Donald M. Moe, former State Senator, and
Larry Martin, executive director, Minnesota Legislative Commission on Pensions and Retirement

Civic Caucus, 8301 Creekside Circle, #920, Bloomington, MN 55437

Friday, June 25, 2010

Present: Verne C. Johnson, chair; David Broden, Janis Clay, Marianne Curry, Paul Gilje, Jim Hetland (phone), Jan Hively (phone), Sallie Kemper, Dan Loritz, Wayne Popham (phone), Jim Olson (phone), and Bob White

Summary: Today's summary covers a Civic Caucus meeting with **former State Sen. Donald M. Moe and Larry Martin,** executive director, Minnesota Legislative Commission on Pensions and Retirement. The current system of public pensions in Minnesota offers too much incentive for public employees and retirees to seek—and legislators to grant— increases in retirement benefits, according to Donald Moe. Noting that retirees also receive Social Security benefits, Moe suggests that for non-public safety employees the state should gradually replace public pensions that guarantee specific benefits with a plan where benefits are based exclusively on amounts contributed and investments earned. He also advocates centralizing policy proposals on pensions in the office of the Governor.

A. Context of the meeting —The Civic Caucus is giving high priority to major issues facing the Minnesota Governor and Legislature, along with spotlighting creative proposals for rethinking and redesigning responses to these issues, in a time of severe budgetary constraints.

B. Welcome and introductions —Verne and Paul welcomed and introduced**former State Sen. Donald M. Moe** and **Larry Martin,**executive director, Minnesota Legislative Commission on Pensions and Retirement (LCPR). Moe, a native of Crookston, MN, has a bachelor's degree in business administration from the University of Minnesota. He was a member of the LCPR during his service in the Minnesota Legislature from 1971- 80 in the Minnesota House and from 1981-1990 in the Minnesota Senate. He continues to follow pension issues closely. Martin is a native of St. Paul and a graduate of the University of Minnesota and the William Mitchell School of Law. He has worked in pension policy since 1974. After an initial period from 1974 to 1982 with the LCPR, he moved to

Pennsylvania for four years as director of that state's legislative pension commission. Since 1986 he has been director of the LCPR.

C. Background — Public pensions represent a large and growing segment of state and local government expenses. Pension issues don't always emerge during general discussions of government spending, because they are handled separately from the more publicly-identified budgeting process. But they involve major long term policy questions, nevertheless. Among questions discussed in today's summary are (a) whether a change in the fundamental structure of state local pensions should be considered, (b) whether enough money is being set aside to pay promised pension benefits, and (c) whether the Governor is in a position to exercise needed leadership on public pensions. Before getting into policy questions, some background information:

1. Two kinds of approaches for retirement benefits —Retirement benefits broadly fall into two categories, defined benefit (the traditional fixed pension) and defined contribution (such as provided by IRAs, individual retirement accounts). Overwhelmingly, Minnesota state-local pension plans are defined benefit.

a. Defined benefit— A pension plan under which an employee receives a set monthly amount upon retirement, guaranteed for their life or the joint lives of the member and their spouse. This benefit may also include a cost-of-living increase each year during retirement. The monthly benefit amount is based upon the participant's wages and length of service.

b. Defined contribution— A retirement savings program under which an employer promises certain contributions to a participant's account during employment, but with no guaranteed retirement benefit. The ultimate benefit is based exclusively upon the contributions to, and investment earnings of the plan. The benefit ceases when the account balance is depleted, regardless of the retiree's age or circumstances. Examples of such plans are 457, 401(k), and 403(b) plans.

2. Number of persons covered— According to the Legislative Commission on Pensions and Retirement about 295,000 current state and local public employees are covered by the several defined benefit pension plans in Minnesota. Another 140,000 retirees are receiving benefits. The largest plan, covering local government, is the Public Employees Retirement Association (PERA) general employees plan, with about 142,000 members. Next largest is the Teachers Retirement Association (TRA), with about 77,000 members, followed by the Minnesota State Retirement System general employees plan, with about 49,000 members. There are several other smaller plans covering various categories of state and local employees.

3. **Benefits received**—While benefits are not uniform, a typical pension for an employee with 30 years of service and an average of $60,000 salary for the employee's five highest salary years is about $30,600 annually. Retirees receive approximately a 2.5 percent increase during each year of retirement, according to Minnesota House Research: http://bit.ly/bRQ43v

4. Payroll Contributions— Employers and employees each contribute a percentage of payroll, about 5 percent to 7 percent, depending upon employer.

5. Retirement age —Most employees hired before 1989 can retire and immediately receive full benefits if the employee's age plus years of service equals 90. For most post-1989 hires, the retirement age is indexed to the Social Security retirement age.

6. Amount set aside to pay future benefits —As of June 30, 2009, about $41.3 billion in contributions by state and local governments and their employees was available for paying future benefits, according to the LCPR. In pension circles that amount is called "current assets". The vast majority of this money is invested by the State Board of Investment, composed of the state's constitutional officers.

