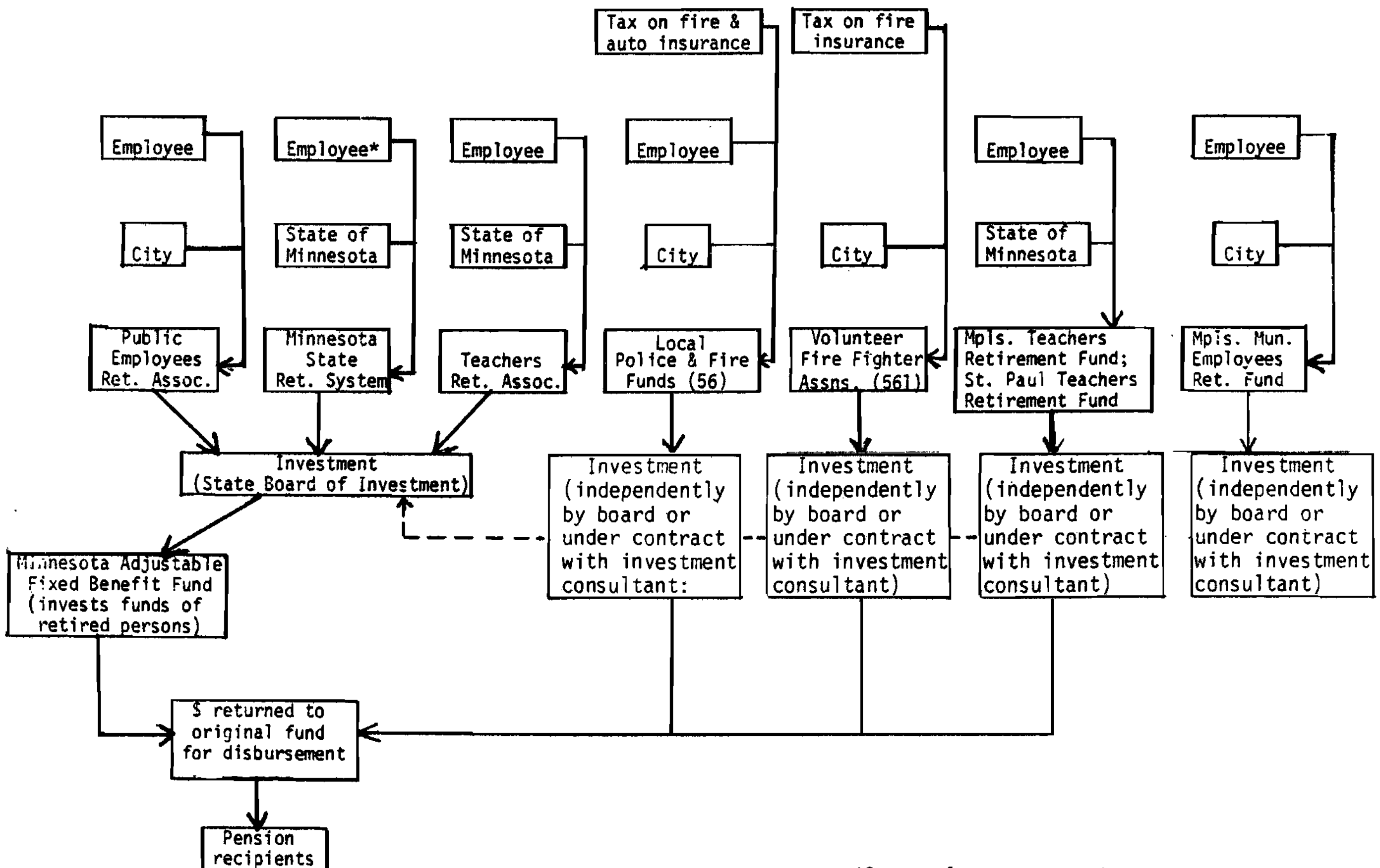
The study committee did not feel that merger was necessary. As such the Board adopted amendments calling for the merger of local police and fire plans with PERA Police and Fire.

One of the minority reports recommended that the Board endorse a funding policy calling for full funding of all pension benefits over a specified period of time ...thereby rejecting the policy recommended by the committee. In its discussion the Board concurred with the committee. It was thought that the committee's proposal would spread the cost of pensions among taxpayers in a more equitable fashion. And, over a long period of time, the committee's recommendation would result in funding for all promised benefits.

The Board adopted an amendment calling for a one-year waiting period between the passage of pension legislation and its implementation. Some committee recommendations were aimed at improving the discussion of proposed policy. The Board felt these recommendations were justified. However, it was felt that a "back up" measure was needed. The one-year waiting period was recommended only if the Governor and Legislature fail to implement the committee's other recommendations with respect to pension policy and administration.

APPENDIX A

THE FLOW OF MONEY TO PUBLIC PENSION PLANS, ITS INVESTMENT, AND PAYMENT AS PENSION BENEFITS



*Some employee groups make no contribution, e.g., judges.

APPENDIX B

COMPARISON OF MONTHLY RETIREMENT BENEFITS

1. The table on the next page shows the following:

   -Monthly retirement benefits for persons in plans with defined benefits.

   -Monthly retirement income as a per cent of the employee's final year's salary. In each case the final salary was adjusted on an annual basis for inflation.

   Assumptions:

   -Our hypothetical employees were all 65 years old on January 1, 1974. None were policemen or firemen. And, they each had 30 years of public service during their working careers. And, they each began drawing benefits as soon as they were eligible for full pension benefits given their length of service. For example, none retired at age 62 with reduced benefits.

   -Each retiree is single...drawing the maximum benefit with no joint or survivor annuity.

   -For 1974-1977, the actual rate of salary increase for state and local employees was applied to the retiree's assumed 1973 salary and used to compute the pension benefit as a per cent of income.

   For 1978-1982, it was assumed that all salaries would increase at an annual rate of 7%. And for the purposes of computing social security, it was assumed that the consumer price index would increase at a rate of 6% per year.

2. The defined contribution benefits in Table 2 on page 9 were calculated for the committee by the TRA. The assumptions listed above were used.

APPENDIX B (continued)

	Date	Age		FINAL SALARY = $10,480	$19,213	$36,679
				Benefit ($/month) and Replacement Rate (%)		
	Jan. 1974	65	Social Security (SS)	$300	$328	$ 328
			Public Pension (PP)	323	592	1130
			Total Benefit and Replacement Rate as a % of Final Salary (T)	623 (69%)	920 (56%)	1458 (46%)
	Jan. 1976	67	SS	363	405	405
			PP	323	592	1130
			T	686 (70%)	997 (56%)	1535 (45%)
COORDINATED PLANS: -TRA -MSRS -PERA -MMER*	Jan. 1978	69	SS	406	457	457
			PP	336**	616**	1175**
			T	742 (69%)	1073 (55%)	1632 (44%)
	Jan. 1980	71	SS	458	518	518
			PP	349***	641***	1222***
			T	807 (66%)	1159 (52%)	1740 (41%)
	Jan. 1982	73	SS	514	582	582
			PP	363***	667***	1271***
			T	877 (63%)	1249 (49%)	1853 (38%)
	Jan. 1974	65	SS	-	-	-
			PP	565	1036	1977
			T	565 (63%)	1036 (63%)	1977 (63%)
BASIC PLANS: -TRA -MSRS -PERA -MMER	Jan. 1976	67	SS	-	-	-
			PP	565	1036	1977
			T	565 (58%)	1036 (58%)	1977 (58%)
	Jan. 1978	69	SS	-	-	-
			PP	588**	1077**	2056**
			T	588 (55%)	1077 (55%)	2056 (55%)
	Jan. 1980	71	SS	-	-	-
			PP	612***	1121***	2138***
			T	612 (50%)	1121 (50%)	2138 (50%)
	Jan. 1982	73	SS	-	-	-
			PP	636***	1166***	2224***
			T	636 (45%)	1166 (45%)	2224 (45%)

*MMER; coordination is mandatory for new employees as of 7/1/78.
**Includes a 4% increase through the Minnesota Adjustable Fixed Benefit Fund (MAFB).
***Assumes a 4% increase through the MAFB.

