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OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

EVALUATION REPORT

Postemployment Benefits for Public Employees

JANUARY 2007

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OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MINNESOTA • James Nobles, Legislative Auditor

January 2007

Members of the Legislative Audit Commission:

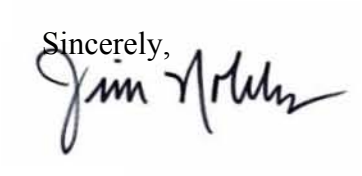
The cost of postemployment benefits for public employees is a growing concern. Much of the attention has focused on whether public pension plans are adequately funded, but there is also concern about promises some government entities have made to pay retirees' health care insurance premiums. In April 2006, the Legislative Audit Commission directed OLA to evaluate postretirement benefits for public employees.

We found that Minnesota's statewide public pension plans face significant challenges. We are particularly concerned that the state has not adequately disclosed or addressed a deficit in the Postretirement Investment Fund, which pools assets from each of the statewide basic pension plans when their members retire. We make a number of recommendations to correct this situation.

We also found that some local jurisdictions have accumulated large liabilities to pay retiree health insurance benefits, and those costs are likely to significantly grow. We recommend giving local jurisdictions clear authority to establish trust funds as a means for funding these obligations.

This report was researched and written by Jody Hauer (project manager), Dan Jacobson, and Terry Risbey.

Sincerely,



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Summary

Some government entities in Minnesota have accumulated large post-employment benefit obligations that are not adequately funded.

Major Findings:

- Twenty-four public employers in Minnesota have accumulated $1.5 billion in liabilities from promises to pay for retiree benefits (excluding pension obligations) over the next 30 years. This estimate could grow significantly as additional jurisdictions have actuarial studies completed (p. 20).
- The principal postemployment benefit public employers pay for—other than pensions—is health care insurance. Currently, significant spending on this and similar postemployment benefits is concentrated in a small number of jurisdictions. In 2005, 11 cities and school districts spent more than 5 percent of their annual operating budgets on these retiree benefits (p. 24).
- Most local governments are not setting aside money to fund liabilities for nonpension post-employment benefits that will come due in the future as employees retire (p. 24).
- Widely reported funding ratios make statewide pension plans appear better funded than they really are because they do not reflect a $4 billion deficit in the Postretirement Fund used to pay benefits to retirees (p. 44).
- Recent legislative changes will help statewide pension funds become fully funded and have improved the Postretirement Fund's formula for increasing benefits; but they will not solve the Postretirement Fund's deficit or eliminate risk of future deficits (pp. 46 and 52).
- Among the major local pension plans, the St. Paul Teachers' Retirement Fund currently is the most at risk of serious future funding problems (p. 57).

Recommendations:

- The Legislature should allow local governments to establish irrevocable trusts to fund postemployment benefits other than pensions (p. 32).
- The Legislature should require statewide pension plans' funding ratios to reflect the actual market-related value of the Postretirement Fund (p. 45).
- The Legislature should fully fund the Postretirement Fund and change the benefit formula to protect against future deficits, treat retirees equitably, and better protect pension benefits against inflation (p. 55).
- The Legislature should disallow certain benefit increases when local teacher pension funds have large deficits. It should consider changing the formulas used to increase postretirement benefits, and it should consider increasing contributions for the St. Paul Teachers' Retirement Fund (p. 60).

Report Summary

In some communities, rising medical costs and extensive retiree health benefits have created large liabilities for "other post-employment benefits."

Postemployment benefits—pensions and other retiree benefits such as health care insurance—are a form of compensation employees receive in exchange for their work. Unlike wages, though, postemployment benefits are paid when workers reach retirement. The compensation is deferred, but it is earned based on services provided today.

Recent changes to accounting standards require public employers to account for "other post-employment benefits"—health care and other insurance benefits for retirees—in the same time period that employees work. Until now, most employers have accounted for these benefits when they were paid out (at retirement), not when they were earned. The changes align accounting procedures with those in place for pensions.

The health care postemployment benefit is of particular concern because of rising medical costs. Many public employers promised the benefits years ago when health insurance cost far less than today. In addition to medical inflation, demographic trends suggest that large shares of employees are nearing retirement ages. Retirees are also living longer than in the past, meaning employers could be paying for the benefits for longer periods.

About 1 in 5 Minnesota public employers (excluding small townships) reported paying for other postemployment benefits, and a few offer extensive benefits.

A study by the State Auditor estimated that 21 percent of 1,730 local governments and school districts pay for other postemployment benefits. Most school districts and counties, in contrast with cities and special districts, pay for these benefits. We found that health care coverage is the most common retiree benefit, although some also offer dental or life insurance. Few state employees qualify. In fiscal year 2006, about 5 percent of state pensioners received employer-paid health care.

Most local jurisdictions that pay for retiree health care provide a limited set of benefits. Seventeen jurisdictions pay for retiree health care for all employee groups, cover spouses or dependents, provide benefits for the retiree's lifetime, and pay all or nearly all of the premium. Most of them, however, have cut-off dates by which new hires no longer qualify, or in some other way have limited the scope of the benefit package.

Known liabilities total $1.5 billion, but they could reach $3.3 billion.

Accounting standards will begin requiring most public employers to conduct actuarial studies at least every two years to estimate their liabilities for other postemployment benefits. Among 24 Minnesota jurisdictions that have already conducted studies, the liability totals $1.5 billion over the next 30 years. Duluth accounts for $280 million of that liability, and the Metropolitan Council, $275 million.

Because most jurisdictions have not completed actuarial studies, the total liability statewide is unknown. In lieu of actuarial estimates, we made a rough estimate based on the amount of spending in fiscal year 2005 for postemployment health care benefits. Although this method does not provide precise estimates of individual jurisdictions' liabilities, it indicates that statewide liabilities could reach $3.3 billion when all jurisdictions have actuarial studies completed.

All governments offering health insurance have at least some liability for other postemployment benefits.

State statutes require public employers to allow employees to continue indefinitely in their employer-sponsored medical and dental insurance

groups. Coverage is at employees' expense unless otherwise provided for in bargaining agreements or personnel policies. In addition, for the purpose of setting health care premiums, statutes require employers to pool retirees to age 65 together with active employees. Because retirees typically consume more health care than younger employees, they cost more, yet their premiums are the same as for active employees. Accounting standards say that this so-called "implicit rate subsidy" must be accounted for as a liability for other postemployment benefits.

High spending on retiree benefits in fiscal year 2005 was concentrated in a few localities.

Lacking actuarial data for most jurisdictions' liabilities, we analyzed spending on retiree benefits. We identified 11 jurisdictions that spent more than 5 percent of their operating expenditures in fiscal year 2005 on other postemployment benefits. All were located in northeastern Minnesota. Most jurisdictions that pay for other postemployment benefits spent less than 1 percent that year.

The Legislature should allow local governments to establish trust funds to pay for retiree benefits, and it should set standards for those trust funds.

In addition, employers who have not capped their contributions to premiums can expect higher costs. This is particularly true if the price of health care continues growing above inflation, as has been the trend.

Controls on spending for other postemployment benefits are limited.

Among jurisdictions that pay for other postemployment benefits, 54 percent have reduced or eliminated retiree health care for at least some employee groups. Most of them have discontinued offering the benefit to newly hired employees, however some did this only recently and may not see effects of the change for another 25 or more years. About 41 percent of the jurisdictions capped or otherwise limited the employer's share of retiree health care premiums.

With nearly any change, however, jurisdictions face limitations. In a recent court case, judges ruled that a public employer could not unilaterally reduce the "aggregate value" of health benefits in its collective bargaining agreement without first negotiating the change with the employees' representatives. Another ruling stated that a public employer's duty to pay promised health benefits for retirees did not expire when the collective bargaining agreement expired.

Minnesota's local jurisdictions lack clear authority to establish irrevocable trusts for funding other postemployment benefits.

Accounting standards will require public employers to report and account for other postemployment benefits in the same period that employees earn the benefits. They do not, however, require funding the liabilities in that same period.

Some jurisdictions, realizing that they face large future liabilities for the benefits, have begun reserving money to pay for them. Amounts set aside to date are small relative to liabilities.

Governments that opt to fund their liabilities in advance are required by accounting standards to reserve money in irrevocable trusts. In Minnesota, however, authority to set up such trusts is unclear. The Legislature should allow local governments to establish irrevocable trusts for this purpose and prescribe fiduciary standards for the trust funds.

Minnesota's statewide public pension plans are not as fully funded as reported funding ratios make them appear.

Minnesota has basic statewide pension funds—for the Public Employees Retirement Association (PERA), the Teachers Retirement Association (TRA), and the Minnesota State Retirement System (MSRS)—into which most state and local employees and their employers make contributions

The Legislature should require that funding ratios for the statewide pension plans reflect the deficit in the Postretirement Fund.

throughout employees' careers. Upon retirement, assets to cover retirees' benefits are transferred to the Postretirement Investment Fund, which is used to pay pension annuities for the duration of retirement.

One way to measure the financial health of a pension plan is to examine the ratio of its assets to its liabilities. As of July 1, 2006, the "funding ratios" ranged from a low of 75 percent for PERA's Public Employee Retirement Plan to a high of 96 percent for the MSRS General Plan. The total unfunded liability (deficit) for the statewide plans was $6.7 billion. However, the funding ratios for the plans appear better than they really are because they do not reflect the Postretirement Fund's deficit of $4 billion.

Recent changes in state law will increase pension plan contributions by most employees and employers in amounts sufficient to nearly achieve full funding by target dates ranging from 2020 to 2037. There is no mechanism, however, to ensure that the Postretirement Fund will achieve or maintain full funding.

The Legislature should require that funding ratios for the statewide plans reflect the Postretirement Fund's deficit, as accounting standards require.

The Legislature should develop a plan to fully fund the Postretirement Fund and change the benefit formula to help avoid future deficits.

Benefit increases in the recent past contributed to a significant deficit in the state's Postretirement Fund.

By giving large, permanent benefit increases when the stock market temporarily did very well, the benefit formula for the Postretirement Fund placed the fund at risk for deficits. Benefits increased when investment earnings were high, but they did not decrease when earnings were negative. The deficit risk existed because the fund did not retain sufficient earnings during good years to offset bad years.

In addition, the fund's benefit increases were not aligned with inflation. During 1997 to 2001, benefit increases consistently exceeded inflation by 3 to 9 percentage points. But for the last three years, benefit increases lagged behind inflation. This, combined with a requirement that the fund may not award investment-based increases when it has a deficit, created inequities between cohorts of employees.

The 2006 Legislature capped the amount of future benefit increases at 5 percent starting in 2010. The cap reduces, but does not eliminate, risks of future deficits from investment-based benefit increases, and it does not resolve today's deficit.

The Legislature should develop a plan to eventually achieve full funding of the Postretirement Fund. This could include increased contributions from employers or employees, additional state appropriations, or reductions in the size of retirees' benefit increases, all of which pose tradeoffs. Concurrently, the Legislature should change the formula to increase benefits by eliminating the investment-based component and enhancing the inflation component.

The St. Paul Teachers' Retirement Fund is at risk of serious future funding problems.

Seven local pension funds have funding ratios below 93 percent as of the last fiscal year. The St. Paul Teachers' Retirement Fund had the lowest funding ratio (69.1 percent) and the largest deficit ($420 million). Its formula for increasing benefits and insufficient contributions from employees and employers each led to the deficit. The Duluth Teachers' Retirement Fund has a deficit but is in better shape than St. Paul's fund. The Legislature should change the benefit formula to disallow certain benefit increases when large deficits exist in the local teacher pension plans. It should consider basing the postretirement benefit formulas on inflation. Further, it should consider increasing contributions to improve the financial health of St. Paul's fund.

Introduction

Benefits—pensions and other postemployment benefits such as health insurance—for retired public employees have recently come under scrutiny. Concern heightened over mounting liabilities for promises to pay retiree health insurance with disclosures that a number of cities across the nation, including Duluth, Minnesota, faced liabilities far larger than their total annual spending. In addition, certain public employee retirement systems around the country have experienced financial difficulties due in part to a downturn in the stock market in the first years of this decade. In Minnesota, concern over the deteriorating financial condition of the Minneapolis Teachers' Retirement Fund led to legislation in the 2006 legislative session that consolidated the fund into the statewide Teachers Retirement Association.

In April 2006, the Legislative Audit Commission directed the Office of the Legislative Auditor to evaluate public employees' postretirement benefits. Our evaluation addresses the following questions:

- **Excluding pensions, to what extent do Minnesota governments offer "other postemployment benefits," and how large are the liabilities?**

- **What is needed to control liabilities for other postemployment benefits?**

- **What are the financial conditions of Minnesota's statewide pension funds and the major local pension funds?**

- **How well has Minnesota's formula worked for increasing pension benefits after retirement?**

- **How does Minnesota compare with other states on retiree health care and pensions? How do its pension plans compare with those in the private sector?**

To answer the questions, we researched statutes, court cases, and literature on postemployment benefits. We interviewed directors of major pension funds, heads of several labor organizations, and personnel representing the state, University of Minnesota, and Minnesota State Colleges and Universities. For information about local government retiree benefits, we relied on in-depth interviews with a sample of finance officers and benefit managers from 129 jurisdictions around the state. Where actuarial studies were available on local jurisdictions' retiree benefits, we examined their results. We also analyzed data from Minnesota pension plans and made comparisons with other states and the private sector.

Because of legislators' concerns, we examined how much the benefits are expected to cost and how well they are being funded. We did not examine whether the benefits were adequate to fund retirees' needs for health care or retirement income. Nor did we analyze the investment strategies for the state's pension funds. Because of legislative interest in differences between public and private sector pension plans, we make some comparisons between Minnesota's public pension plans and those in the private sector. This report does not, however, explore the pros and cons of defined benefit versus defined contribution pension plans. Nor does it address the effectiveness of the 2006 consolidation of the Minneapolis Teachers' Retirement Fund Association into the Teachers Retirement Association.

The first chapter provides background information on pensions and postemployment benefits other than pensions. Chapter 2 focuses on postemployment benefits other than pensions, particularly retiree health care. In Chapter 3, we analyze certain issues relevant to Minnesota's major pension plans. The appendix compares Minnesota with other states on both retiree health care and pension plans, and it contrasts certain features of Minnesota's major pension plans with those in the private sector.

1 Background

SUMMARY

Postemployment benefits include pensions and other benefits, such as health care insurance, paid by employers for use by their retired employees. Accounting standards require public employers to account for pension benefits in the same time period that employees earn them, and new accounting standards with similar requirements for benefits other than pensions will start to take effect in 2007. Trends in the aging of the workforce, increased life expectancies, retirement ages, and rising health care costs all suggest that the price tag for postemployment benefits will increase.