7. Sufficiency of amount set aside —Experts in projecting future pension obligations, known as actuaries, analyze a host of data, including amounts being contributed, promised benefits, ages of current employees and retirees, their likely life expectancy, and their current and projected compensation. Using this and other data, actuaries estimate what ultimately will be needed to pay benefits. As of June 30, 2009, the amount calculated was about $65.6 billion. In pension circles that amount is called "accrued liability".

To pay all benefits as promised a shortfall between "current assets" and "accrued liability" represents additional dollars that ultimately will need to be raised in state and local taxes and/from employee contributions. The shortfall is called "unfunded accrued liability".

Conceivably a shortfall also could be eliminated by reduction in pension benefits. Whether such reductions might not stand up to court challenges, according to LCPR, because state-local pension benefits, placed in state law, are regarded as enforceable contracts between the unit of government and the employee.

As of June 30, 2009, the unfunded accrued liability for all state-local pension funds in Minnesota totaled $24.3 billion, according to LCPR, which is the difference between an accrued liability of $65.6 billion and current assets of $41.3 billion. Expressed another way, Minnesota's funding ratio (assets as a percentage of liabilities) was 63.0 percent.

8. Alternative approaches to estimating pension shortfalls —LCPR actuaries also calculate unfunded accrued liability using an alternative approach, which reflects ups and downs in the investment markets. Adjusting for those ups and downs, an actuarial value of assets in Minnesota pension plans was placed at $50.2 billion as of June 30, 2009, which would have the effect of shrinking the unfunded accrued liability by about $9 billion. Using actuarial value of assets increases Minnesota's funding ratio to 76.6 percent.

However, others contend that the figure of $65.6 billion for "accrued liability" is understated. For example, state law requires actuaries to estimate an 8.5 percent annual return on pension investments. That number might sound high today, but LCPR cites data that illustrate annual return exceeded 8.5 percent for many years. According to one estimate, reported by the Minnesota Taxpayers Association (MTA), accrued liability would increase by about $1 billion if an 8.0 percent annual return were used. If a rate of 5 percent or 6 percent (a typical government bond rate) were chosen, unfunded liabilities would rise by about 30 percent, according to the MTA.

In its most recent newsletter the MTA said that a national organization that establishes accounting standards, The Government Accounting Standards Board, is considering changes that would have the effect of further increasing accrued liability.

9. Decentralized organization —Minnesota has the second most decentralized pension plan organization in the nation. Some 10 percent of all public pension plans in the nation are located within Minnesota. Each pension plan has its own legislatively-determined structure and its own board of directors. Statewide there are 14 plans. At the local level are two teachers' plans (Duluth and St. Paul) and firefighters' relief associations in cities across the state.

No comprehensive proposal covering all public pension plans is ever presented to the Legislature by the Governor, in contrast, for example, to the Governor's biennial budget proposal and biennial capital improvements budget. Thus, the Legislature makes adjustments in each pension plan, one-by-one.

The LCPR, made up of five members from the House and five from the Senate, was established at least partially to give the Legislature some potential to establish overall policy. The LCPR reviews bills that are introduced affecting the various pension plans. The LCPR has adopted a set of principles to guide its review of proposed legislation.

10. Changes enacted in 2010 —A law was passed in the 2010 Legislature that would required higher contributions by workers and state and local governments and also curtail benefits. There is controversy over whether the new legislation adds to the long-term unfunded liability of the state's pension plans. The law includes an eventual 2 percent increase in school district and teacher contributions to reduce future liabilities in the statewide teachers plan.

The law includes significant help for the Minneapolis Employees Retirement Fund, with almost 5,000 retirees and only about 100 employees still paying into the fund. In addition to $9 million a year in state appropriations the new law adds up to $15 million a year to keep the fund from insolvency.

11. Legality of reduction in benefits being challenged— A lawsuit is challenging the legality of reduction in employee benefits that was part of the 2010 legislation. The challenge is based on certain past court decisions that have regarded pension benefits as legally-binding contracts between employer and employee that can't be later reduced by legislation.

D. Comments and discussion —During Moe's and Martin's comments and in discussion with the Civic Caucus the following points were raised:

1. History of pension plans in Minnesota —Fire department relief associations in St. Paul (1868), Minneapolis (1874), and Fergus Falls (1874) were the earliest public pension plans in the state, according to the LCPR. Teacher retirement plans were introduced in Duluth, Minneapolis, and St. Paul in 1910. Statewide plans were introduced for teachers in 1915, for state employees in 1929, and local government employees in 1931.

2. Demand for increased benefits is insatiable —Pension plans attract very little public or legislative interest. They are immensely complicated. But they are of great significance to employees and retirees, both of whom are always seeking improvements in benefits, Moe said. A very small change in law might not seem very significant on the surface but can have immense long-term expense consequences, he said.

3. Effective lobbying —Some 15 to 20 political campaign funding organizations along with employee organizations are very effective in raising money to support candidates for the Legislature as well as to lobby for changes in pension law, Moe said. Their effectiveness is enhanced because the pension system is so decentralized and complicated, he said.