APPENDIX C

COMPARISON OF MAJOR BENEFITS*

The following table presents hypothetical retirement benefits for a range of service periods for the various public pension funds, programs and plans. The benefits are calculated on a $12,000 highest five successive years average salary, the last five years salary increasing at a 3.5% annual progression, and with a final year's salary of $12,840.

Those funds, programs or plans providing a benefit which is coordinated with social security are indicated by the symbol (C). Only a portion of the total coordinated retirement benefit is provided by the fund, program or plan. Where the coordinated benefit is an offset benefit (Guaranteed benefit amount - social security benefit at retirement = benefit provided), this is indicated by the symbol (C-O).

Fund, Program, or Plan	10 years	20 years	25 years	30 years	40 years
DTRFA (C)	$1,380 (115/mo)	$2,760 (230/mo)	$3,450 (288/mo)	$4,140 (345/mo)	$ 5,520 (460/mo)
Elected State Officers	4,714 (393/mo)	6,857 (571/mo)	7,928 (661/mo)	9,000 (750/mo)	10,071 (839/mo)
Highway Patrol	3,000 (250/mo)	6,000 (500/mo)	7,200 (600/mo)	8,400 (700/mo)	10,800 (900/mo)
Judges (C-O)	3,000 (250/mo)	6,000 (500/mo)	7,500 (625/mo)	9,000 (750/mo)	12,000 (1000/mo)
Legislators — New Basic	3,000 (250/mo)	6,000 (500/mo)	6,000 (500/mo)	6,000 (500/mo)	6,000 (500/mo)
Legislators — Old Basic	5,400 (450/mo)	8,400 (700/mo)	9,900 (825)mo)	11,400 (950/mo)	14,400 (1200/mo)
Local Paid Fire Funds	—	5,136 (428/mo)	6,260 (522/mo)	6,260 (522/mo)	6,260 (522/mo)
Local Police Funds	—	5,136 (428/mo)	6,260 (522/mo)	6,260 (522/mo)	6,260 (522/mo)
MTC/TOD (C)	1,200 (100/mo)	2,520 (210/mo)	3,240 (270/mo)	3,960 (330/mo)	5,520 (460/mo)
MMER — New Coord.(C)	1,200 (100/mo)	3,000 (250/mo)	3,900 (325/mo)	4,800 (400/mo)	6,600 (550/mo)
MMER — Basic	2,400 (200/mo)	5,400 (450/mo)	6,900 (575/mo)	8,400 (700/mo)	11,400 (950/mo)
Mpls TRFA — New Crd. (C)	1,200 (100/mo)	3,000 (250/mo)	3,900 (325/mo)	4,800 (400/mo)	6,600 (550/mo)
Mpls TRFA — New Basic	2,700 (225/mo)	5,400 (450/mo)	6,750 (563/mo)	8,100 (675/mo)	8,100 (675/mo)
Mpls TRFA — Old Basic	2,000 (167/mo)	4,000 (333/mo)	5,000 (417/mo)	6,000 (500/mo)	8,000 (667/mo)
MSRS (C)	1,200 (100/mo)	3,000 (250/mo)	3,900 (325/mo)	4,800 (400/mo)	6,600(550/mo)
MSRS — Correctional (C-O)	3,000 (250/mo)	6,000 (500/mo)	7,200 (600/mo)	8,400 (700/mo)	9,000 (750/mo)
PERA — Basic	2,400 (200/mo)	5,400 (450/mo)	6,900 (575/mo)	8,400 (700/mo)	11,400 (950/mo)
PERA — Coordinated (C)	1,200 (100/mo)	3,000 (250/mo)	3,900 (325/mo)	4,800 (400/mo)	6,600(550/mo)
PERA — Police & Fire	3,000 (250/mo)	6,000 (500/mo)	7,200 (600/mo)	8,400 (700/mo)	10,800 (900/mo)
St. PTRFA — New Crd. (C)	1,200 (100/mo)	3,000 (250/mo)	3,900 (325/mo)	4,800 (400/mo)	6,600 (550/mo)
St. PTRFA — New Basic	2,400 (200/mo)	4,800 (400/mo)	6,000 (500/mo)	7,200 (600/mo)	9,600 (800/mo)
St. Paul TRFA — Old Basic	2,160 (180/mo)	4,320 (360/mo)	5,400 (450/mo)	6,480 (540/mo)	8,640 (720/mo)
TRA — Basic	2,400 (200/mo)	5,400 (450/mo)	6,900 (575/mo)	8,400 (700/mo)	11,400 (950/mo)
TRA — Coordinated (C)	1,200 (100/mo)	3,000 (250/mo)	3,900 (325/mo)	4,800 (400/mo)	6,600 (550/mo)
Univ. Faculty Supp. (C-O)	2,000 (167/mo)	4,000 (333/mo)	5,000 (417/mo)	6,000 (500/mo)	6,000 (500/mo)
University Police	2,400 (200/mo)	4,800 (400/mo)	6,000 (500/mo)	6,000 (500/mo)	6,000 (500/mo)

*SOURCE: Report to the 1977-1978 Minnesota State Legislature, Legislative Commission on Pensions and Retirement. Benefits as of 1977. Does not reflect changes approved during 1978.