Postemployment benefits are one form of compensation that employees receive in exchange for their work. While wages are typically earned and paid out on a biweekly or other pay-period basis, postemployment benefits are earned by current workers but deferred until a future time, which is either defined in law or in employees' terms of employment. This chapter provides an overview of postemployment benefits and what makes them a timely issue. Specifically, this chapter answers the following research questions:

- **What are postemployment benefits?**
- **How are governments required to account for and disclose information about their postemployment benefits?**
- **What national trends are focusing attention on postemployment benefits?**

To answer these questions, we reviewed literature on benefits for retirees. We researched the accounting standards that apply to postemployment benefits and how they are distinct from accounting standards for other types of benefits. We also analyzed data on demographics and health care costs for both Minnesota and the nation.

Postemployment benefits include pensions and other retiree benefits, such as health care insurance.

POSTEMPLOYMENT BENEFITS

Postemployment benefits may be grouped into either (1) pension benefits or (2) all other types of benefits awarded to retirees. The latter group includes retiree health care insurance, dental insurance, life insurance, vision benefits, prescription drug benefits, disability insurance, and long-term care insurance.

Pension Benefits

In recent decades, many Americans reaching retirement age have come to depend on three sources of retirement revenue: Social Security, personal savings, and pension income. Of the three, we focus on pension income in this report.

Pension benefit plans are usually one of two types. One is a defined benefit plan in which eligible retired workers receive a specified income for life. The initial benefit amount is usually based, not on how much was contributed during the working years, but on the number of years the employee worked and the highest salary he or she earned. Age can also be a factor in the amount of the benefit when employees choose to retire earlier than the normal retirement age.

The second type of pension benefit plan is a defined contribution plan. In this type, the amount contributed to the pension plan is a specific amount for an individual employee, but the benefit amount to be garnered at retirement is not specified. The employee often decides how the money will be invested, usually from among a set of investments selected by the employer or plan administrator. The total benefit available when an employee retires depends on both how much was contributed and investment returns over time.[1]

Most public pension plans nationally and in Minnesota are defined benefit plans, which pay retired workers a specified income for life.

Distinctions between defined benefit and defined contribution pension plans are important. In defined benefit plans, the employer takes on the investment risk. Contributions made throughout the employee's tenure are invested to pay the promised benefit. If assets are insufficient to pay the specific promised benefits, the employer assumes the market risk and generally makes up the difference.[2] On the other hand, in defined contribution plans, the individual employee bears the investment risk. That is, the retiree's pension income is directly affected by the investment performance of his or her pension account.

Most public employment retirement plans around the country, including most in Minnesota, are of the defined benefit type.[3] Over the last few decades, private companies offering pension benefits have increasingly converted from defined benefit to defined contribution plans.[4] The appendix provides more detail on distinctions between private and public sector pension plans.

Benefits Other Than Pensions

Besides pensions, some employers provide other benefits to retiring employees who meet eligibility requirements. These "other postemployment benefits" are most often health care insurance but may include dental or life insurance or other benefits provided to active employees.[5]

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[1] A third type of pension benefit plan has evolved as a hybrid of the first two. In many hybrid plans employers make certain contributions, usually as a percentage of an employee's current earnings; each account is credited at a specified rate of interest. However, employers own the assets and manage investments until employees retire, at which time the retiree may draw upon the account.

[2] Bankruptcy can lead to lost benefits, but it is a rarity in the public sector.

[3] Sugit M. CanagaRetna, *America's Public Retirement Plans [Stresses in the System]* (Atlanta: The Council of State Governments, October 2004), 6.

[4] Government Accountability Office, *Highlights of a GAO Forum: The Future of the Defined Benefit System and the Pension Benefit Guaranty Corporation GAO-05-578SP* (Washington, D.C.: Government Accountability Office, June 2005), 7.

[5] By law, Minnesota public employers must continue paying their portion of health insurance for peace officers or firefighters disabled in the line of duty; coverage must continue until the disabled officer or firefighter reaches age 65. See *Minnesota Statutes* 2006, 299A.465.

Extending health care insurance to retirees has recently become an issue because health care costs and insurance premiums have increased, sometimes dramatically, between the time that employees begin their careers and the time of their retirement. These costs are largely beyond employers' control.

ACCOUNTING FOR POSTEMPLOYMENT BENEFITS

Financial reporting requirements for the state and local governments are promulgated by the Governmental Accounting Standards Board (GASB), a nonprofit organization.[6] In short, GASB is the official source of generally accepted accounting principles used by state and local governments to prepare their end-of-year financial statements.

Although GASB standards, which are issued in the form of official statements of the board, do not carry the weight of law, auditors judge the financial statements they audit against GASB standards. State and local governments tend to adhere to the standards because the need for complete and comparable financial reporting is widely recognized and accepted. Beyond that, credit rating organizations (such as Moody's Investment Services) and the credit industry they serve expect financial statements to conform to GASB standards.

Pension Accounting

Accounting standards require public employers to disclose costs for pension benefits at the time employees earn them.

From an accounting standpoint, pension benefits are a form of deferred compensation. GASB standards require that public employers disclose the costs for pension benefits at the time employees earn them. In 1994, GASB issued accounting standards specific to public sector pensions (GASB Statement Numbers 25 and 27), replacing earlier accounting principles that had applied to both private and public sector pensions.[7] The 1994 standards require governments to show how well they are keeping up with funding the pension benefits they have promised.

Financial reporting standards recognize the long-term nature of defined benefit pension plans. They require current financial information but also historical trend information to show the progress being made in accumulating sufficient assets to pay pension benefits as they come due. Furthermore, the standards require, among other things, an actuarial study at least every other year to estimate the value of a pension plan's projected benefits in today's dollars.

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[6] Governmental Accounting Standards Board, "GASB at a Glance"; www.gasb.org/news/gasb_at_a_glance.pdf; accessed November 28, 2006.

[7] Governmental Accounting Standards Board, *Statement No. 25 Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans* and *Statement No. 27 of the Governmental Accounting Standards Board Accounting for Pensions by State and Local Governmental Employers* (Norwalk, CT: Governmental Accounting Standards Board, November 1994). Statement No. 25 applies to financial reporting required of pension plans, while Statement No. 27 applies to public employers' pension expenditures and related liabilities and assets.

In August 2006, GASB started two new projects related to standards for pension benefit accounting and reporting.[8] One was intended to make the disclosure requirements for pension plans consistent with those approved in 2004 for other postemployment benefits; a draft proposal on this matter is under consideration through early 2007. The second and longer-term project was to determine the effectiveness of existing accounting standards for pensions and whether additional changes are needed.

New accounting standards for "other post-employment benefits" begin in 2007 for the largest governments.

Accounting for Other Postemployment Benefits

In 2004, GASB adopted Statement Number 45, which set new accounting standards for postemployment benefits other than pensions, such as retiree health care.[9] Starting in 2007 for the largest governments, the new rules require public employers to disclose the total accumulated amount of the promised benefits to date, instead of just the current year's cost.

Also like GASB standards for public pensions, accounting standards for other postemployment benefits require most public employers to conduct actuarial studies at least every two years. (Triennial studies are required for very small public employers, which are those with 200 or fewer employees and retirees.)

In these actuarial valuations, an actuary estimates (1) what the jurisdiction's future liabilities will be for other postemployment benefits that cover current members and (2) what the jurisdiction will have to pay in a given year to meet those obligations.[10] Making assumptions about future events and relying on accepted actuarial practices, the actuary is to project future costs of benefits already earned and discount the projected benefits to their present value in today's dollars. Using an actuarial estimate of liability, the actuary estimates how much is unfunded and how much the public employer has to pay annually. The annual payment includes amounts for future benefits attributable to the current year's operations and an amortized portion of the liability that remains unpaid.

The new standards will apply to Minnesota jurisdictions of all sizes for fiscal periods ending after December 15, 2009.

GASB 45 requirements are phasing in over a three-year period. For Minnesota's largest cities and counties (with annual revenues of $100 million or more), GASB 45 will first apply to financial statements for the fiscal year that ends on or after December 31, 2007. For the state, it will first apply to statements for the fiscal year that ends June 30, 2008. For fiscal periods ending after December 15, 2009, the requirements of GASB 45 will apply to Minnesota jurisdictions of all sizes.

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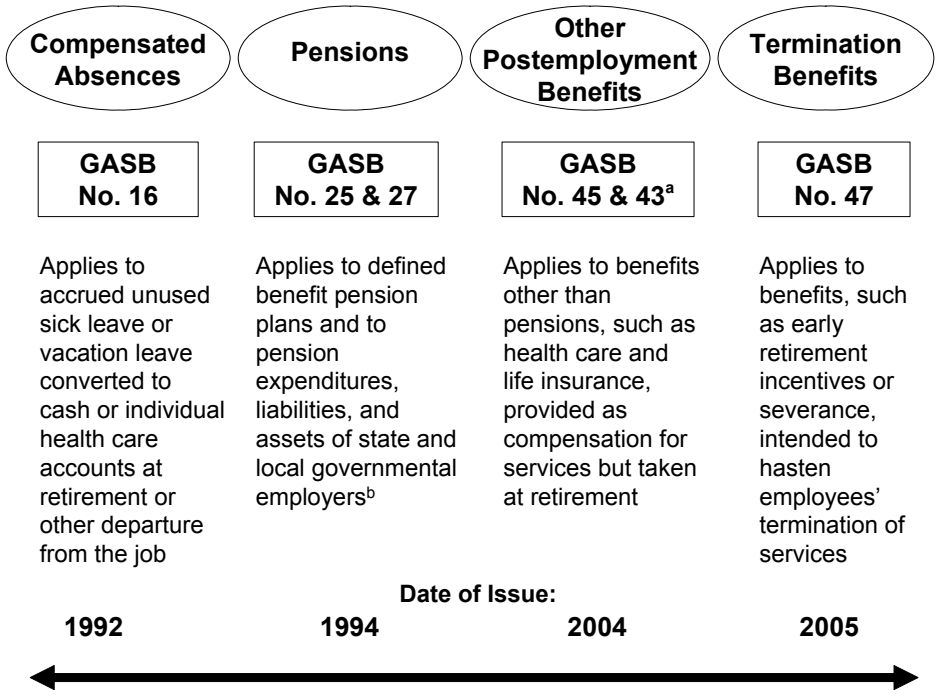
[8] Governmental Accounting Standards Board, "GASB Adds Short-Term Project to Enhance Disclosure Requirements of Governmental Pension Plans" (August 2006); www.gasb.org/news/nr083106.html; accessed September 8, 2006.

[9] Governmental Accounting Standards Board, *Statement No. 45 of the Governmental Accounting Standards Board Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (Chicago: Governmental Accounting Standards Board, June 2005). Standards in GASB Statement No. 45 apply to employers. Standards in GASB No. 43 are similar but apply to the plans that actually administer other postemployment benefits. Accounting standards for these benefits in the private sector have been in place since 1990.

[10] Very small jurisdictions (fewer than 100 members in the benefit plan) may, without involving actuaries, use an alternative method to estimate liability for other postemployment benefits. Governmental Accounting Standards Board, *Statement No. 45*, 11423, paragraphs 33-34.

Some benefits are expressly excluded from GASB 45. For example, workers' compensation benefits are not considered other postemployment benefits for accounting purposes. Also excluded is the conversion of accumulated but unused sick leave or paid time off into an individual account to pay for a retiree's benefits. Such benefits are known as "compensated absences," and they include severance packages in which employers convert unused sick or vacation leave to cash or an individual health care account. In addition, early retirement benefits or other incentives to hasten the termination of services (known as "termination benefits") are excluded from GASB 45.[11] Figure 1.1 distinguishes among the different accounting statements related to various benefits.

Figure 1.1: Governmental Accounting Standards Board Statements Pertaining to Various Benefits



[a] GASB 45 applies to public employers; GASB 43 applies to the plans that administer retiree benefits.

[b] GASB 25 establishes financial reporting standards for defined benefit pension plans and for the notes to the financial statements of defined contribution plans. For accounting purposes, if a retiree benefit, such as a disability payment, is provided as an integral part of a pension plan, it will be accounted for under rules for pension plans.

SOURCE: Office of Legislative Auditor analysis of statements issued by the Governmental Accounting Standards Board.

[11] An exception is when a compensated absence or termination benefit enhances an existing retiree health care benefit. Another exception is a severance package in which certain increments of hours of unused leave entitle the retiree to a given number of months of employer-paid health care premiums. In these cases, the benefits come under GASB 45 standards.

TRENDS AFFECTING POSTEMPLOYMENT BENEFITS

Demographic and other trends can have important effects on state and local governments' provision of postemployment benefits. We reviewed a number of these trends, including the aging of the workforce and life expectancies. We also analyzed retirement ages of Minnesota's public employees and health care cost increases.

Aging of the Workforce

Public employers in Minnesota can expect increasing numbers of retirees who will be eligible for postemployment benefits. Among Minnesota state employees, the median age increased from 38 in 1984 to 42 in 1994 and to 45 in 2000.[12] For local government employees, the largest groups are those at or nearing retirement age. For pension purposes, most local government employees are members of the Public Employees Retirement Association's (PERA's) Public Employees Retirement Plan and, as shown in Figure 1.2, the largest group of the plan's members is between ages 45 and 54. This group could have a high share of retirees within 10 years. The second largest group is aged 55 to 64, and 28 percent of them are already retired. Among school teachers who are members of the Teachers Retirement Association (TRA), the largest group is made up of those aged 55 to 64, and nearly half of the members in this age group were already retired as of July 2006.[13]

Life Expectancies

Increased life expectancies mean increased costs for certain public employers.