4. Overstating solvency —It has been possible for pension advocates to take advantage of the complexity of pensions and the difficulty in creating interest and understanding in the Legislature as a whole and in the general public, Moe said. For example, state law requires that, in calculating how much money will be needed to pay future pension claims, actuaries must assume pension investments will yield an average of 8.5 percent return every year, Moe said. While higher returns have been recorded in some years, such a figure has the effect of overstating the solvency of pension plans, he said. Moreover, retirees have successfully lobbied for a bump in benefits in years when the 8.5 percent has been exceeded, he said.

5. Moe's proposal for a change in the structure of public pensions —Moe would gradually phase out Minnesota's existing defined benefit approach. Current employees would continue to be covered under the current system, now and when they retire. New employees would be covered by the defined contribution approach. Thus, the defined benefit approach wouldn't be totally phased out—and the defined contribution approach totally phased in—until the death of the last current employee or survivor. The State Board of Investment would continue to manage investments from defined contributions, just as it currently manages pension investments. Employees would be given a limited number of investment choices.

Retirees would continue to receive Social Security, which is a defined benefit program, Moe noted.

Under defined contribution the state has no long-term liability. The employee's future pension is exclusively dependent upon the amounts contributed by the employee and the employer and the investment earnings on those contributions. All employees would have their own investment accounts. Individuals would decide how much to withdraw in each year of retirement.

The Legislature would never be called on to bail out a defined contribution plan, as is the case with the Minneapolis Employees Retirement Fund, he said.

The defined contribution approach is widely used in the private sector and in a few cases in Minnesota's public sector, such as retirement plans for higher education faculty and as supplemental to some defined benefit plans.

The 2010 Legislature called for the LCPR to conduct a study of defined contribution plans.

6. More portability claimed for defined contribution plans— Moe contended that new employees are likely to welcome the defined contribution approach because an employee's pension fund is easily portable back and forth between private sector and public sector jobs. Moe contended that new employees would favor defined contribution if given a choice.

7. Defined contribution is in effect some other states' public systems— Since 1997 new public employees in Michigan have been covered by defined contribution. A few other states provide a combination of defined contribution and defined benefit. Moe said he opposes a combination because he believes employee groups would successfully apply pressure to ever increase pensions under the defined benefit. He also noted that public employees in Minnesota already are covered by social security, so they are receiving a defined benefit from that program.

8. Arguments against defined contribution —Because public employees would be given a greater role in determining how their pension funds are invested, some risk exists that they could make ill-advised choices. Also employees could opt to spend their defined contribution investments earlier in life, thereby leaving them without retirement funds.

9. Treat public safety employees differently— If defined contribution were more widely used in the public sector, special arrangements would need to be made for public safety employees, Martin said. He pointed out a public safety employee could be killed while on duty and a survivor could be left with nothing were it not for the defined benefit plan.

10. Long-term impact of public pensions on the state's general fund —Pension decisions—such as those enacted by the 2010 Legislature—require additional contributions from state and local governments, as well as by employees, Martin said in response to a question. However, those additional governmental contributions don't show up as appropriations in this session, but will have an automatic claim on the general fund in coming years.

11. Question of the extent to which unfunded liabilities represent a serious problem for the state —Martin said that having been associated with Minnesota pension plans for 30-plus years, he's not panicky about gaps between what ultimately will be required to pay pensions and amounts likely to be available given current employer and employee contributions. Anything as serious as bankruptcy is not in foreseeable future, he said. There's always been significant lead time available to increase contributions in advance of a crisis, he said. In the discussion, it was agreed, however, that an increased amount of tax revenue will be needed in coming years to pay defined benefits.

12. Urgent need for statewide leadership on pension policy —With the absence of the Governor in any structured responsibility for public pensions, overall leadership on behalf of the state's electorate is absent, Moe said. The LCPR was created to help fill this vacuum, but top legislative leaders must assure that the LCPR members they select are independent and objective, he said. The LCPR doesn't advocate comprehensive changes; rather it evaluates proposals made by individual legislators and pension plans.

The conversation moved to whether Minnesota should consider a framework whereby the Governor would be required to propose comprehensive pension legislation, giving the Legislature a chance to review overall policy changes, not just changes advocated by the individual plans. Such a change would not necessarily require placing all pension funds under the Governor, as is the case in Wisconsin, which has centralized its pension plans in one body, the Department of Employee Trust Funds http://bit.ly/9sLwM9 .

In 1988 Moe tried unsuccessfully (S. F. 958) to create a pension bureau within the Minnesota Department of Employee Relations.

13. Opposition to using pension funds to help balance the state's budget —During the meeting it was noted that the state of New York will borrow from invested pension funds to pay pension contributions for current employees. It also was noted that that someone who follows the Minnesota State Legislature very closely has said that proposals might be advanced to use invested pension funds in Minnesota to help balance the 2011 budget. Moe said he strongly opposes any such use of pension funds.

14. Thanks —On behalf of the Civic Caucus, Verne thanked Moe and Martin for meeting with us today.