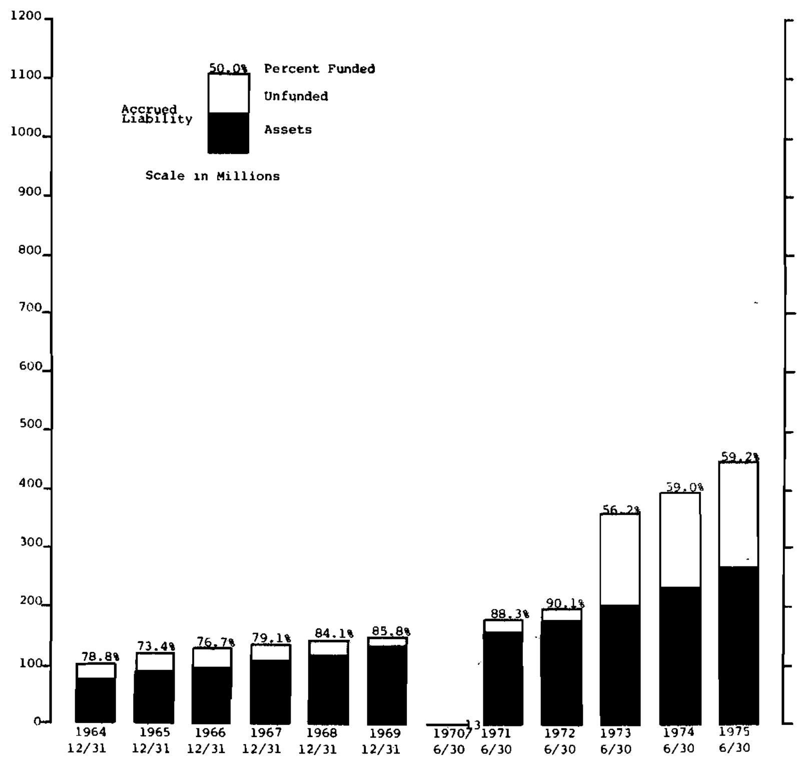
APPENDIX D

GROWTH OF ACCRUED LIABILITIES AND ASSETS OVER TIME*

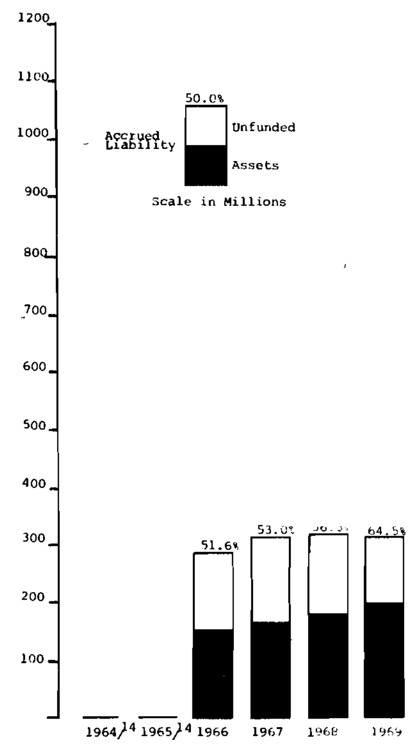
The charts set forth the relationship of assets to accrued liabilities annually for the last several years for the various retirement funds. For MSRS, PERA, PERA Police and Fire, TRA, and the Highway Patrol, there were substantial benefit increases in 1973. The interest assumption has changed over time, limiting to some extent the comparability of the accrued liability figures year to year. The following is the statutory interest assumption for the period 1964 to 1975: 1964-1968, 3.0%; 1968-1972, 3.5%; 1973-1975, 5.0%.

*SOURCE: Overview of Minnesota Public Pension Plans, Supplementary Report to the Minnesota Legislature, 1977 Session; Legislative Commission on Pensions and Retirement.

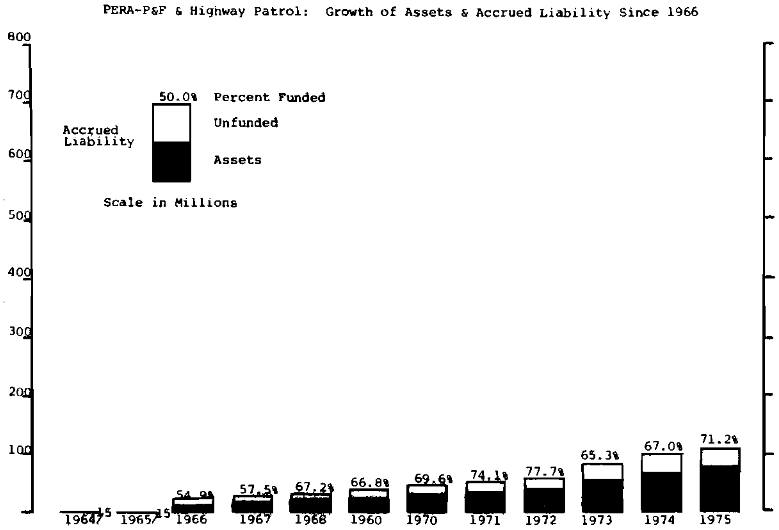
MSRS: Growth of Assets and Accrued Liability Since 1964



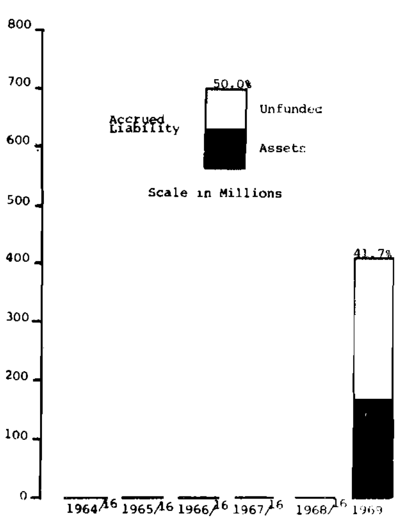
PERA : Growth of Ass



PERA-P&F & Highway Patrol: Growth of Assets & Accrued Liability Since 1966



First Class City Funds (MMER, DTRFA, MTRFA,



13 MSRS changed its plan year from a calendar year basis to a July 1 to June 30 fiscal year basis in 1969 and did not file a valuation in the year 1970.

14 No valuations of PERA were made in 1964 and 1965. The most current valuation prior to 1966 was made as of 6/30/1963.

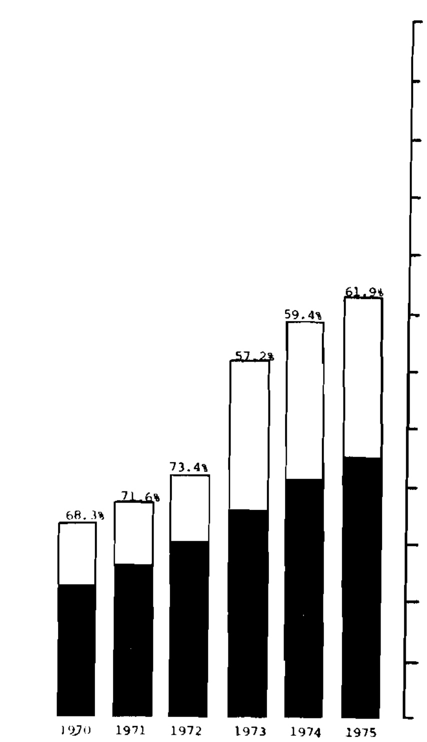
15 No valuations for PERA-P&F were made in 1964 and 1965, and the most current valuation prior to 1966 was made as of 6/30/63. The Highway Patrol Fund (and the State Police Fund which was consolidated into the Highway Patrol Fund in in 1969) has made continuous valuations since 1964.

16 The First Class City Funds were not required to submit annual financial reports and actuarial valuations under Minnesota Statutes, Chapter 356, until 1969.