Postemployment benefits that are provided for the life of the retiree, such as pension benefits or lifetime health insurance, can generate increasing costs as people live longer lives. Minnesota's life expectancy, at 79.8 years in 2003, was considerably higher than the national average of 77.5 years.[14]

Life expectancy at age 65 is a particularly important measure when considering postemployment benefits because it suggests how long a person can expect to live after a typical retirement age. As shown in Figure 1.3, Minnesota's life expectancy at age 65 has been consistently higher than that of the U.S., with both increasing steadily over time. By 2004, a Minnesotan at age 65 could expect to live an additional 19.5 years (17.9 years for males, 20.8 for females).[15]

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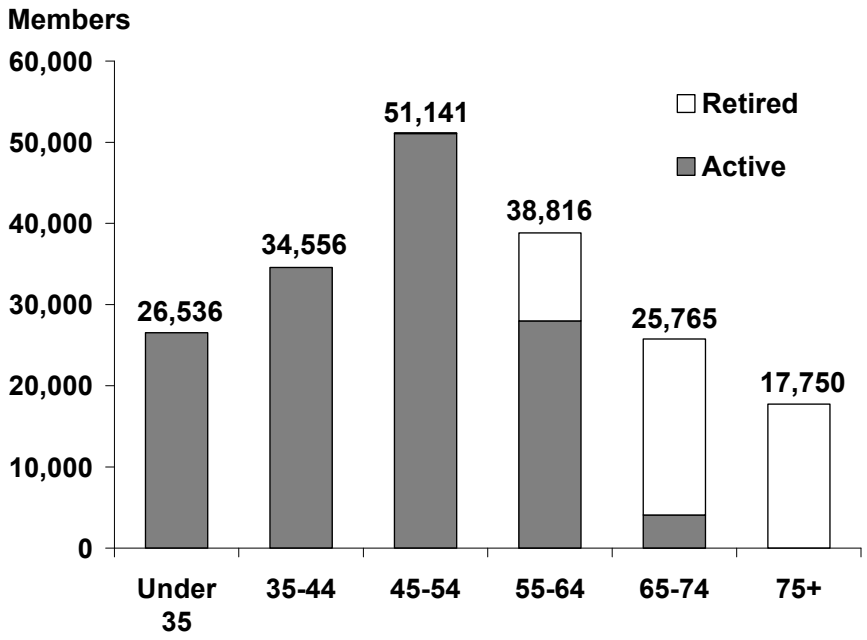
[12] Martha McMurray, State Demographic Center, *Minnesota State Government Workforce*, (St. Paul: June 2001), 6.

[13] Office of the Legislative Auditor, analysis of actuarial valuations from: The Segal Group, Inc., *Public Employees Retirement Association of Minnesota* (November 10, 2006), 8-11 and *Teachers Retirement Association Fund* (November 28, 2006), 9-12 (Englewood, CO: The Segal Company).

[14] Martha McMurry, Minnesota State Demographic Center, "Minnesota Mortality Rates Decline Between 2000 and 2003," *Population Notes* (St. Paul: April 2006).

[15] Martha McMurray, Minnesota State Demographic Center, *Minnesota Life Expectancy at Birth and Age 65*, data received by electronic mail, accessed November 15, 2006.

Figure 1.2: Age Distribution of Public Employees Retirement Association Pension Plan Members, 2006



NOTE: Data are for July 1, 2006 and include only members of PERA's Public Employees Retirement Plan. Active employees 70 years and older were included among those 65 to 74. Two retirees under 45 were included among those 35 to 44. The 51,141 members in the 45-54 age group include 80 retirees that are not visible because of the scale of the figure.

SOURCE: Office of the Legislative Auditor, analysis of The Segal Group, Inc., *Public Employees Retirement Association of Minnesota Actuarial Valuation and Review as of July 1, 2006*, (Englewood, CO: The Segal Company, November 10, 2006).

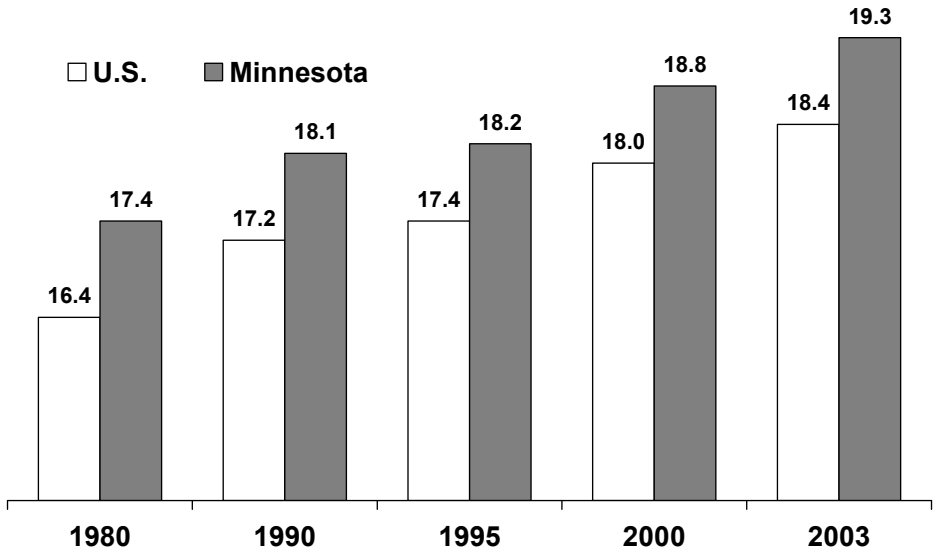
Large numbers of Minnesota's local government employees are at or nearing the ages of retirement.

Retirement Ages for Minnesota Public Employees

Employees who retire at earlier ages than others are more likely to receive postemployment benefits for longer periods, thereby increasing costs. The median retirement age of public employees in Minnesota's three largest pension plans was 60 years between 2000 and 2004, according to studies of those plans' membership.[16] TRA members retired at a median age of 58 years, while the

[16] This calculation was based on an analysis of data from experience studies for each of Minnesota's three statewide pension plans. See: The Segal Group, Inc., MSRS *State Employees Retirement Actuarial Experience Study for the period July 1, 2000 through June 30, 2004* (December 29, 2005), *PERA Actuarial Experience Study for the period July 1, 2000 through June 30, 2004* (November 14, 2005), and *TRA Actuarial Experience Study for the period July 1, 2000 through June 30, 2004* (February 2, 2006), (Englewood, CO: The Segal Group, Inc.).

Figure 1.3: Additional Years of Life Expectancy at Age 65, 1980-2003



SOURCES: Office of the Legislative Auditor, analysis of data from: National Center for Health Statistics, *Health, United States, 2005 With Chartbook on Trends in the Health of Americans* (Hyattsville, Maryland: U.S. Department of Health and Human Services, 2005) 167; http://www.cdc.gov/nchs/data/hus/hus05.pdf#027; accessed November 2, 2006; Minnesota State Demographic Center, "Minnesota Mortality Rates Decline between 2000 and 2003," *Population Notes*, (St. Paul, April 2006); Martha McMurray, Minnesota State Demographic Center, *Minnesota Life Expectancy at Birth and Age 65*, data received by electronic mail, accessed November 15, 2006.

median retirement ages for most state employees and other local employee groups were 61 and 62, respectively.[17]

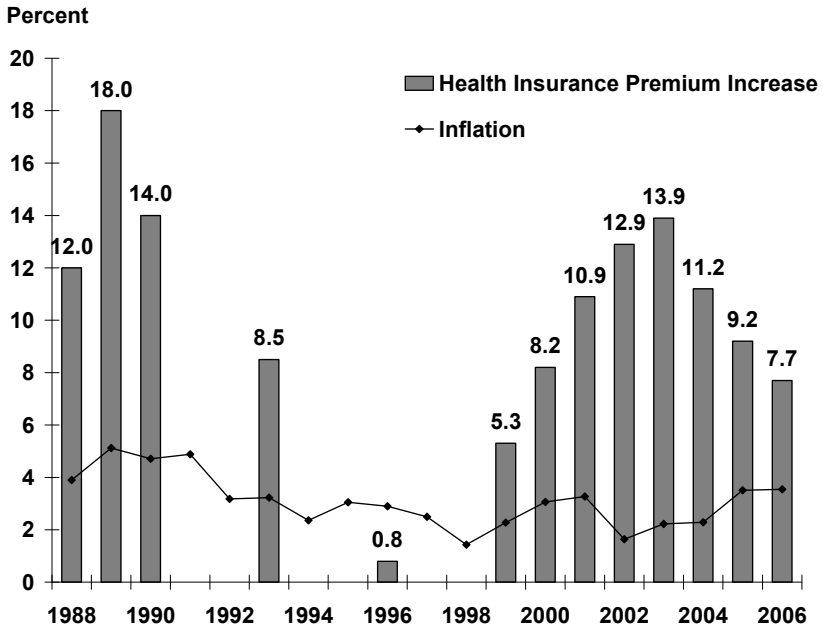
Health Care Cost Increases

The rising cost of health care places increasing demands on employers that pay for retirees' health care benefits. In particular, rising health care costs increase the burden for employers that do not limit their share of retiree health care premiums. For both private and public employers, one survey found that the average annual health insurance premium for a family of four was $11,480 in 2006.[18] Between 1988 and 2006, these premiums grew considerably more than inflation. As shown in Figure 1.4, the rate of increase in these premiums was greater than inflation in every year with available data except 1996. Premium

[17] Public safety officials are eligible to retire at younger ages than other public employees. For example, the PERA Police and Fire Fund members retired at a median age of 54 between 1997 and 2001, compared with a median age of 61 between 1996 and 2000 for members of PERA's General Plan. Mercer Human Resource Consulting, *Experience Study 1997-2001 Public Employees Police and Fire Fund of Minnesota* (Minneapolis: Mercer Human Resource Consulting, December 10, 2002), 16.

[18] Office of the Legislative Auditor, analysis of data from: Kaiser Family Foundation and Health Research and Education Trust, *Employer Health Benefits 2006 Annual Survey* (Washington, D.C.: Kaiser Family Foundation and Health Research and Education Trust, September 26, 2006), Section 1, page 11.

Figure 1.4: Family Health Insurance Premium Increases Compared With Inflation, 1988-2006



Increases in health care insurance premiums typically have exceeded inflation in recent decades.

NOTE: Overall inflation is measured by the Consumer Price Index, U.S. City Average of Annual Inflation (April to April), 1988-2006. Data were not available for health insurance premium increases in 1991, 1992, 1994, 1995, 1997, and 1998.

SOURCE: Kaiser Family Foundation and Health Research and Education Trust, *Employer Health Benefits 2006 Annual Survey* (Washington, D.C.: Kaiser Family Foundation and Health Research and Education Trust, September 26, 2006), Section 1, page 2; Office of the Legislative Auditor analysis of data downloaded from Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers* (Washington, D.C.: Bureau of Labor Statistics); http://www.bls.gov/cpi/; accessed January 2, 2007.

increases for state and local governments since 1999 mirror this overall trend.[19] Premiums for Medicare-eligible retirees have also increased above inflation. For example, in the city of St. Paul, health insurance premiums for single coverage of Medicare-eligible retirees increased 254 percent between 1986 and 2005 compared with an increase of 79 percent in the Consumer Price Index over the same period.[20] For many employers, increases in health care costs represent a direct increase in the costs of benefits provided to retirees.

[19] *Ibid.,* Section 1, page 9.

[20] The Consumer Price Index, U.S. City Average of Annual Inflation (April to April), was used to measure inflation.

2 Postemployment Benefits Other Than Pensions

SUMMARY

Retiree health insurance is a common "other postemployment benefit," and about 21 percent of 1,730 local jurisdictions in Minnesota, mostly school districts, reported to the State Auditor that they pay for it. Several cities, counties, and school districts chiefly in northeastern Minnesota and the metropolitan area offer the most extensive retiree health care—covering all employee groups and spouses for life and paying all or almost all of the premiums. Among state government retirees, about 5 percent qualify for employer-paid retiree benefits. Twenty-four jurisdictions providing other postemployment benefits have already completed actuarial studies on their benefits, and their liabilities are estimated to be approximately $1.5 billion over the next 30 years. This liability could reach $3.3 billion when other jurisdictions complete their studies. All Minnesota units of government that offer health insurance—even those who do not pay premiums for retirees—have at least some liability for other postemployment benefits. This is due to the indirect subsidy paid on behalf of retirees who have higher health care costs than active employees but share the same premiums. Although liabilities are not required to be funded in advance, local jurisdictions that want to set up trusts for this purpose lack clear authority to do so. The Legislature should allow establishing such trusts.

Postemployment benefits are employee compensation that is unavailable for use until employees retire. Pension benefits are perhaps the best known such benefit and are covered in Chapter 3. Postemployment benefits *other* than pensions are the subject of this chapter, which addresses the following research questions:

- **To what extent do Minnesota governments offer other postemployment benefits?**
- **How large are the liabilities for other postemployment benefits?**
- **What is needed to control liabilities for other postemployment benefits?**

To answer these questions, we reviewed state statutes, relevant legal cases, and accounting standards of the Governmental Accounting Standards Board (GASB). We spoke with actuaries, local government finance experts, and labor union leaders about retiree benefits. We interviewed personnel representing the state, University of Minnesota, and the Minnesota State Colleges and Universities. To collect information on the scope of other postemployment benefits across Minnesota, we conducted in-depth interviews with a sample of local jurisdictions. Primarily using data collected in early summer 2006 by the State Auditor, we selected a sample of 129 counties, cities, school districts, and special

districts.[1] We based our sample first on the largest jurisdictions and those where preliminary data indicated high per capita liabilities for other postemployment benefits. We then chose random samples from the remaining jurisdictions grouped by type. Our sample is representative of jurisdictions that pay for other postemployment benefits, but it is not representative of local jurisdictions in general. Before conducting the interviews, we studied each jurisdiction's annual financial report and e-mailed our questions to local benefit managers or finance officers. Where available, we analyzed copies of actuarial valuations on other postemployment benefits.

EXTENT OF OTHER POSTEMPLOYMENT BENEFITS

The extent of other postemployment benefits varies widely across Minnesota. We found that:

- **One in five public employers in Minnesota (excluding small townships) reported paying for at least some retirees' health care premiums, and a few of those jurisdictions offer extensive retiree health care benefits.**

Most jurisdictions do not pay for their retirees' health insurance or other postemployment benefits. In the following sections we explain how this varies for state employees and local government workers.

State Employees

About 5 percent of Minnesota state government retirees receive state-paid health insurance.

Few state employees qualify for state-paid health care upon retirement. Only the highway patrol, conservation officers, correctional counselors at state correctional facilities, public defenders, employees of Iron Range Resources, and a select group of workers from the Department of Human Services are eligible, as depicted in Table 2.1.[2] Current retirees in those professions receiving state-paid benefits represent 5 percent of total state pensioners.

At the University of Minnesota, retirees do not receive employer-paid health care. Disability payments made to certain faculty and academic employees who receive long-term disability income are considered to be postemployment benefits under GASB 45 requirements. Such payments, however, are limited and affect very few employees (less than 1 percent). No retirees from the Minnesota State Colleges and Universities receive employer-paid retiree health care.[3]

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[1] The city of Hibbing was not in our sample, but, for certain analyses, we used State Auditor data for that city.