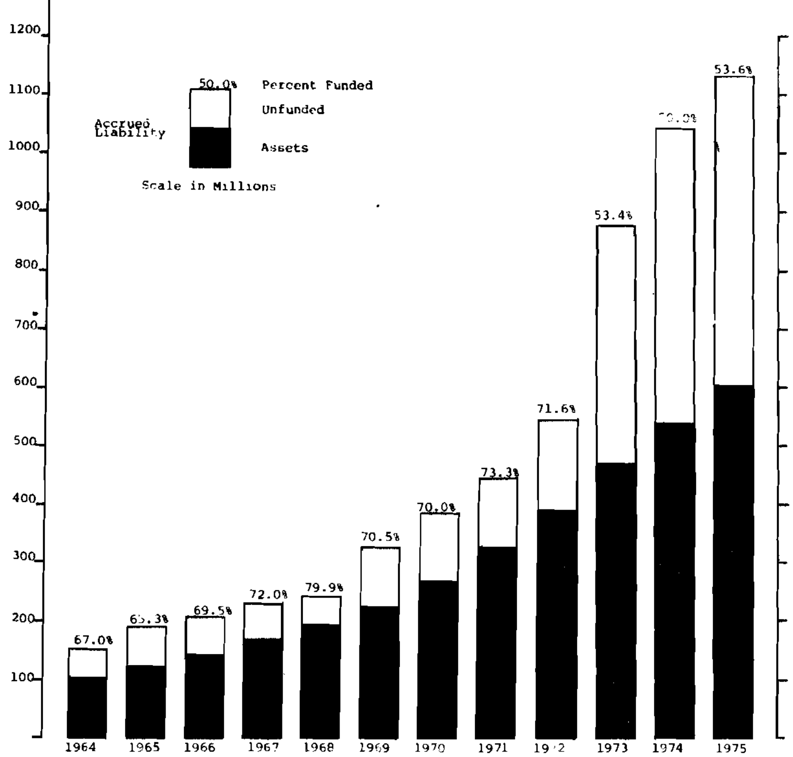
17 Unlike the asset and accrued liability figures for the major pension funds, these figures for the local police and paid fire funds used in compiling the chart were not reviewed by the Commission's actuary.

18 "Current" includes the most recent valuation data reported, but repeats the 1972 valuation data in many instances.

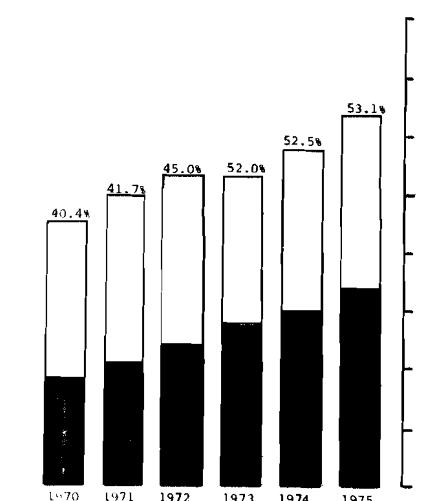
Accrued Liability Since 1966



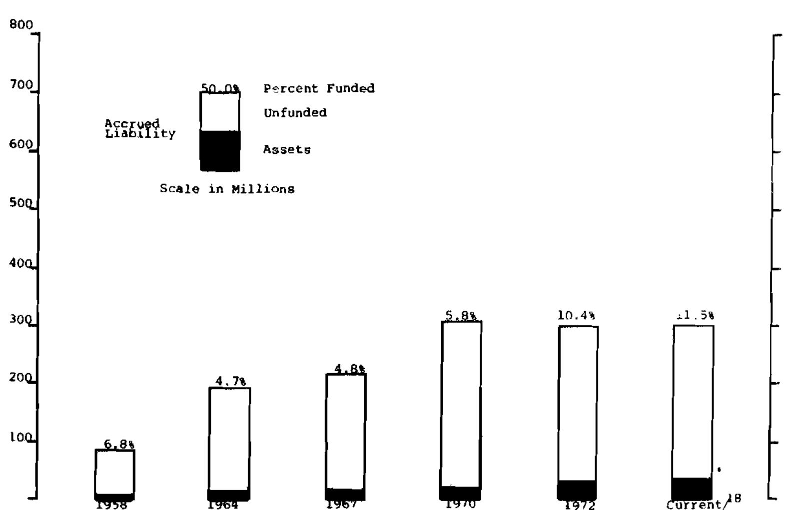
TRA: Growth of Assets and Accrued Liability Since 1964



St.PTRFA): Growth of Assets & Accrued Liability Since 1969



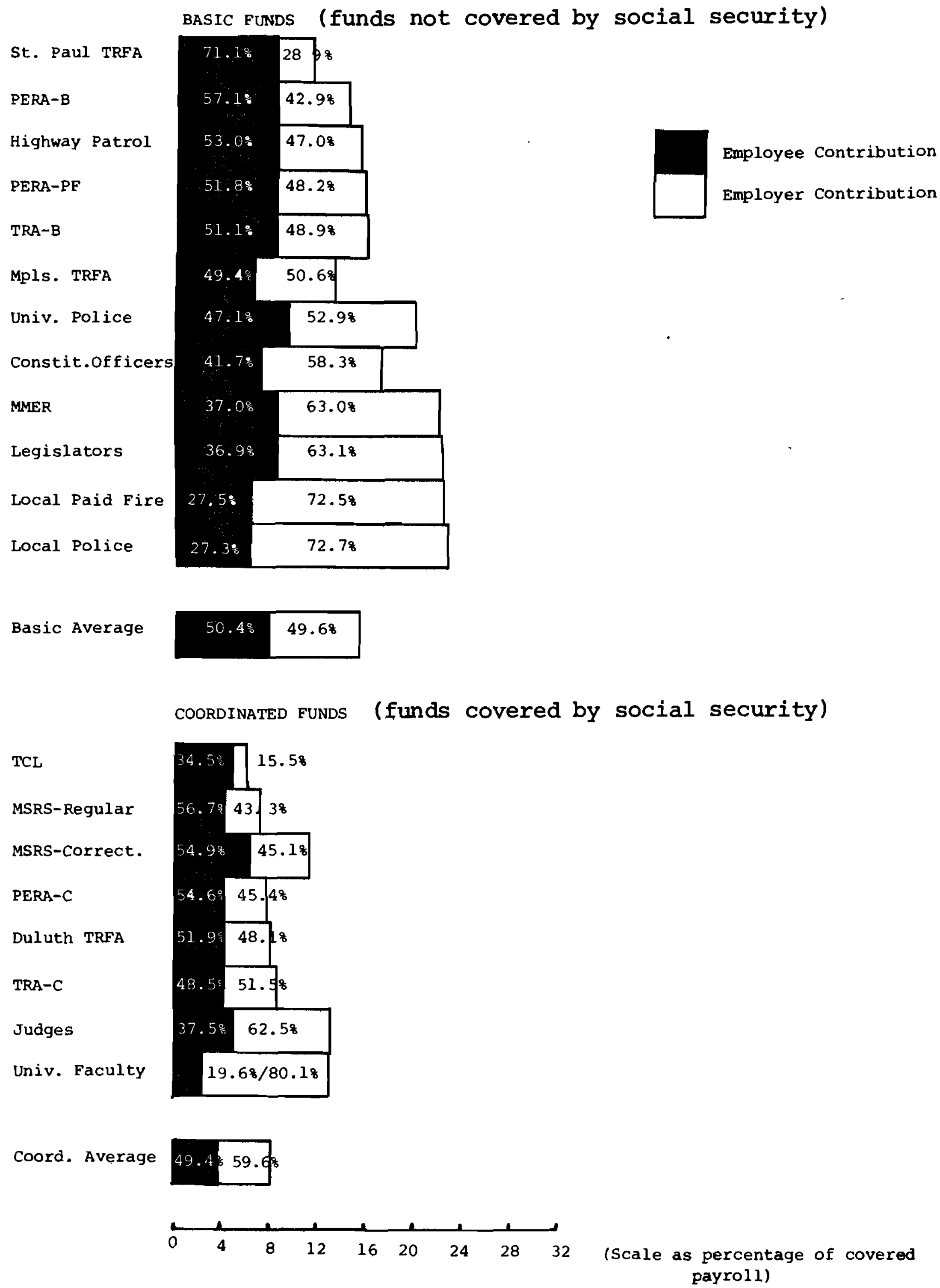
Local Paid Fire & Police Funds: Growth of Assets & Accrued Liability Since 1958 [17]