[2] Employer-paid coverage is available only until retirees reach age 65. Eligible Department of Human Services employees are those who were at risk of losing their positions due to the state's policy move away from state–run regional treatment centers and nursing homes in favor of community-based facilities.

[3] A limited number of former employees of the University of Minnesota and others from MnSCU have used early retirement incentives that include health care, but these are termination benefits and are excluded from GASB 45 accounting standards' definition of other postemployment benefits.

Table 2.1: Retired State Employees Receiving Employer-Paid Medical Coverage, FY 2006

	Single Coverage	Family Coverage	Total	Percentage of Total State Retirees[a]
Department of Corrections	213	289	502	2%
Department of Human Services	175	198	373	2
Department of Public Safety[b]	53	156	209	1
Department of Natural Resources	17	55	72	0.3
Iron Range Resources	3	5	8	<0.1
Public Defense Board	1	5	6	<0.1
Total	462	708	1,170	5%

NOTE: Certain employees of Minnesota State Colleges and Universities are eligible for retiree health care as part of an early retirement incentive that is excluded from the accounting standards' definition of other postemployment benefits.

[a] Counts for "Total State Retirees" include retirees and disabled persons receiving pensions as of fiscal year 2006.

[b] The Department of Public Safety numbers include officers in the State Patrol and special agents in the Bureau of Criminal Apprehension.

SOURCE: Office of Legislative Auditor, analysis of data from Department of Employee Relations, "Employer-Paid Retiree Health Care" (St. Paul: November 16, 2006).

Local Employees

Minnesota's school districts and counties are more likely than other types of local governments to pay for other postemployment benefits.

About 21 percent of 1,730 local jurisdictions in Minnesota, most of them school districts, reported to the State Auditor in 2006 that they pay for other postemployment benefits.[4] However, the exact number of local jurisdictions paying for other postemployment benefits is difficult to determine, and the information reported to the State Auditor has some errors.[5] Furthermore, this percentage does not include jurisdictions that offer to retirees only continuation of insurance coverage at retirees' own expense, which could result in subsidized insurance premiums, as is discussed later. It is clear, though, that school districts are the most likely of all types of local jurisdictions to offer other postemployment benefits. As Table 2.2 shows, a majority of school districts and counties reported to the State Auditor that they offer these benefits, but the proportions of cities, townships, and special districts are far lower.

[4] Minnesota Office of the State Auditor, *Special Study Other Postemployment Benefit Liability of Local Governments in Minnesota* (St. Paul: October 2006), 8. The study included only the 215 largest townships out of 1,790 townships in the state.

[5] About 9 percent of the jurisdictions we interviewed (from among those responding to the State Auditor's survey) do not actually offer other postemployment benefits even though they reported to the State Auditor that they do. Typically, these were jurisdictions that convert unused sick leave balances to health care savings plans at retirement; such conversions should not be accounted for as other postemployment benefits, as noted in Chapter 1. We cannot determine how imprecise the estimate is, because we do not know how many (if any) jurisdictions reported to the State Auditor that they have no liability for other postemployment benefits when, in fact, they do.

Table 2.2: Local Jurisdictions Reporting That They Offer Other Postemployment Benefits, 2006

	Number Responding to State Auditor Survey	Reported Offering Other Postemployment Benefits	
		Number	Percentage
School districts	317	222	70%
Counties	87	45	52
Cities	773	69	9
Special districts	399	23	6
Townships	154[a]	3	2
Total	1,730	362	21%

NOTE: The number of jurisdictions offering other postemployment benefits may be slightly overstated because a small share of the jurisdictions reported offering these benefits when they do not.

[a] Of 1,790 townships in Minnesota, the State Auditor's Office surveyed only the 215 largest having at least $250,000 in annual revenue.

SOURCE: State Auditor's Office, *Special Study: Other Postemployment Benefit Liability of Local Governments in Minnesota* (St. Paul: October 2006), 8.

Variation Among Retiree Benefits in Local Jurisdictions

Nearly all—99 percent—of the spending for other post-employment benefits by Minnesota jurisdictions in fiscal year 2005 was on health care insurance.

Health care for retirees is by far the most common of the other postemployment benefits offered in Minnesota. Among the local jurisdictions that paid for retiree health care for retirees or certain groups of retirees, just 23 percent also paid for either dental or life insurance, or both.[6] Most of the fiscal year 2005 local government spending on other postemployment benefits—99 percent—was for retiree health care, while dental and life insurance accounted for less than 1 percent each. Because retiree health care is the most prevalent of the other postemployment benefits, the following analysis pertains to health care only.

Among local jurisdictions, the scope of employer-paid health care benefits ranges from extensive to basic. Table 2.3 explains how we defined this range. Most Minnesota local jurisdictions that pay for other postemployment benefits provide a basic, not extensive, set of retiree health care benefits. For instance, most paying for the health care benefit do not offer it to all employees, nor do they pay it for a retiree's lifetime; instead, they pay for it only to certain employee groups and until the retiree becomes eligible for Medicare (usually at age 65). Table 2.4 details the extent of the health care benefits in jurisdictions that pay for other postemployment benefits.

Local Jurisdictions With Extensive Benefits

The city of Duluth is among those local governments with the most extensive retiree health benefits. Duluth provides retiree health care to all employee groups, covers spouses and dependents, provides benefits for the lifetime of the

[6] Among jurisdictions paying for retiree health care, 32 percent paid it for all employee groups and 68 percent paid it for only some groups.

Table 2.3: Defining the Range of Retiree Health Care Benefits

Extensive Benefits	Basic Benefits
• Offered to all employees	• Offered to only certain employees or groups of employees
• Offered to retirees' spouses or dependents	• Offered to employees only
• Available until retirees or spouses die	• Available for a limited amount of time
• All or most of the premium is paid by the employer	• A limited share of the premium is paid by the employer
• The employer bears the full cost of premium increases over time	• The employer's contribution to the premium is capped[a]
• Employees need only minimal years of service to qualify	• Employees need a significant number of years of service to qualify

[a] The employer's contribution could be limited to a monthly cap, a lifetime amount, or the monthly premium paid at the time the employee retired.

SOURCE: Office of the Legislative Auditor, analysis of interviews with local jurisdictions, 2006.

Most jurisdictions that pay for other postemployment benefits offer a basic, not an extensive, package of retiree health care benefits.

retiree, and paid 100 percent of the premium for retirees hired before 2004.[7] In addition, for all but police officers, only three years of service are required to qualify for retiree health care; therefore, up to 2004, someone hired at age 52 who worked for three years could retire at age 55 and qualify for lifetime health benefits. Of the 101 jurisdictions we interviewed that offer other postemployment benefits, only three others have similarly extensive benefits: Hibbing School District and the cities of Coleraine and Nashwauk.[8]

As shown in Table 2.5, another ten jurisdictions have similarly extensive benefits and, like Duluth, they have instituted cut-off dates by which new hires (1) no longer qualify for the benefit, (2) receive a reduced benefit, or (3) receive an employer contribution capped at a certain amount. Three other jurisdictions offer benefits nearly as extensive as Duluth, and they set dates after which new hires no longer receive the retiree benefit, but in all cases the percentage of the retiree premium paid by the employer varies depending on the number of years the employee worked.[9]

[7] For employees hired after 2004, Duluth pays a percentage of the retiree health care that varies based on years of service. With 20 years of service, the city pays 100 percent; at 5 years of service, it pays 25 percent.

[8] The Hibbing School District pays 92 percent of the premium for single coverage less $50, while retirees pay the $50 and 8 percent of the premium; retirees must have 10 years of service in the district. Nashwauk also requires 10 years of service.

[9] Additional jurisdictions could be said to have extensive benefits, but we separated them for the following reasons: Cass County, Crow Wing County, and Central Minnesota Community Corrections offer lifetime benefits to only some (not all) employee groups; Freeborn County caps its contributions at $113 per month and ended the benefit for new hires after April 1987.

Table 2.4: Extent of Retiree Health Care Benefits Paid by Local Jurisdictions Providing Other Postemployment Benefits, 2005

	Percentage of Jurisdictions
Employee groups eligible	
All	32%
Most	53
Some	14
	100
Term of benefit	
Until Medicare age (typically 65)	59
Past Medicare age but not for life[a]	22
Lifetime benefit[b]	19
	100
Spouse or family coverage	
For one or more employee groups	65
For no employee group	35
	100
Employer's share of premiums	
Single coverage[c]	
All or nearly all of the premium	45
Some other negotiated amount	28
An amount up to a cap	12
Amount at time of employee's retirement	9
Up to 100%, but amount varies with years of service	6
	100
Family coverage[c]	
Not offered	49
All or nearly all of the premium	13
Some other negotiated amount	16
Same as single coverage or single plus additional amount	9
An amount up to a cap	6
Amount at time of employee's retirement	5
Up to 100%, but amount varies with years of service	2
	100
Limited time or amount of employer-paid health care[c]	
Unlimited	18
Limited to Medicare age	39
Limit on amount per retiree	9
Other limits	34
	100
Years of service needed to qualify	
0-9 years	22
10-14 years	28
15-19 years	34
20 or more years	16
	100

Among jurisdictions paying for retiree health care insurance, 32 percent offer benefits to all retirees, and 19 percent cover retirees for life.

NOTE: N = 101 jurisdictions that pay for retiree benefits. Percentages may not sum to 100 due to rounding.

[a] In 14 percent of the cases, the term was for all employee groups, and in 8 percent it was for only some employee groups.

[b] In 14 percent of the cases, lifetime benefits applied to all employee groups, and in 5 percent they applied to only some employee groups.

[c] In cases where employer-paid retiree health care varies by employee group, the data are for the largest group of employees within the jurisdiction, such as teachers within a school district.

SOURCE: Office of the Legislative Auditor, analysis of interviews with local jurisdictions, 2006.

Table 2.5: Local Jurisdictions With Extensive Retiree Health Care Benefits, 2006

Jurisdiction	Years of Service Required	Employer Share of Premium for Single Coverage	Changes in Extent of Health Care Benefit
Anoka County	10	Based on years of service	Ended for new hires after January 6, 2007
Coleraine	3	100 percent	None
Duluth	3	100 percent[a]	Employer share of premium for new hires after 2004 varies by years of service
Hibbing Schools	10	92 percent less $50	None
International Falls	15	100 percent	Ended for new hires after 1995
Lyon County	15	Based on years of service[b]	Ended for new hires after May 1, 1997
Mesabi-East Schools	15	90 percent in 2005, but this varies	Retirees after 1989 receive less than 100 percent of the premium
Metropolitan Council	10 or more	100 percent[c]	Ended for new transit hires after 2004 and other new hires after 1996-97
Nashwauk	10	100 percent	None
Pope County	10	100 percent	Ended for new hires after March 1995; $500 cap for some employees[d]
Ramsey County	20 for most	Same amount as for active employees or it varies[e]	Ended for new hires after 2005; regular retirees after 1995 make employee contributions for insurance
Scott County	10	Based on years of service	Ended for new hires after 1992
St. Paul	20	100 percent, $350, or $300[f]	Capped contribution for retirees and new hires after 1996;[f] ended for some new hires after July 2005
St. Paul Schools	15	Amount paid at time employee retired	Employees hired before 1996 but retired after 1998 are limited to $300 for single coverage past age 65; new hires after 1996 are covered to age 65 only
Stillwater	10	100 percent	Ended for new hires after 1998
Virginia Schools	8	100 percent less $10	Ended for some new hires in 1984 and others in 1987
Washington County	10	Same amount as for active employees or it varies[g]	Ended for new hires after 2002

NOTE: Jurisdictions listed have paid health care insurance for life to all employee groups and cover some portion of spouses' premiums. Some are not listed here: Cass County, Crow Wing County, and Central Minnesota Community Corrections offer lifetime benefits to only some employee groups; Freeborn County has extensive benefits but caps its contributions at $113 per month and ended the benefit for new hires after April 1987. Many jurisdictions that ended retiree insurance replaced it with contributions to individual health accounts.

[a] For employees hired after 2004, Duluth pays 100 percent of health insurance for 20 or more years of service and lower shares for fewer years of service down to 25 percent for five years of service.

[b] For each year of service worked for Lyon County, retirees receive 4 percent of the amount the county pays for active employees' premiums, which currently covers the premium after employees pay a deductible.

[c] The Metropolitan Council pays 100 percent of transit union retirees' premiums until age 65 and 67 percent thereafter.

[d] Pope County will pay up to $500 per month for law enforcement employees hired before March 1995 and who reach the rule of 80 by December 31, 2010 (this applies to one active employee). No cap exists for employees reaching the rule of 80 before July 2006.

[e] Ramsey County pays the same amount of the premium for retirees as it does for active employees if retirees were hired before July 1992. It pays a percentage of the premium (up to 90 percent) based on years of service for those hired between July 1992 and December 31, 2005. Retirees after 1995 must make a monthly contribution for coverage past age 65.

[f] St. Paul pays 100 percent of coverage for employees who retired prior to 1996. For those hired before 1996 but retired after 1996, St. Paul pays up to $350 per month for early retirees and up to $550 per month for regular retirees. For those hired after January 1996, St. Paul pays up to $300 per month. St. Paul discontinued the insurance benefit for certain new hires after July 2005.

[g] For those with 8, 9, or 10 years of county service before 1985, Washington County pays 50, 75, or 100 percent of the premium, respectively. For those hired between 1977 and 1985 but without 8 years of service by 1985, the county pays the greater of $230 per month or the same premium as for active employees. For employees hired between January 2, 1985, and December 31, 2001, the county pays the same premium for retirees as for active employees.

SOURCE: Office of the Legislative Auditor, analysis of interviews with local jurisdictions, 2006.

LIABILITIES

Because Minnesota jurisdictions are not yet required to comply with the GASB 45 accounting standards, only a handful have completed actuarial valuations for other postemployment benefits. When all jurisdictions are required to have them, the actuarial studies will provide the best estimate of liabilities across the state for public retirement benefits other than pensions. Nevertheless, from data currently available, we found that:

- **Local jurisdictions with completed actuarial studies have approximately $1.5 billion in liabilities for other postemployment benefits over the next 30 years.**

Only a handful of government entities in Minnesota have completed actuarial valuations of their other post-employment benefit obligations.

The $1.5 billion represents accrued actuarial liability for just 24 jurisdictions around the state, but based on our interviews and the survey from the State Auditor's Office, we believe this group contains most of the jurisdictions with actuarial valuations and very large liabilities.[10] Some jurisdictions have already set aside money to pay these future benefits; subtracting the amounts set aside by jurisdictions with actuarial studies leaves a liability of approximately $1.3 billion.[11]

Two jurisdictions account for 37 percent of the $1.5 billion liability—the city of Duluth ($279.9 million) and the Metropolitan Council ($275 million). Along our spectrum of retiree health benefits, these two jurisdictions have extensive benefit packages. Duluth and the Metropolitan Council were in the top three jurisdictions in terms of liability as a percentage of annual current expenditures, at 354 and 69 percent, respectively.