APPENDIX E - Part I

CONTRIBUTION TO MEET NORMAL COST: EMPLOYER AND EMPLOYEE SHARE*

The chart compares the normal cost requirement for the various funds and plans, distinguishing between Basic programs, where there is not social security coverage, and Coordinated programs, where there is social security coverage. In addition, the chart compares the share of normal cost as a percentage of the total normal cost paid by the employee and employer. The Commission policy as stated in the 1973 Report to the Legislature is that the contribution to normal cost should be met by matching contributions by the employer and employee.

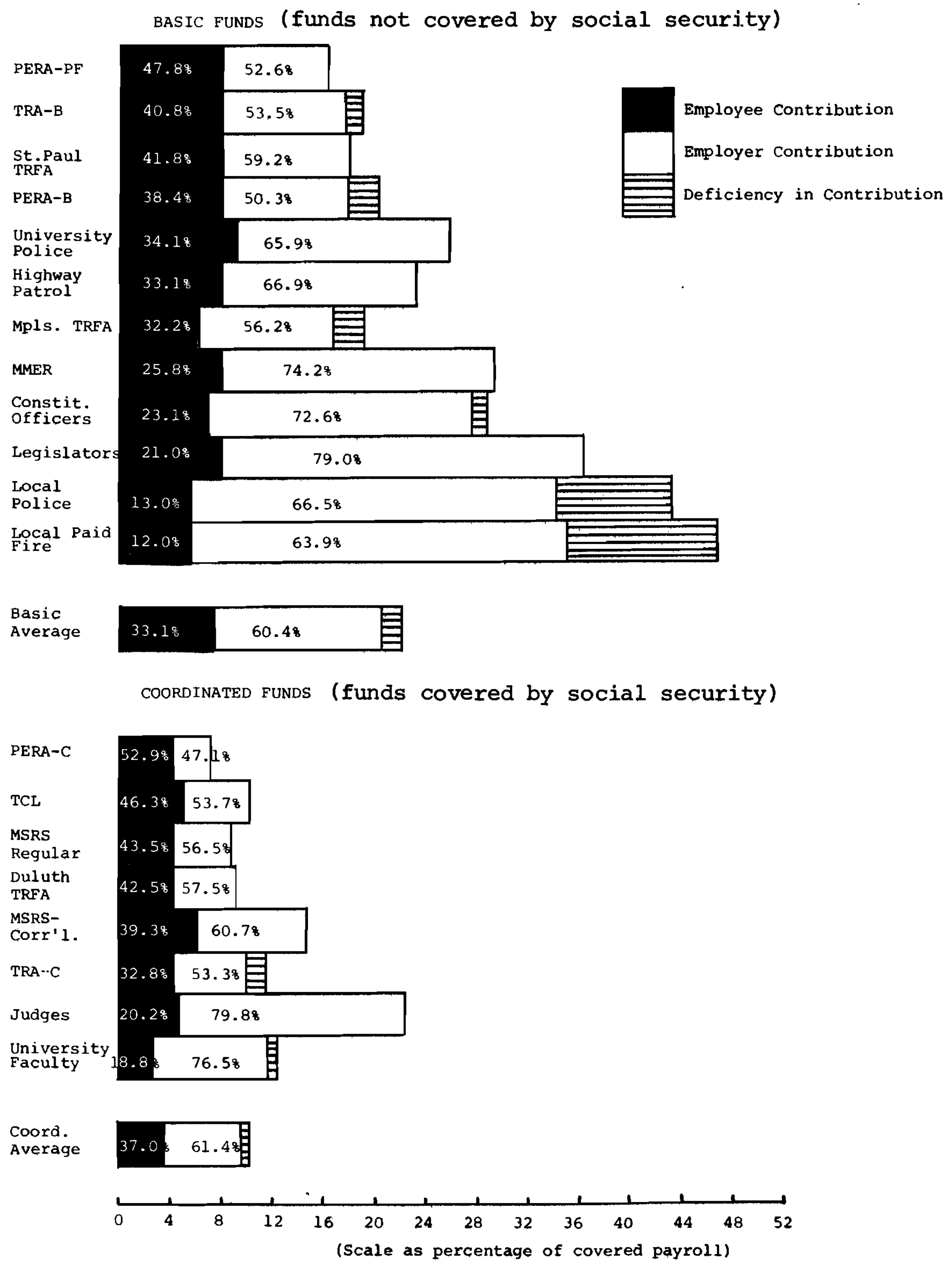


*SOURCE: Overview of Minnesota Public Pension Plans, Supplementary Report to the Minnesota Legislature, 1977 Session - Legislative Commission on Pensions and Retirement.

APPENDIX E - PART II

CONTRIBUTION BY FUND TO MEET NORMAL COST PLUS INTEREST IN THE DEFICIT: EMPLOYER AND EMPLOYEE SHARE*

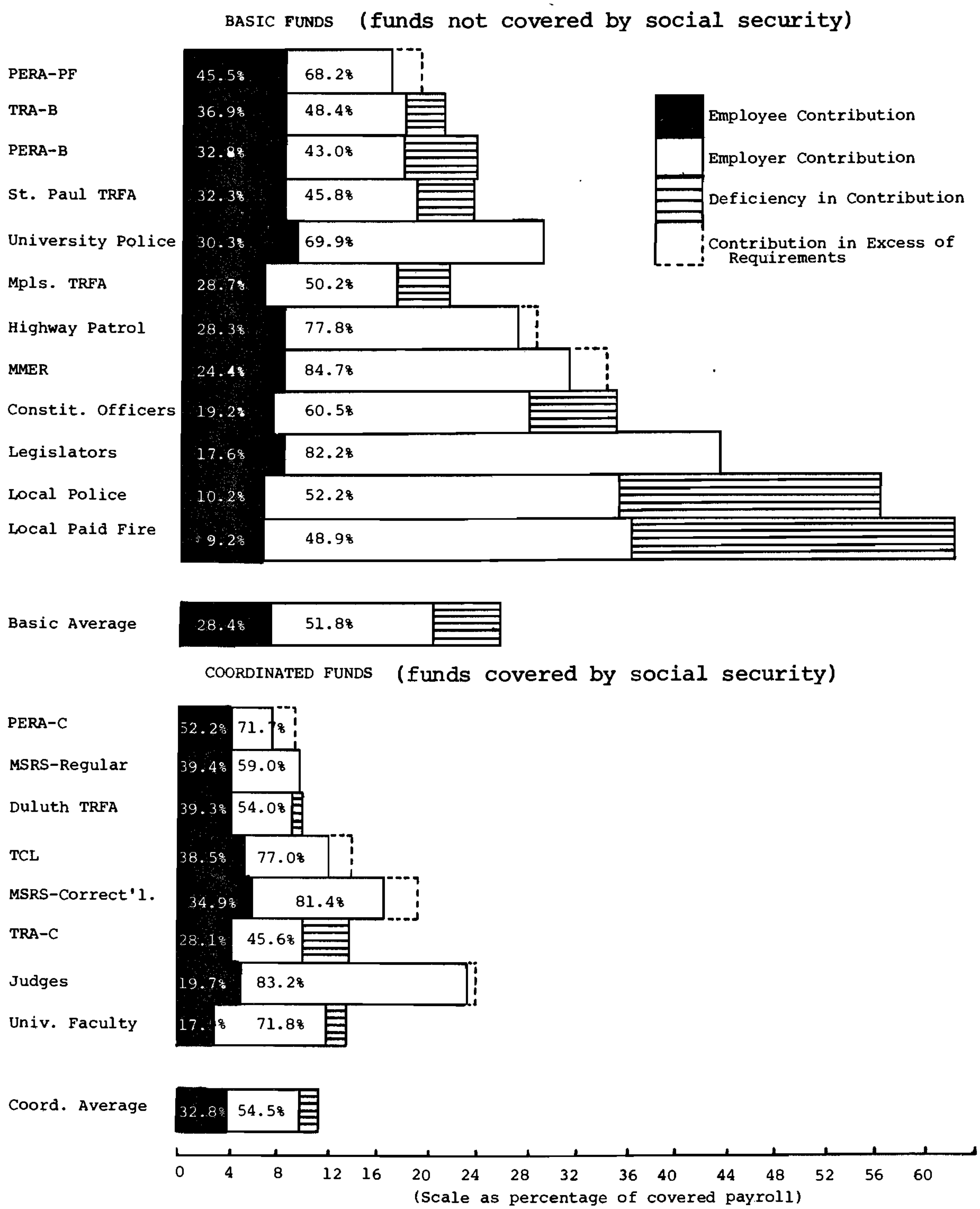
The chart compares the normal cost plus interest on the deficit funding requirement for the various funds and plans, distinguishing between Basic programs, where there is not social security coverage, and Coordinated programs, where there is social security coverage. The chart also compares the share of the funding requirement as a percentage of the total funding requirement paid by the employee and the employer. The funding requirement is the minimum contribution level necessary for a plan with a deficit in meeting the plan's prior service liability which is being financed on a prefunded basis.



APPENDIX E - Part III

CONTRIBUTION BY FUND TO MEET NORMAL COST PLUS AMORTIZATION: EMPLOYEE AND EMPLOYER SHARE*

The chart compares the normal cost plus amortization funding requirement for the various funds and plans, distinguishing between Basic programs, where there is not social security coverage, and Coordinated programs, where there is social security coverage. The chart also presents a comparison of the share of the funding requirement as a percentage of the total funding requirement paid by the employee and the employer. The funding requirement is the full contribution necessary to insure that the retirement fund or plan is financed on a prefunded basis.[1]



[1] Contribution to meet normal cost and amortization is based on amortization by 1997. The employer appropriation to the Legislators Plan is the amount required in 1975 to fully fund the MAFB reserves for retiring legislators and does not represent an annual contribution. The employer appropriation for the Judges Plan is handled in the same manner. The employer appropriation for the Consti-

APPENDIX F

COMPARISON OF MEMBERSHIP OF BOARDS OF DIRECTORS OF PUBLIC PENSION PLANS

FUND	MEMBERS	TERM	SELECTION PROCESS
Teachers Retirement Association (TRA)	8 members. -4 active teachers. -1 retired teacher. -Comm. of Ed. -Comm. of Fin. -Comm. of Ins.	.4 years for active members. .2 years for retired teachers.	.teachers are elected by active membership. .retired member elected by retirees. .Commissioners serve by office.
Public Employees Retirement Association (PERA)	15 members. -10 active employees. -1 representative from the: -League of MN Cities. -School Boards Association. -Ass'n of MN Counties. -State AFL-CIO. -1 retired employee.	.elected members serve 4 years. Terms are staggered. .appointed members serve at the pleasure of the appointing body.	.9 elected by district by the members from the district. The three districts are: -Northern Minnesota. -Southern Minnesota. -Hennepin, Ramsey, Anoka, and Washington Counties. .1 elected by the members of the police and fire fund. .1 elected by retirees.
Minnesota State Retirement System (MSRS)	9 members. -4 representatives of the general membership. -1 representative of highway patrolmen. -1 retiree. -3 representatives of the public.	4 years.	.employee representatives are elected by active membership. .retiree elected by retirees. .public members appointed by governor. One must be a department head.
	1/79 another member will be added representing the MTC.	4 years.	.appointed by the operating division of the MTC.

APPENDIX F (continued)

FUND			
Minneapolis Municipal Employees Retirement Fund (MMER)	7 members. -4 employees or retired members (all members must have lived in Mpls. at least 5 years to be eligible). -Comptroller-treasurer. -1 alderman. -Mayor or his appointee.	2 years.	.employee members elected by fund members. .comptroller-treasurer by office. .alderman appointed by city council.
Minneapolis Teachers Retirement Association (MTRA)	7 members. -1 representative of the board. -6 employee representatives.	.3 years for elected member. .board representative serves at pleasure of the president of school board.	.employee representative elected by all members of the fund. .board representative chosen by the president of the school board.
Minneapolis Fire Department Retirement Association	-6 members of the department. -chief. -city attorney.	3 year staggered terms.	.6 elected by active members of the department. .2 are members by office.
Minneapolis Police Relief Association	8 directors. -5 employee representatives. -mayor. -chief of police. -comptroller-treasurer.	5 year staggered terms for employee representatives.	.5 employee representatives are elected by active membership. .3 are members by office.
St. Paul Teachers Retirement Association	10 members. -9 members of the plan. -president of school board.	3 years	.9 chosen by election by active and retired members. .1 ex officio.

APPENDIX F (continued)

St. Paul Fire Department Relief Association	-7 members of the board of examiners. 6 are active firemen. 1 is a physician. -22 members of the board of directors: -16 active firemen. -5 retirees.	.Officers of the board of examiners serve 1 year. .Members of board of examiners serve 3 years. .Directors serve a 1 year term.	All members are elected by the general membership.
St. Paul Police Department Relief Association	5 active members -mayor -chief of police -city's chief financial officer.	5 year staggered terms	.5 elected by active membership. .3 are members by office.

APPENDIX G

VARIETIES OF ACTUARIAL FUNDING POLICIES*

1. Tilove makes the following general observations with respect to funding and funding policies:

   -Funding policies vary greatly.

   -Basic to each policy is a "goal and a schedule by which to reach it...."

   -The schedule is built around 'anticipated experience' with respect to certain factors (e.g., benefits, life expectancy, years of service, etc.)

   -"There is a wide variety of choice of funding goals and a further choice of the period of years and the contribution schedule by which to achieve the desired goal."

   -No single goal and schedule is "correct"...."The choice is a matter of policy."

2. Alternative method of actuarial funding:

   -Terminal funding: Each year a contribution is made based on the total value of benefits accumulated by employees retiring that year. The value is discounted by the expected yield on investment.