The $1.5 billion liability estimate includes liabilities from only 5 of the 17 jurisdictions listed earlier as having extensive retiree health care benefits. The remaining 12 have not completed actuarial valuations and, therefore, are not part of the estimate. The five jurisdictions with completed actuarial valuations were Anoka County, Duluth, the Metropolitan Council, Scott County, and the St. Paul School District; they represent 46 percent of the spending on retiree health care in fiscal year 2005 for jurisdictions with extensive benefits.

Jurisdictions Without Actuarial Studies

For jurisdictions without actuarial studies, the liability for other postemployment benefits is still unknown. Lacking actuarial data, we used data on local jurisdictions' expenditures for retiree health care in fiscal year 2005 to make a ballpark estimate of liability statewide. We concluded that:

[10] This does not include either Ramsey County or the city of St. Paul, which together may have liabilities around $700 million.

[11] In addition, a small number of jurisdictions without actuarial studies have set aside some money for other postemployment benefits. As described later in this chapter, for jurisdictions intending to prefund their liabilities, accounting standards require reserving the money in irrevocable trusts or equivalent arrangements.

- **Total liabilities for other postemployment benefits statewide could reach $3.3 billion once additional actuarial studies are completed by 2010.**

Although we based the statewide estimate on known amounts of spending for retiree health care, the estimate has great uncertainty and must be interpreted with caution. Estimates of liabilities made without following actuarial standards, as this one was, can be unreliable. Actuaries' estimates are complex and rely on assumptions about expected retirement rates, rates of withdrawal from the workforce, and medical cost inflation, among other things, none of which was a part of our analysis, as explained below.[12]

To arrive at the figure of estimated liability, we summed the liabilities for two groups and estimated liabilities for a third group. Table 2.6 shows how the liabilities break down by the three groups. The first group was the one for which liabilities have already been estimated—24 jurisdictions with completed actuarial valuations, as discussed previously. The second comprised jurisdictions that in our judgment had made reasonable estimates of their liability for other postemployment benefits. This group includes a few large jurisdictions, including Ramsey County, whose estimate of liability was based on reasonable

Table 2.6: Estimated Statewide Liabilities for Other Postemployment Benefits, by Three Groups of Jurisdictions, 2005

Jurisdictions	Estimated Liability (in billions)
Group 1 – Estimates based on actuarial valuations	$1.5
Group 2 – Reasonable self-estimated liabilities	0.8
Group 3 – Other estimates of liabilities[a]	1.0
Total	$3.3

NOTE: Estimates are primarily for jurisdictions that pay for other postemployment benefits; they largely exclude jurisdictions with only implicit rate subsidies, meaning jurisdictions where the health insurance premium is the same for active employees and retirees, but employers pay a subsidy for retirees whose health care costs are higher than those of active employees.

[a] The estimate for this group must be used with caution as it was based in large part on ratios derived from an analysis of jurisdictions' annual spending on retiree benefits and data from jurisdictions with actuarially-determined liabilities. The figure also includes an estimate of differences between our sample and all jurisdictions that pay for other postemployment benefits.

SOURCE: Office of the Legislative Auditor, analysis of interviews with local jurisdictions, 2006.

[12] In addition, GASB 45 allows actuaries to use any of six actuarial methods to estimate the present value of other postemployment benefits, and each method may result in different liability estimates. For Minnesota pensions, *Minnesota Statutes* 2006, 356.215, subd. 5 requires the use of a single actuarial method, and subd. 8 specifies the interest rate that actuaries must use in their estimates. Such requirements for other postemployment benefits would standardize the estimation of liabilities and produce comparable liability estimates over time; however, we have not analyzed which of the permissible cost methods, or which rate of return, would be most appropriate.

assumptions but still contained a number of uncertainties. Most jurisdictions in this second group, though, were smaller jurisdictions with retiree health care benefits that were easily predictable, because they were fixed amounts for limited time periods. For instance, one school district offered retiree health care only to teachers who had been hired by 1999 and administrators; the benefit was capped at $375 per month (which the premium exceeded), and the district would pay it only until retirees reached age 65. The unknown factor was the point at which employees would actually retire, but the district estimated retirement dates after talking with eligible employees.

An actuarial estimate of liabilities for other post-employment benefits for state employees is expected by mid-2007.

The third group contained jurisdictions that could not reasonably estimate their own liabilities without the help of actuaries. For this group, we estimated liabilities based on jurisdictions' retiree health care spending in fiscal year 2005. We calculated the ratio of spending to liabilities for the first group of jurisdictions with actuarial valuations. This ratio ranged between 15 and 166 and averaged 30. For the third group, we applied our average ratio to each jurisdiction's retiree health care spending in fiscal year 2005. Assuming that the group with actuarial valuations is generally representative of jurisdictions that pay for other postemployment benefits, this is a reasonable way to estimate statewide liabilities. The method is not, however, intended to provide precise estimates of each individual jurisdiction's liability; an actuarial valuation is required for that. The third group also contains our estimates of differences between our sample and all jurisdictions that pay for other postemployment benefits.

The state does not have an actuarial valuation of liability for other postemployment benefits provided to state retirees, but it expects to have one in early summer 2007. The employer-paid benefits for state retirees, however, are among those we have defined as basic: Only a small share of state employees are eligible for them, and the state pays premiums only until retirees turn 65. At the same time, for eligible retirees, single coverage is available at no cost to the retiree, and the state bears the cost of any premium increases for most retirees.[13]

Implicit Rate Subsidies

State statutes require public employers to allow retiring employees to continue indefinitely in the employer-sponsored medical and dental insurance groups.

Many local governments offer no employer-paid health care insurance to their retirees. Despite this, we found that:

- **Because of implicit health care insurance rate subsidies, all units of government in Minnesota that offer health insurance have at least some liability for other postemployment benefits.**

State statutes require local governments to allow employees upon retirement to continue indefinitely in their employer-sponsored medical and dental insurance group.[14] Further, for the purpose of setting premiums, statutes require governments to pool the retirees to age 65 with active employees. Similarly for

[13] The state's share of the premium is capped for a portion of the eligible retirees. For example, for state nurses who work in correctional facilities, the state pays an amount equivalent to the premium at the time of retirement plus $100 per month. Beyond that, those retirees pay premium increases.

[14] This applies to employees who qualify for a pension annuity or disability benefit. *Minnesota Statutes* 2006, 471.61, subd. 2b. The law does not affect employers who do not offer insurance.

Retirees tend to consume more health care services and cost more than younger employees, but their insurance premiums are the same.

state employees, statutes allow former employees who are eligible to receive pension benefits and meet eligibility requirements to purchase health insurance through the state employees' insurance program.[15]

Because employees and retirees under age 65 are insured together as a group, their health care premiums are the same. Health care costs, however, typically go up as people age. Retirees tend to consume more health care services and, thus, cost more than younger employees. In effect, premiums are less for retirees than are retirees' actual costs, while they are higher than actual costs for younger employees. The amount of retirees' health care exceeding what they pay in premiums is a subsidy for those retirees. Accounting standards call the subsidy an "implicit rate subsidy," and they obligate employers to disclose such subsidies. The standards require that employers project the future costs of retiree health care benefits by separating premium costs for retirees from those for active employees or using costs of actual claims for those groups.[16]

The state and all subdivisions of government in Minnesota that offer health care insurance incur an implicit rate subsidy and are subject to the GASB 45 accounting and reporting requirements. This remains the case even when retirees pay the premium at their own expense, because employers pay more for their active employees' coverage than they would if the more expensive retirees were not in the same group for setting premiums.

Liabilities due to the implicit rate subsidy could be a significant part of our estimated $3.5 billion in potential statewide liabilities, and we further analyzed the possible extent of this liability for school districts. We received data from nine school districts where actuarial studies specified the size of the implicit rate subsidy; for those districts, the implicit rate subsidies ranged from $317 to $3,721 per student and totaled $132 million.[17] The average was about $1,300. If the districts for which we have data are typical (and there is uncertainty about this assumption), we estimate that districts around the state face an average liability for implicit rate subsidies of roughly $1,300 per student enrolled or $1.1 billion statewide. The wide range in the implicit rate subsidies per student suggests considerable uncertainty about the precision of this estimate, but we include the amount as an indication of the possible scope of the liability. The Anoka-Hennepin School District, whose only liability for postemployment benefits is the implicit rate subsidy, had an actuarial-estimated liability of $36.7 million as of June 30, 2006.[18]

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[15] *Minnesota Statutes* 2006 43A.27, subd. 3(a)-(d) and 43A.316, subd. 8. Spouses of deceased retirees may also purchase the coverage.

[16] Employers are exempt from the requirement if their health care premiums result from a "community-rated" health plan in which rates reflect claims experiences of all participating employers instead of a single employer.

[17] Among those nine were some of the state's largest school districts, including Anoka-Hennepin, Duluth, Osseo, Rosemount-Apple Valley-Eagan, and St. Cloud.

[18] Van Iwaarden Associates, *Anoka-Hennepin Independent School District No. 11 June 30, 2006 Actuarial Valuation of the Postretirement Benefits Other Than Pension Benefits* (Minneapolis: Van Iwaarden Associates, October 2006), 8. The implicit rate subsidy in Anoka-Hennepin School District extends to Medicare-eligible retirees because they are pooled with younger retirees and active employees when setting premiums.

Among state employees, few retirees receive employer-paid other postemployment benefits, as mentioned previously, but the state faces an unknown amount of liability for the implicit rate subsidy. Because state retirees pay the same health care premiums as active employees, an analysis was done in 2006 to estimate the difference between retirees' insurance claims and their premiums.[19] Although the analysis did not estimate the state's liability for other postemployment benefits, it estimated an excess of $13.9 million in retiree health claims costs over the amounts paid for retiree health care premiums in 2005. This demonstrates the magnitude of the subsidy due to blending premiums for state employees and retirees to age 65.

Spending on Retiree Benefits

While accounting standards will now require more complete disclosure of liabilities that jurisdictions will likely pay in the future, most Minnesota governments that offer other postemployment benefits pay for them on a yearly basis as employees retire. For example, the state of Minnesota paid $9.2 million in fiscal year 2006 for retiree health and dental insurance. We estimate that local jurisdictions paying for other postemployment benefits paid nearly $110 million in fiscal year 2005 for retiree benefits. While several jurisdictions spent more than $1 million in fiscal year 2005 on retiree benefits, a better way to compare across jurisdictions is to look at what proportions those expenditures were of annual spending. Our analysis showed that:

- **High spending in fiscal year 2005 for retiree health care was concentrated in a small number of local jurisdictions, with 11 cities and school districts spending more than 5 percent of their annual operating expenditures on retiree benefits.**

Spending on other postemployment benefits by most local jurisdictions amounted to less than 1 percent of their annual operating expenditures in fiscal year 2005.

Of the local jurisdictions that paid for retiree benefits in fiscal year 2005, 58 percent spent under 1 percent of annual operating expenditures on other postemployment benefits (the median was 0.8 percent). But for 12 percent of local jurisdictions, at least 2 percent of their operating expenditures went to retiree benefits that year. Among the top 20 jurisdictions, 17 were located in northeastern Minnesota, as evident from Table 2.7. Any of these jurisdictions that are also experiencing declining enrollments or eroding tax bases may face difficulty paying for their postemployment benefit promises.

Reserving Money for Other Postemployment Benefits

Some jurisdictions have taken steps to pay their future liabilities for other postemployment benefits, but we found that:

- **Most jurisdictions are not setting aside money to pay their liabilities for other postemployment benefits, and some may face serious unfunded liabilities because additional growth in liabilities can be expected.**

[19] Mike Schoeberl, Julie Maendel, and Michael de Leon, Deloitte, memorandum to Budd Johnson, Department of Employee Relations, *Projected 2005 Retiree Rating Subsidy*, June 19, 2006.

Most of the local jurisdictions with high spending on retiree insurance as a percentage of annual operating expenditures were located in northeastern Minnesota.

Table 2.7: Top 20 Local Jurisdictions in Spending on Other Postemployment Benefits as a Percentage of Operating Expenditures, 2005

Jurisdiction	Other Postemployment Benefit Spending in FY 2005	Other Postemployment Benefits as Percentage of Operating Expenditures[a]	Location by Region
Mesabi-East School District	$1,115,000	12.8%	Northeast
Greenway School District	972,000	8.3	Northeast
Duluth	6,554,101	8.3	Northeast
Bovey	60,974	8.3	Northeast
Hibbing School District	1,669,500	8.0	Northeast
Coleraine	85,000	7.8	Northeast
Nashwauk	69,658	7.6	Northeast
Virginia	584,000	6.2	Northeast
Virginia School District	788,127	6.1	Northeast
Chisholm School District	375,430	5.9	Northeast
Ely School District	314,000	5.6	Northeast
Hibbing	576,715	4.7	Northeast
Hoyt Lakes	106,977	4.4	Northeast
Chisholm	152,282	4.3	Northeast
Stillwater	324,984	3.3	Metropolitan
Grand Rapids School District	1,040,548	3.2	Northeast
Traverse County	186,065	3.2	West central
Calumet	9,212	3.1	Northeast
St. Paul	8,046,072	3.0	Metropolitan
Itasca County	1,341,000	2.8	Northeast

NOTE: The analysis includes jurisdictions we interviewed that pay for other postemployment benefits and one jurisdiction (Hibbing) that was not in our sample and for whom we used data from the State Auditor's Office.

[a] Operating expenditures are current expenditures net of capital spending and represent the year ending December 31, 2004, for cities and counties and the 2004-2005 school year for school districts.

SOURCE: Office of the Legislative Auditor, analysis of interviews with local jurisdictions, 2006; State Auditor's Office, *Special Study: Other Postemployment Benefit Liability of Local Governments in Minnesota* (St. Paul: October 2006), 49; State Auditor's Office, *Database Search* [on city and county revenues, expenditures, and debt]; http://www.osa.state.mn.us/default.aspx?page=dbsearch; accessed November 1, 2006; and Minnesota Department of Education, *Resources for Administrators* "2005 Expenditures per ADM"; www.education.state.mn.us/mde/index.html; accessed May 23, 2006.

A minority of the Minnesota local governments that offer employer-paid retiree benefits have set aside money to pay currently accruing benefits that will come due in the future. We estimate that 26 percent have done so, although even most of those that reserved some money have not set aside enough to fully fund their liabilities. The amount set aside totaled $260 million by fiscal year 2005—a small share relative to our estimate of these jurisdictions' $1.8 billion in liability. Jurisdictions often set aside money in the form of a designation of funds in their fund balances. As discussed in more detail below, setting aside money in this way does not meet actuarial standards.

Certain jurisdictions are more likely than others to face fast growth in unfunded liabilities for other postemployment benefits. For instance, compared with jurisdictions employing a young workforce and having few retirees, jurisdictions where a significant proportion of employees is nearing retirement age are far more likely to face quickly growing costs for postemployment benefits.

Paying for growing benefit costs could be particularly difficult for school districts with declining enrollments, because they will have fewer resources available in coming years to pay for other postemployment benefits, even as some will see more retirees becoming eligible for retiree health care. In addition, school districts may have difficulty raising additional local revenues to cover costs. Unlike cities and counties, Minnesota school districts must receive voter-approved referenda to increase locally raised revenues. Finally, cities or counties in areas of the state with declining populations face similar issues to the extent that their tax bases may be eroding.

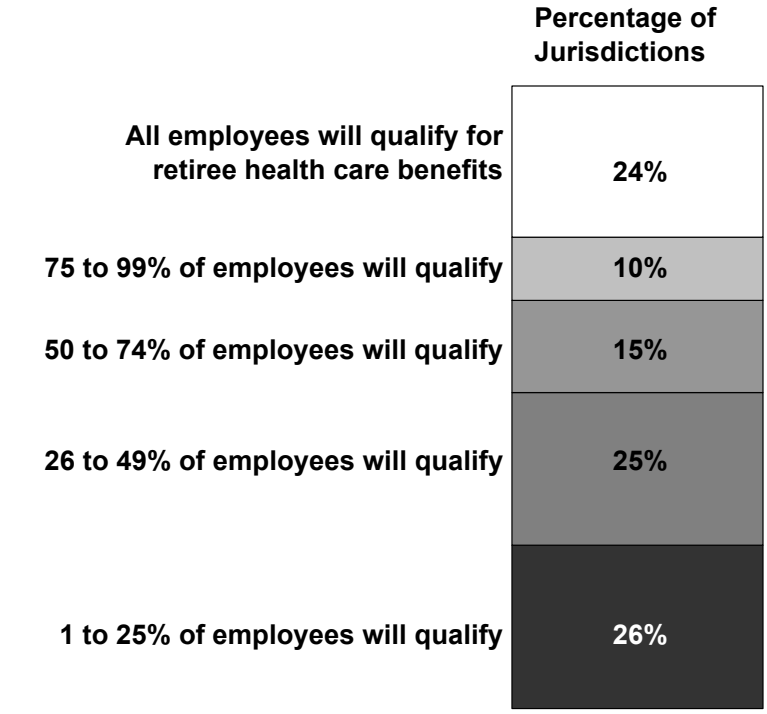
Retiree health care costs are expected to grow. As described in Chapter 1, increases in national health care insurance premiums have outpaced inflation growth nearly every year since the mid-1980s. If the trend continues, public employers that have not capped their contribution toward premiums for retiree health care will bear those increases. As Table 2.4 showed earlier, only 21 percent of jurisdictions that pay for other postemployment benefits have limited their contributions for single coverage by either imposing a monthly cap or restricting their contributions to the amount in place at the time the employee retired.

Jurisdictions with large shares of employees nearing retirement age may see fast growing costs for retiree health care insurance.

Many jurisdictions have substantial shares of active employees who will become eligible for other postemployment benefits, assuming workers stay in their positions long enough to meet service requirements. As employees retire, these jurisdictions will experience growing costs for retiree health care. Figure 2.1 shows that in nearly half the jurisdictions paying for other postemployment benefits, 50 percent or more of the workers currently eligible for regular health care benefits will eventually be eligible for retiree health care benefits (this excludes workers who are part-time or seasonal or would not otherwise qualify for benefits while working). Even though not all employees will stay in their positions until retirement, these jurisdictions could potentially have large additions to the number of retirees receiving employer-paid health care. How soon these workers will retire is not yet known for each jurisdiction (but will be estimated as part of actuarial valuations). Yet, as Chapter 1 explained, demographic trends suggest that large cohorts of Minnesota government workers are at or approaching retirement age. As more of them retire, jurisdictions paying for other postemployment benefits will face growing costs.[20]

[20] At the same time, workers hired at older ages may never qualify for the benefits. Half the jurisdictions require most of their workers to have worked 15 years to qualify for retiree benefits; any of their workers who started after age 50 and retired at 65, for instance, will not qualify.

Figure 2.1: Local Jurisdictions by Extent of Employees Who Will Qualify for Retiree Health Care Benefits, 2006



NOTE: Data include only local jurisdictions in our sample that pay for other postemployment benefits. We defined employees qualifying for retiree health care as workers in 2005 who received benefits and would become eligible for retiree health care if they stayed in their positions long enough to meet years-of-service requirements. Benefit-eligible employees typically do not include temporary or seasonal workers or those working only a few hours per week.

SOURCE: Office of the Legislative Auditor, analysis of interviews with local jurisdictions, 2006.

Most jurisdictions began offering other post-employment benefits decades ago when the cost of retiree health care insurance was relatively inexpensive.

CONTROLLING LIABILITIES

Most of Minnesota's local governments and school districts began offering other postemployment benefits decades ago when the cost of retiree health care coverage was relatively inexpensive. Over time, though, many have made changes to these benefits, and we found that:

- **Some local jurisdictions have taken steps to control the growth of liabilities for other postemployment benefits, but many controls will have only limited impacts.**

As Table 2.4 showed, many jurisdictions have structured benefits in ways to control their costs. For instance, employers limited the benefits to only certain employee groups, for specific time periods, and with limited amounts of employer contributions, and some have opted against paying for retiree dependents' benefits.

Further, some jurisdictions have helped control future retiree health care costs by limiting eligibility for the benefit, as shown in Table 2.8. About 54 percent of jurisdictions paying for other postemployment benefits have already reduced or eliminated the health care benefit for at least some groups of employees.

Table 2.8: Local Jurisdictions' Use of Methods to Limit Eligibility for Retiree Health Care Benefits, 2006

Change	Percentage	Impact on Liabilities
Benefits eliminated for newly hired employees		
Change applies to all groups of eligible employees	29%	Bigger Impact
Change applies to some groups	19	Smaller impact
Benefits reduced or capped for newly hired employees		
Change applies to all groups of eligible employees	6	Bigger Impact
Change applies to some groups	6	Smaller impact
Timing of changing benefits for new hires		
Before 1990	6	Bigger Impact
Between 1990 and 1994	10	↕
Between 1995 and 1999	11	
Between 2000 and 2004	4	
Since 2004	8	Smaller Impact
Employees retiring after a certain date have benefits eliminated, reduced, or capped		
Change applies to all groups of eligible employees	15	Bigger Impact
Change applies to some groups	<1	Smaller impact
Total jurisdictions that changed the scope of benefits	54%[a]	

[a] Subtotals do not sum to the total because some jurisdictions used more than one method.

SOURCE: Office of the Legislative Auditor, analysis of interviews with local jurisdictions, 2006.

Changing benefits for newly hired employees will have a far slower impact on liabilities than changing them for new retirees.

How well this change will control liabilities, however, depends on (1) its timing and (2) whether it applies to all or just a portion of eligible employees. Regarding timing, jurisdictions that discontinue paying retiree health care for employees retiring after a certain date will see a more immediate impact on their liabilities than others that discontinue retiree health care for newly hired employees. Changing the retiree health care benefit for employees hired after 2004, for instance, may not have much effect for another 25 or 30 years, depending on the age of the new hires and eligibility requirements. On the other hand, changing the benefit for employees *retiring* after 2004 will have an immediate impact on the liability. Changing benefits for employees already on the job, however, is less common than changing them for new hires, because existing employees are represented at the negotiating table where benefits are typically bargained. Benefit changes that apply to all eligible retirees will have a larger impact than changes that apply to a small proportion of them.

Capping the employer share of retiree health care premiums is another way to control costs. With a cap, as premiums increase the amount the employer pays remains constant. We estimate that 41 percent of local jurisdictions paying for other postemployment benefits have either capped the contribution that the employer makes or make fixed dollar contributions that are not scheduled to change. Nearly all apply the cap to all retiree groups eligible for the benefit. Capping the amount of the employer's contribution will have a larger effect over time than will limiting the employer's share to the amount of the premium paid at the time employees retire; the latter still subjects the employer to medical inflation. For example, the city of St. Paul capped the amount it pays toward retiree health care premiums at $300 per month for employees hired after January 1996.[21] The city's cost for these retirees stays the same even as premiums increase: The 2006 monthly premiums ranged from $332 to $479 for single coverage and $866 to $1,252 for family coverage.

Legal Limits on Ability to Control Liabilities

Most public employers must negotiate with employee bargaining units to change retiree insurance benefits.

Most employers cannot unilaterally change retiree health benefits. In most jurisdictions, proposed changes to health care benefits must be negotiated with employee bargaining units.[22] Several jurisdictions we interviewed discussed changes they would like to institute but cannot without agreement by the employees' exclusive bargaining units. The Minnesota Court of Appeals ruled in 2006 that, under the Public Employee Labor Relations Act, an employer cannot unilaterally reduce the aggregate value of health benefits without first bringing the proposed benefit reductions to the negotiating table.[23]

Changes agreed to in collective bargaining agreements do not automatically permit employers to change benefits for those already retired. In another 2006 case, the Minnesota Supreme Court ruled that the employer's duty to pay the promised health benefits for retirees did not expire when the collective bargaining agreement expired.[24] In this case, the retiree's right to the benefit had been established in the bargaining agreement existing at the time of retirement and could not be changed without the expressed consent of the retiree. From our interviews, we learned that many employers change the design of their health care plans from year to year. Often the design changes apply both to active employees and to retirees, and some jurisdictions explained that they make such changes through processes involving retiree input, such as labor/management committees that contain retired members.

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[21] For St. Paul employees retiring before 1996, the city pays the full premium; for those hired before January 1996 but retiring after that date, the city pays up to $550 for regular retirees and $350 for early retirees.

[22] Some cities and counties do not have employees who are represented by unions; they typically have retiree benefits specified in employee personnel agreements. In a few cases, benefits have been provided in resolutions passed by the city council or county board.

[23] West St. Paul Federation of Teachers v. Independent School District No. 197 West St. Paul, Minnesota, 713 N.W. 2d 366, 14 (Minnesota Court of Appeals, April 18, 2006).

[24] Housing and Redevelopment Authority of Chisholm, Minnesota v. Carolee E. Norman, 696 N.W. 2d 329, 14 (Minnesota Supreme Court, May 19, 2005).

Using Trusts to Fund Other Postemployment Benefits

GASB 45 standards require public employers to report and account for other postemployment benefits in certain ways, but they do not require jurisdictions to actually set aside the money and fund the liability up front. We found that:

- **Although governments are not required to reserve money to pay for other postemployment benefits in the same period that employees earn them, doing so has advantages.**

As mentioned earlier, most Minnesota governments pay for other postemployment benefits only when employees leave their jobs (called a "pay-as-you-go" approach). Some, however, have begun funding these benefits in advance, which means that employers pay for benefits in the same period that employees earn the compensation.

Advance funding for other post-retirement benefits ensures that money is available when it is needed and avoids pushing today's costs off onto future taxpayers.

There are multiple reasons to prefund other postemployment benefits. First, prefunding ensures that money is available at the time it is needed, when employees retire. Second, it recognizes retiree benefits for what they truly are—a form of compensation earned as employees work. Third, with advance funding, current taxpayers pay for services being currently provided, instead of pushing today's costs off onto future taxpayers.

For jurisdictions that decide to prefund retiree benefits, accounting standards require protecting the assets by transferring them to "irrevocable trusts" or equivalent arrangements. The trusts must be structured such that assets are dedicated solely to the purpose of providing benefits to retirees. They must legally protect assets from creditors' claims, including creditors both of the employer and whoever is administering the trust. Further, once contributed to the trust, assets cannot be recovered by the employer for other purposes.

The value of using irrevocable trusts for prefunding other postemployment benefits is two-fold. First, similar to pension funds, a trust provides a guarantee that money will be available for future retirees' benefits. The money is exclusively held in trust for this sole purpose. Second, establishing a trust can lower a jurisdiction's actuarial-estimated liability. This occurs because investment returns from a trust are expected to be higher than those local governments can typically earn through customary investment mechanisms. Minnesota statutes limit local governments to using only certain types of relatively low-risk investments, such as U.S. government bonds and time-deposit accounts insured by the Federal Deposit Insurance Corporation.[25] Irrevocable trusts allow assets to grow faster, because they typically can take advantage of higher-risk investments, such as corporate stocks and international securities.

Accounting standards require converting future liabilities into today's dollars by using a rate based on the long-term expected rate of return on investments. They presume that the long-term return on higher risk investments will be greater than that on lower risk investments. When actuaries use higher rates from returns that irrevocable trusts are expected to produce, liabilities reported in today's dollars

[25] *Minnesota Statutes* 2006, 118A.04, subd. 1-8. On the other hand, *Minnesota Statutes* 2006, 11A.24, subd. 1-6 allow the State Board of Investment to make higher-risk investments.

are lower than otherwise. Lower liabilities mean the jurisdiction owes less to pay its obligation each year for current retirees' health care and the promised benefits. They also may offer advantages in the financial markets as bond rating agencies review jurisdictions' liabilities.

Despite the advantages of irrevocable trusts, we found that:

- **Minnesota's local governments do not have clear authority to establish the trusts that are the funding method required by accounting standards to fund other postemployment benefits.**

In Minnesota, the State Auditor and Attorney General's Office questioned the legal authority to establish trusts for funding other postemployment benefits. In early 2006, the State Auditor wrote of concerns that local governments were creating trusts "without either an express or implied authority" to do so.[26] Further, the Attorney General's Office wrote in June 2006 that it does not believe that local governments are "statutorily authorized to create trust funds for payment of retirees' insurance benefits."[27] Statutes authorize local governments (other than school districts) that pay all or part of insurance premiums for retired employees to levy taxes "in the next annual tax levy" to pay for the premiums.[28] The Attorney General's office has interpreted this statute as suggesting that local governments use a pay-as-you-go approach.

Most local jurisdictions do not currently have plans to set up irrevocable trusts to fund their other post-employment benefit liabilities.