   Contributions vary from year to year, depending on the number of employees retiring. And, as a result, public plans have been reluctant to use this method.

   -Unit Credit Funding: Under this method, the annual contribution has two components: a current service contribution and a past service contribution. The current service contribution is determined by calculating "the amount of benefits attributable to the current year of service by covered employees"....and then reducing it by the expected yield on investments between the current year and the date of retirement....this is also known as the "normal cost."

   The past service contribution is made to fund benefits for service before the plan began. Past service contributions are typically spread out over twenty to forty years. Once the past service is paid off (or amortized), contributions drop significantly.

   As was true with terminal funding, contributions for the unit credit method fluctuate....the current service contributions tend to increase as the

*SOURCE: Public Employee Pension Funds, Robert Tilove, Columbia University Press, 1976.

APPENDIX G (continued)

covered employees get older and the past service contribution will drop abruptly when it is paid in full.

-Entry Age Normal: This method is widely used. The contribution under this method is based on the same two components as the unit credit method, that is, a current service contribution and a past service contribution.

However, the current service contribution is calculated so that it is "level from entry to retirement." Thus, in the early years of employment, contributions exceed the actual amount of accrued benefits and, in the later years, they are less than accrued benefits.

When a plan using the "entry age normal" method reaches full funding (i.e., all past service is paid off), its assets will be greater than the value of accrued benefits. This is because of the way current service contributions are made. By contrast, under the unit credit method, assets at full funding will be equal to the value of accrued benefits.

-Entry-Age-Normal, "Interest-Only" Funding: The contribution under this method also has two components: First, the current service contribution calculated so that it is level from entry to retirement; and, second, interest at some assumed rate on any unfunded accrued liability.

This is the only method which results in a total contribution which is level. Tilove points out that this funding method is "advocated by some as particularly relevant for public employee retirement systems where permanence can be taken for granted...."

Two major problems with this method are: First, in a plan where a large number of employees are approaching retirement at the same time, additional contributions are likely to be needed; and, second, the method tends to hide the price of benefit changes. For example, if an increase is granted to retirees, it will not change the current service contribution, but it will increase the unfunded accrued liability and reduce reserves. This increase will only show up in higher interest payments and therefore it may look cheaper than it actually is.

-Entry-Age Normal, Freeze the Deficit: The same as above except additional payments are made to freeze the deficit. By doing so, the cost of benefit improvements is easier to see.

-Perpetual Period of Amortization: Under this method, a time schedule is set up for paying off the past service liability, for example, twenty years. However, this is a rolling date....it is always twenty years out. Full funding is pursued but never reached.

-Individual Level Premium Funding: This method makes no distinction between past and current service. Rather, for each employee, a pension is projected and then the annual contribution is calculated at the level amount "necessary to fund each person's pension over the period from his attained age to his retirement age."

This method results in high initial costs, especially if there is a large number of employees about to retire. Also, contributions must be recalculated with each benefit change.

APPENDIX G (continued)

-<u>Aggregate Funding</u>: This method takes the accrued liability of a plan (for both past and current service) and pays it off over approximately the average future service period of the current employees. This, while not used in Minnesota, is widely used for public funds because it works on the principle that an employee be fully funded at retirement.

Contributions at the start are high because they include payments for benefits accrued through past service. But, if no changes in benefits are made, they will decline and eventually become constant.

-<u>Attained-Age-Normal Funding</u>: This is a hybrid of the aggregate funding method. Separate calculations are made for current service and past service. The schedule for paying current service might be shorter than that for paying off any past service liability. The effect of this is to lower the contributions, at least initially.

-<u>Fixed-Period Projection Method</u>: This method is based on year-to-year projections of benefit payments, employee and employer contributions, expenses, investment yield, and fund balances. With this information, the actuary can compute a contribution rate that at the end of a specified number of years will produce "any desired relationship among assets, liabilities, contributions, and benefits."

The disadvantages of this method are: It requires some extremely complex computations. The number of years used to compute the contribution rate is arbitrary and subject to change.

-<u>The Unfunded Present Value Funding Method</u>: According to this method, the annual contribution is a predetermined percent of the "total unfunded present value of <u>all</u> future benefits." No distinction is made between payments for current and past service. And, the percent is fixed depending on the "ultimate (funding) objective."

This method or some variation is attractive because it does set contributions at a fixed percent of accrued benefits. And, as benefits are changed, the dollar amount of contributions automatically adjusts.

This method is not widely used by the private sector because of some uncertainty regarding its acceptability to the Internal Revenue Service. The uncertainty arises because there is no firm schedule for paying off benefits accrued for past service. Tilove points out that the public sector use has been "held back by inertia." The method is new and "has not been sanctified by tradition and general practice."

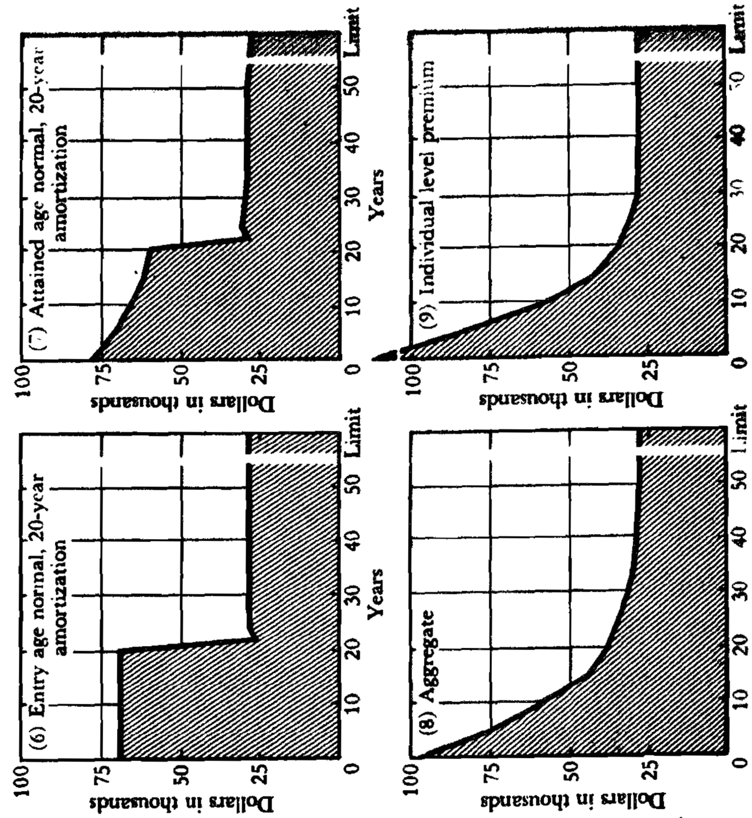
Table 8.1 ◆ *Illustrative Projections Of Traditional Funding Schedules*