Most local jurisdictions paying for other postemployment benefits told us they do not currently have plans to set up a trust for their liabilities, as Figure 2.2 illustrates. Several indicated they want to set up a trust, but the uncertain legality of trusts has made them hesitate. Most of these jurisdictions have not yet had actuarial valuations conducted but, once they do, knowing the size of their liability for other postemployment benefits may help them make informed decisions about establishing trusts.

Some local jurisdictions indicated they plan to continue their pay-as-you-go approach. We learned about some local governments that have either small liabilities for other postemployment benefits or liabilities that will be paid off within a few years. They told us that the time and money needed to change their approach outweighed any benefit of the change.

Legislation introduced in 2006 would have required local governments interested in setting up a trust for other postemployment benefits to do so using accounts established by the Public Employees Retirement Association (PERA).[29] This bill did not pass. Local governments we interviewed have mixed feelings about proposals to mandate use of accounts for other postemployment benefits through a fund managed by PERA. A plurality indicated that they disagreed with the idea, as shown in Figure 2.3.

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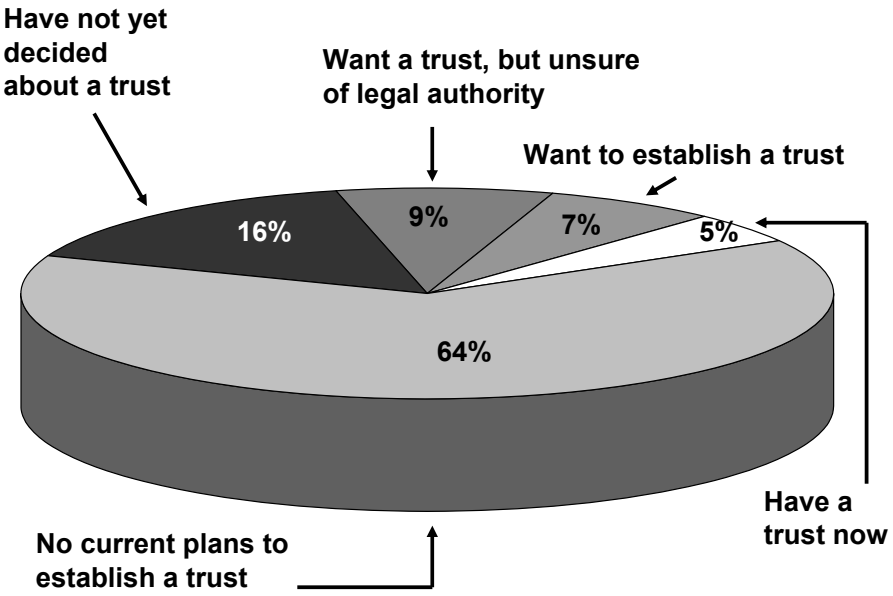
[26] Patricia Anderson, Minnesota State Auditor, letter to Attorney General Mike Hatch, *OPEB Trust,* May 16, 2006.

[27] Kenneth E. Raschke, Jr., Assistant Attorney General, Office of the Attorney General, letter to State Auditor Patricia Anderson, June 6, 2006.

[28] *Minnesota Statutes* 2006, 471.61, subd. 2a. For school districts, *Minnesota Statutes* 2006, 123B.77, subd. 6 requires accounting for retiree health insurance according to uniform financial accounting and reporting standards.

[29] *Senate File 2489*, 1st Engrossment, Minnesota Legislature 2006. The bill's final language provided authority for only the city of Duluth, not other local governments, to reserve money for other postemployment benefits in a PERA account.

Figure 2.2: Use of Trusts to Fund Local Jurisdictions' Other Postemployment Benefits, 2006



NOTE: Numbers do not add to 100 percent due to rounding. Data include only jurisdictions in our sample that pay for other postemployment benefits. The interview question was "Have you established a trust or equivalent account to reserve money for retiree benefits? [If no], do you plan to?"

SOURCE: Office of the Legislative Auditor, analysis of interviews with local jurisdictions, 2006.

Although some jurisdictions reported that they have already set up trusts to fund other postemployment benefits, authority to do so is in dispute, and we believe that local governments and school districts need clear authority in this matter. We recommend that:

RECOMMENDATION

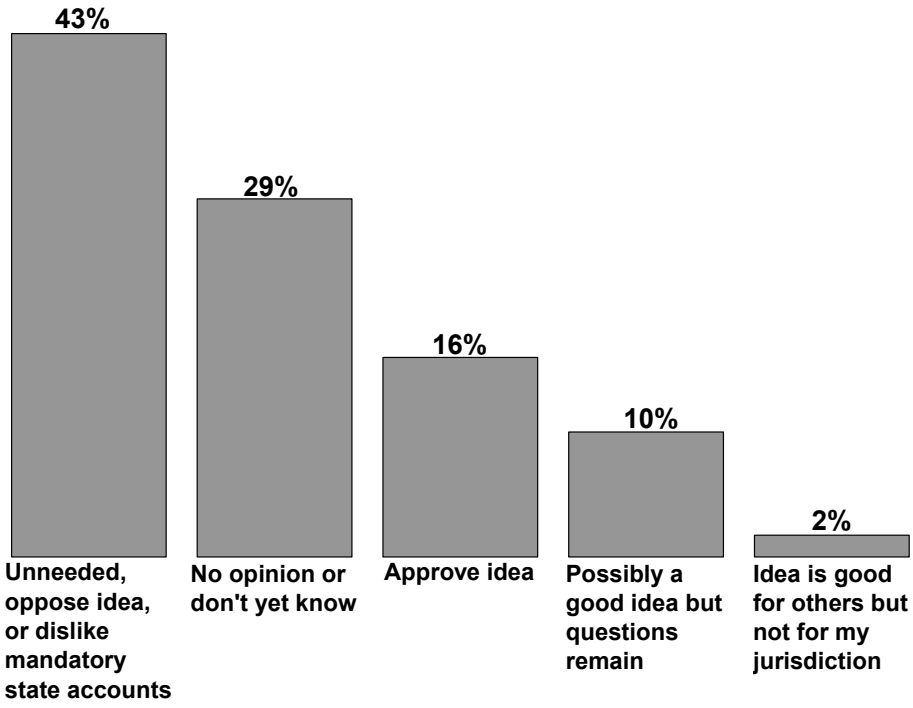
The Legislature should amend Minnesota Statutes to allow local governments to establish trusts for funding other postemployment benefits.

Statutes should specify legal title to ownership of trust fund assets and prescribe fiduciary standards for trustees.

In addition to granting authority for establishing trusts, statutes should specify the legal title to asset ownership and prescribe fiduciary duties and standards for trustees. Requirements for public pensions provide an example: statutes specify who holds title to pension plans' assets and the types of investment securities that plans are authorized to use.[30] For fiduciaries charged with managing a pension plan and its assets, statutes set a "prudent person" investment standard, which requires fiduciaries to use the judgment and care that persons of prudence,

[30] *Minnesota Statutes* 2006, 356A.06, subd. 1, 6-8.

Figure 2.3: Local Jurisdictions' Opinions on Mandating Use of PERA-Managed Accounts to Fund Other Postemployment Benefits, 2006



NOTE: Data include only local jurisdictions that pay for other postemployment benefits. The interview question was "Legislators this year considered a bill to require local governments interested in establishing such a trust to do so through a fund managed by PERA. This did not pass, but would your jurisdiction consider such a law helpful or not?"

SOURCE: Office of the Legislative Auditor, Analysis of Interviews With Local Jurisdictions, 2006.

discretion, and intelligence would exercise in their own affairs.[31] They also require fiduciaries to file statements of economic interest and proscribe activities that would personally profit the fiduciaries. We believe that it would behoove local jurisdictions to follow similar standards when they set up trusts for investing money to pay for other postemployment benefits.

Less obvious is whether local jurisdictions ought to be required to use the State Board of Investment to manage assets. There are advantages and disadvantages to state-managed accounts. First, the State Auditor's Office suggests that investments through the State Board of Investment can improve local governments' rates of return.[32] The State Board of Investment uses a public pension standard for investing assets, which, as noted earlier, allows investments in equities and other investments that statutes currently prohibit for local governments. Second, the investment performance for the State Board of

[31] *Minnesota Statutes* 2006, 356A.04, subd. 2; and 11A.09.

[32] Office of the State Auditor, *Other Postemployment Benefit Liability of Local Governments in Minnesota*, 31.

Investment has been stronger than certain comparable local investments. A comparison of rates of return for the State Board of Investment and volunteer firefighter relief associations showed that an account in the board's Supplemental Investment Fund averaged an annual return of 7.7 percent for 1997-2004, which was three percentage points higher than the average return for volunteer firefighter pension funds.[33]

The State Board of Investment can offer local jurisdictions attractive investment options to help fund their other postemployment benefits.

Third, Minnesota already has a model illustrating how local government accounts could be centrally managed. Volunteer firefighter relief associations have the option of investing their pension assets through the State Board of Investment's Supplemental Investment Fund. They have options among various accounts ranging from lower to higher risks and may select accounts that best meet their investment needs. Fourth, the State Board of Investment told us that it has historically offered low fees for its investment services. For its Supplemental Investment Fund, the State Board of Investment had management fees ranging from $0.01 to $0.30 per $100 invested in 2006, and staff said public employers could be charged a 1 percent or 2 percent fee elsewhere for managing investments.[34] According to the board's staff, over time, the difference represents significant amounts that can affect a jurisdiction's rate of return.

At the same time, some local governments expressed concern about state management of funds for retiree benefits, citing prior financial troubles of state funds or apprehension over losing control of local money. Others stated they believe they can achieve better investment results than they could using the state to manage investments. Although we did not analyze financial conditions of state and local investments, we are concerned about the mistrust voiced by some jurisdictions. Requiring local jurisdictions to invest only through a state-managed account may be a disincentive to establishing a trust for those who strongly oppose the concept of the state managing local money.

For jurisdictions establishing trusts to fund retiree benefits, state-managed accounts need not be mandatory.

Beyond that, if the Legislature amended statutes to allow local governments to establish trusts, it could also authorize those that meet fiduciary standards to use the same investment securities open to the State Board of Investment. Laws for pension plans permit a broader array of investment securities for the plans that meet certain requirements, including size of assets and use of an investment advisor or the State Board of Investment for investing at least 60 percent of plan assets.[35] Expanded investment authority for local jurisdictions establishing trusts could be predicated on certain standards, such as the use of registered investment advisors.

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[33] The comparison was for the State Board of Investment's Income Share Account, which is a medium-risk account open to volunteer firefighter relief associations. Office of the Legislative Auditor, *Pensions for Volunteer Firefighters* (St. Paul: January 2007). A similar result was found in a 2002 study comparing investment performance among Minnesota's larger public pension funds. See Ed Burek, Deputy Director, Legislative Commission on Pensions and Retirement, memorandum to members, *Larger Public Pension Fund Investment Performance Overview*, August 20, 2002.

[34] State Board of Investment, *Minnesota Supplemental Investment Fund Prospectus July 1, 2006* (St. Paul, July 2006), 6-12. Investment management fees vary by type of account and factors such as whether the account is managed actively or passively.

[35] *Minnesota Statutes* 2006, 356A.06, subd. 6-7.

We think that while state-managed accounts should be an option for local jurisdictions and should be encouraged, they need not be mandatory. Local governments' decisions to pay for other postemployment benefits were made independently, just as they were for setting workers' salaries, based on jurisdictions' knowledge of what was required to attract and retain workers with the necessary skills and abilities to do the work. We believe these jurisdictions are also in a position to understand their own financial conditions and make decisions about how to best fund the benefits they granted.

State Involvement

Even though liabilities for other postemployment benefits around the state have not yet been estimated by actuaries, it appears that local governments with significant liabilities are not widespread. We concluded that:

- **Beyond granting authority to establish trusts, the state does not need to intervene in local management of liabilities for other postemployment benefits at this time.**

Jurisdictions likely to have the largest liabilities have been identified for the most part, and several are taking steps to control the benefits' costs or reserve money to pay for them. Further, assuming that the Legislature grants authority to establish irrevocable trusts, local governments that use the authority could earn higher investment returns and lower their liabilities.

Still, some local jurisdictions, which are among those with high spending for other postemployment benefits and may have correspondingly high liabilities, have not yet taken steps to control their costs for the benefits. Despite the difficulty of making such changes, individual jurisdictions have opportunities to pursue local efforts at curtailing costs. Based on our interviews with jurisdictions paying for other postemployment benefits, we believe much more can be done locally before calling for state intervention. The appropriate steps to take will vary tremendously from location to location, just as the scope of the benefits varies. At this point, state action (beyond authorizing the establishment of irrevocable trusts) could diminish incentives for local jurisdictions to control costs on their own.

3 Pensions

SUMMARY

Widely reported funding ratios make statewide retirement plans appear better funded than they really are because they assume that the Postretirement Fund is fully funded when it actually has a deficit of about $4 billion. In addition, there is no effective mechanism in place to eliminate the fund's deficit. We recommend that the fund's deficit be recognized in funding ratios of statewide pension plans and that the Legislature develop a plan to fully fund the Postretirement Fund at the same time it eliminates investment-based postretirement benefit increases and enhances inflation-based increases. In addition, the St. Paul Teachers' Retirement Fund has a large unfunded liability, and its payroll contributions are insufficient to fully fund the plan in the foreseeable future. To restore the financial health of the St. Paul Teachers' Fund, we recommend that the Legislature consider increasing contributions to the fund. Further, for both of the St. Paul and Duluth Teachers' Retirement Funds, the Legislature should change the formula for postretirement benefit increases to disallow investment-based increases when a fund has a large deficit. The Legislature should also consider replacing those funds' formulas for postretirement benefit increases with formulas based on inflation.

In Chapter 2, we discussed the fact that several Minnesota communities with large liabilities for retiree health benefits have not prefunded these benefits. While mechanisms are in place to fund Minnesota's pension benefits, there is ongoing concern that some plans are not adequately funded. In this chapter, we address the following questions:

- **What is the structure of Minnesota's pension system for public employees?**
- **What are the financial conditions of Minnesota's statewide pension funds?**
- **How well has Minnesota's formula worked for increasing pension benefits after retirement?**
- **What are the financial conditions of Minnesota's local pension funds?**

To answer these questions, we interviewed officials from major state and local retirement plan organizations, the Legislative Commission on Pensions and Retirement, and the State Board of Investment. We also examined documents prepared by these organizations, actuarial valuations, and other pension studies.