Years	(1) Pay-as-you-go	(2) Terminal funding	(3) Unit credit, interest only	(4) Entry age normal, interest only	(5) Unit credit, 20-year amortization	(6) Entry age normal, 20-year amortization	(7) Attained age normal, 20-year amortization	(8) Aggregate	(9) Individual level premium
Beginning of year:	*Contributions (000's)*				*Contributions (000's)*				
1	None	None	$ 36.9	$ 43.2	$ 53.4	$ 68.5	$ 77.9	$ 95.6	$ 126.5
2	$ 0.8	$ 10.2	37.9	43.2	54.4	68.5	75.9	89.9	112.4
3	2.1	15.2	38.8	43.2	55.3	68.5	74.1	84.7	101.5
4	3.5	18.5	39.6	43.2	56.1	68.5	72.5	80.0	9[illegible].8
5	5.3	23.1	40.2	43.2	56.7	68.5	71.0	75.7	8[illegible].1
10	17.3	39.0	42.3	43.2	58.8	68.5	65.3	59.2	57.2
15	30.0	42.3	43.4	43.2	59.9	68.5	61.5	43.3	4[illegible].0
20	40.6	44.1	44.4	43.2	60.9	68.5	58.9	37.7	34.1
21	42.4	44.4	44.5	43.2	34.0	27.1	31.5	36.9	33.0
25	48.2	45.3	45.2	43.2	34.7	27.1	30.2	34.0	30.0
30	54.4	55.8	45.5	43.2	34.9	27.1	29.1	31.6	27.9
35	63.0	63.4	44.0	43.2	33.5	27.1	28.4	29.9	27.1
40	65.6	50.4	43.6	43.2	33.1	27.1	27.9	28.9	27.1
50	64.2	49.2	49.9	43.2	33.4	27.1	27.4	27.9	27.1
Limit	63.0	50.8	44.1	43.2	27.1	27.1	27.1	27.1	27.1
End of year:	*Funds (000's)*				*Funds (000's)*				
1	None	None	$ 37.8	$ 44.3	$ 54.7	$ 70.2	$ 79.8	$ 93.0	$ 129.7
2	None	$ 9.5	76.8	88.9	111.0	141.3	158.8	191.7	247.2
3	None	23.2	116.3	133.2	168.3	212.9	236.5	281.1	355.3
4	None	39.1	156.1	177.3	226.3	284.8	313.1	366.5	455.6
5	None	58.3	195.8	220.5	284.7	356.6	388.3	447.8	548.7
10	None	178.2	380.6	417.3	570.0	707.3	737.4	794.1	918.6
15	None	289.0	528.1	570.9	831.3	1,035.1	1,039.1	1,090.1	1,160.8
20	None	364.7	638.1	682.4	1,070.1	1,343.7	1,302.0	1,251.7	1,315.9
21	None	375.9	656.3	700.4	1,088.3	1,361.7	1,323.5	1,277.3	1,339.2
25	None	410.1	719.6	760.8	1,151.5	1,422.1	1,395.2	1,362.7	1,413.8
30	None	455.0	781.3	815.6	1,213.2	1,476.9	1,459.7	1,438.8	1,475.9
35	None	528.2	803.5	834.6	1,235.4	1,495.9	1,484.8	1,471.4	1,495.9
40	None	536.1	793.6	826.6	1,225.5	1,487.9	1,480.7	1,472.0	1,487.9
50	None	501.0	770.1	806.3	1,202.0	1,467.6	1,464.6	1,461.0	1,467.6
Limit	None	502.1	775.0	810.6	1,206.9	1,471.9	1,471.9	1,471.9	1,471.9
Ratio of fund at limit to:									
(a) year's benefit payments	0	8.0	12.3	12.9	19.2	23.4	23.4	23.4	23.4
(b) liability for pensioners	0	1.0	1.5	1.6	2.4	2.9	2.9	2.9	2.9
(c) value of accrued benefits	0	0.4	0.6	0.7	1.0	1.2	1.2	1.2	1.2
(d) value of all future benefits	0	0.3	0.4	0.5	0.7	0.9	0.9	0.9	0.9

Basis: A hypothetical plan and employee group. The group consists of 1,000 active employees, distributed from age 30 to 64, assumed to be replenished with new entrants each year, and with no retired persons initially. The benefit is $420 annually payable at age 65; the investment yield is assumed to be 2½%.

Source: Charles L. Trowbridge, "Fundamentals of Pension Funding," *Transactions, Society of Actuaries*, Vol. 4, 1952. (Radios added.)

APPENDIX G (continued)



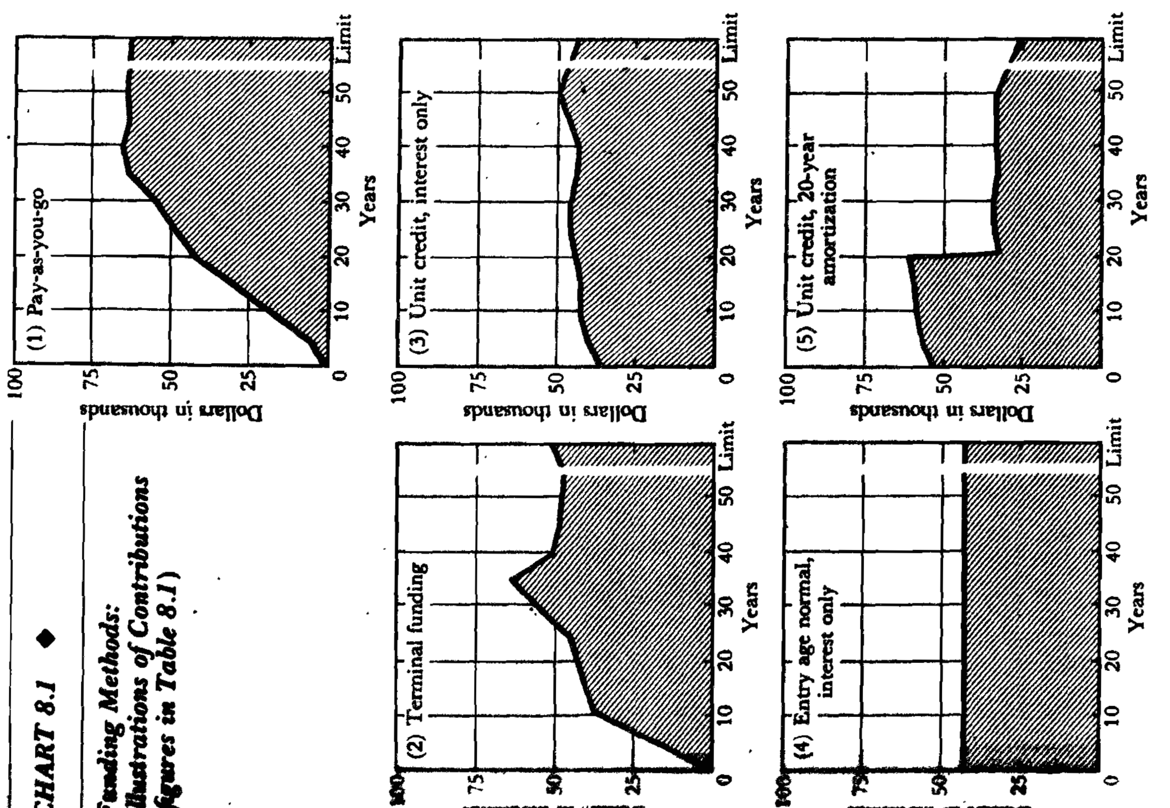


CHART 8.1 ◆

Funding Methods: Illustrations of Contributions (figures in Table 8.1)

Source of Table 8.1 and Chart 8.1:
Public Employee Pension Funds, Robert Tilove,
Columbia University Press, 1976.

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