PENSION SYSTEM STRUCTURE

As we mentioned in Chapter 1, most public employees in Minnesota have a defined benefit pension plan, which typically defines the employees' pension benefits in terms of retirement age, years of service, and the highest average salary during any five-year period. These benefits are paid by collecting employee and employer contributions during the employees' careers and investing those contributions until the benefits are paid. Typically, employees pay half or nearly half of the cost of funding these benefits.

Minnesota's statewide pension plans cover most public employees in state and local governments, including school districts.

Minnesota's statewide pension plans cover most public employees in Minnesota, including state, county, city, and school district employees. The Minnesota State Retirement System (MSRS) administers ten pension plans covering most state employees, civil service employees of the University of Minnesota, and certain employees of metropolitan agencies. The Teachers Retirement Association (TRA) administers a pension plan that covers teachers and administrators from all public school districts in Minnesota except St. Paul and Duluth as well as some college faculty from the Minnesota State Colleges and Universities system. The Public Employees Retirement Association (PERA) administers three plans that cover employees from local units of government, including counties and cities and certain school district employees. All of these statewide plans use the State Board of Investment to invest pension fund assets.

Minnesota has seven local pension plans, not including pension plans for volunteer firefighters.[1] These include two teacher retirement associations (St. Paul and Duluth), four plans for local police or firefighters, and a retirement plan for Minneapolis city employees. Local associations administer each of the local pension plans, but benefits are defined in *Minnesota Statutes*. The Minneapolis Employees Retirement Plan has one fund for employees and one for retirees, the same structure used by statewide plans, as described below. Each of the other local pension plans has one pension fund that includes assets for active employees and retirees. The local pension associations determine how to invest their pension fund assets, under parameters set in state law.

Five of the seven local retirement plans were closed to new members between 1974 and 1980, including the Minneapolis Employees Retirement Plan and all four local police and fire plans. Employees from these jurisdictions not covered by the local retirement plan are covered by one of the statewide plans administered by PERA.

Altogether, Minnesota's defined benefit plans cover about 296,000 employees and 148,000 retirees, beneficiaries, and disabled members, as shown in Table 3.1. The largest three plans—the Public Employees Retirement Plan, the Teachers Retirement Plan, and the State Employees Retirement Plan—account for about 86 percent of all plans' members receiving pension benefits. Local pension plans have about 10,000 members receiving pension benefits, including 5,000 members of the Minneapolis Employees Retirement Plan.

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[1] Minnesota has over 700 pension funds for volunteer firefighters. In early 2007 our office released an evaluation of these funds, *Pensions for Volunteer Firefighters*.

Table 3.1: Membership in Minnesota's Defined Benefit Public Pension Plans, 2006

	Employee Members	Retirees, Beneficiaries, and Disabled Members
Public Employees Retirement Association Plans		
Public Employees Retirement Plan	144,244	59,078
Public Employees Police and Fire Plan	10,591	6,801
Local Government Correctional Service Retirement Plan	3,531	223
Teachers Retirement Association Plan	79,164	44,683
Minnesota State Retirement System		
General State Employees Retirement Plan[a]	48,000	24,204
Correctional Employees Retirement Plan	3,910	1,375
State Patrol Retirement Plan	851	846
Judges Retirement Plan	303	261
Legislators Retirement Plan	76	319
Elective State Officers Retirement Plan	0	15
Local Teacher Retirement Plans		
St. Paul Teachers' Retirement Fund	4,202	2,624
Duluth Teachers' Retirement Fund	1,174	1,190
Local General Employee Retirement Plans		
Minneapolis Employees Retirement Plan	335	4,882
Local Police and Fire Plans		
Minneapolis Police Relief Association	17	904
Minneapolis Firefighters' Relief Association	37	601
Virginia Fire Department Relief Association	0	17
Fairmont Police Relief Association	0	14
Total	296,435	148,037

Minnesota's defined benefit pension plans cover about 444,000 employees, retirees, and others receiving benefits.

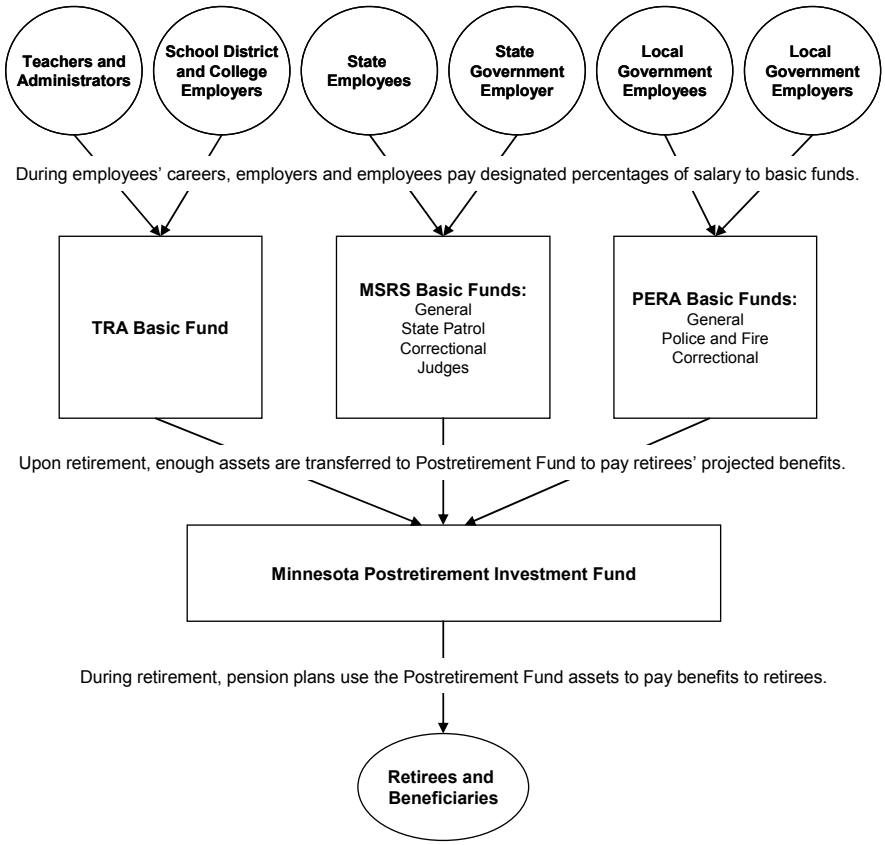
NOTE: The Legislators Retirement Plan and the Elective State Officers Retirement Plan are closed to new members. Some people are members of more than one retirement plan. Figures exclude terminated members who are vested. Figures for statewide plans, local teacher plans, and local general employee plans are for July 1, 2006, while figures for the local police and fire plans are for December 31, 2005.

[a] Figures for the General State Employees Retirement Plan include results for the Military Affairs Retirement Plan, the Transportation Department Pilots Retirement Plan, and the State Fire Marshal Division Arson Investigator Retirement Plan.

SOURCES: Office of the Legislative Auditor, analysis of actuarial valuations for plans administered by: PERA, TRA, MSRS, St. Paul Teachers' Retirement Fund Association, and Duluth Teachers' Retirement Fund Association; http://www.commissions.leg.state.mn.us/lcpr/valuations.htm; Van Iwaarden, *Minneapolis Firefighters' Relief Association Special Fund, Minneapolis Police Relief Association Special Fund,* and *Fairmont Policemen's Relief Association* (Minneapolis, MN: Van Iwaarden, May and July 2006); Gabriel Roeder Smith & Company, *Virginia Fire Department Relief Association,* (Chicago, IL: Gabriel Roeder Smith & Company, April 6, 2006).

Minnesota has a two-part structure for its statewide pension plans, as Figure 3.1 shows. Each statewide plan has a "basic" fund that contains assets for working members, but all statewide plans, except for the Elective State Officers' Plan, use the Postretirement Investment Fund for retirees. The Postretirement Fund pools assets for retirees from each plan. While pension plan members are working, employees and employers contribute a designated percentage of employees' salaries to the basic funds. Upon retirement, enough assets projected to cover the retirees' benefits are transferred from the basic fund to the Postretirement Investment Fund. During retirement, pension plan administrators use the Postretirement Fund's assets to pay pension benefits to retirees.

Figure 3.1: Minnesota Defined Benefit Statewide Pension Fund Structure



NOTE: This figure excludes two MSRS-administered plans that are closed to new members: the Legislators Retirement Plan and the Elected State Officers Retirement Plan.

SOURCE: Office of the Legislative Auditor analysis.

The Postretirement Investment Fund brings together assets for retirees from each of the statewide basic pension funds, but it is not a retirement plan.

FINANCIAL CONDITIONS OF STATEWIDE PENSION PLANS

We analyzed the financial condition of pension plans based on two key indicators. The first indicator is the funding ratio, that is, the ratio of assets to liabilities.[2] A funding ratio of 100 percent means that the fund is estimated to have enough assets to pay the liabilities already accrued as of the valuation date. The second indicator is whether current contribution levels—typically from employer and employees—are sufficient for the pension plan to reach fully-

[2] Funding ratios are defined as actuarial assets as a percentage of actuarial accrued liability. Actuarial assets are obtained by recognizing changes in market value over a five-year period. To determine actuarial accrued liability, actuaries estimate future pension liabilities for each employee and divide that amount among the employee's expected years of service. Actuarial accrued liability is the liability attributable to employee service performed as of the specified date.

funded status by a target date designated in statute. An adequate contribution level means that the employer and employee contribution levels are sufficient to keep pace with liabilities that are being incurred each year, plus pay off any deficit by the target date. Both indicators are based on the principle that pension benefits ought to be funded during an employee's career rather than as benefit payments come due.

Funding Ratios

We found that:

- **Based on currently reported funding ratios—the ratio of assets to liabilities—Minnesota's statewide public pension plans range from being well funded to having large deficits.**

As Table 3.2 shows, the July 1, 2006, funding ratios for the three major statewide pension plans ranged from a low of 75 percent for the Public Employees Retirement Plan administered by PERA to a high of 96 percent for the General State Employees Retirement Plan administered by MSRS. The Teachers Retirement Association Plan was almost fully funded as of July 1, 2005, (99 percent), but in 2006 TRA merged with the Minneapolis Teachers' Retirement Association, leaving the TRA plan with a funding ratio of about 92 percent.

The PERA Public Employees Retirement Plan has a deficit of $4.2 billion.

The Public Employees Retirement Plan has a large deficit of $4.2 billion because of insufficient contribution rates, changing demographics, and benefit improvements. Even though investment returns, on average, have met actuarial assumptions over the past 15 years, the fund still has a large deficit. After 1990, the plan's contribution rates have been deficient for 14 out of 16 years, meaning that employer and employee contribution rates have not been high enough to reach full funding by its target date, which is currently 2031.

Changing demographics and increasing benefits help explain the deficient contribution rates for the Public Employees Retirement Plan. For example, in 1997, actuaries found that the assumptions for employee turnover and mortality were too high, creating a bigger fund deficit than had been recognized. When employee turnover is lower than the assumed turnover rate, the deficit increases because employees who leave prior to retirement receive much lower benefits than employees who stay until retirement. Lower than expected mortality rates increase the deficit because the fund must pay benefits for a longer time period. To cover the resulting higher costs, the plan needed additional contributions of 2 percent of payroll. The Legislature did not raise contribution rates to address this problem until 2001, but even at that, the increase was still 1 percentage point short of what was necessary.

The Legislature increased retirement benefits for members of statewide retirement plans, including PERA during the 1980s and 1990s. The 1982 Legislature created the "Rule of 90" benefit for the PERA plan, under which employees whose age plus years of service equaled 90 or above could retire without the penalty that normally applies to employees who retire before age 65. The 1989 Legislature increased the retirement benefit for employees who retired

Table 3.2: Financial Status of Minnesota's Statewide Pension Plans, July 1, 2006

	Assets (millions)	Liabilities (millions)	Deficit (millions)	Funding Ratio
Public Employees Retirement Association				
Public Employees Retirement Plan	$12,495	$16,738	$4,243	75%
Public Employees Police and Fire Plan	5,018	5,261	243	95
Local Government Correctional Employees Retirement Plan	126	133	8	94
Teachers Retirement Association Plan	19,036	20,679	1,643	92
Minnesota State Retirement System				
General State Employees Retirement Plan[a]	8,487	8,819	332	96
State Patrol Retirement Plan	619	641	22	96
Correctional Employees Retirement Plan	535	647	112	83
Judges Retirement Plan	152	202	50	75
Legislators Retirement Plan	49	81	33	60
Elective State Officers Retirement Plan	0.2	4	4	5
Minnesota Postretirement Investment Fund[b]	22,050	26,089	4,039	85

NOTE: The Elective State Officers Plan and the Legislators Retirement Plan have unusually low funding ratios largely because they rely on pay-as-you-go funding.

[a] Figures for the General State Employees Retirement Plan include results for the Military Affairs Retirement Plan, the Transportation Department Pilots Retirement Plan, and the State Fire Marshal Division Arson Investigator Retirement Plan.

[b] The Minnesota Postretirement Investment Fund is not a pension plan. Its assets and liabilities are included in the actuarial valuations for the statewide pension plans administered by PERA, TRA, and MSRS. As we discuss in this chapter, however, the Postretirement Fund's deficit is not reflected in valuations for the pension plans.

SOURCES: Office of the Legislative Auditor, analysis of actuarial valuations for pension plans administered by: MSRS, PERA, TRA; http://www.commissions.leg.state.mn.us/lcpr/valuations.htm; Howard Bicker, State Board of Investment, interview, December 20, 2006.

at age 65 or older by up to 5 percent of employees' average salary.[3] In 1997, the Legislature increased the normal retirement benefit from 1.5 to 1.7 percent of an employee's "high-five" salary per year of service.[4]

[3] Prior to 1989, the normal retirement benefit equaled 1.0 percent of average "high-five" salary for each year of service for the first ten years plus 1.5 percent per year of service after the tenth year. In 1989, the Legislature adopted a two-tier benefit structure. Employees hired before July 1, 1989, could choose the existing benefit formula or a new formula. Employees hired on or after July 1, 1989, must use the new formula. Under the new formula, benefits were set at 1.5 percent per year of service for all years, an improvement over the old formula. If employees retired early under the new formula, however, they received larger penalties for retiring early than they received under the old formula. Employees who chose to retire under the rule of 90 had to use the old formula. Employees hired after July 1, 1989, could not use the rule of 90.

[4] Under the old formula, benefits were increased from 1.0 to 1.2 percent of the high-five salary for the first ten years of service.

Three of the four public safety plans had funding ratios over 90 percent as of July 1, 2006, including two administered by PERA, the Public Employees Police and Fire Retirement Plan and the Local Government Correctional Employees Retirement Plan, and the State Patrol Retirement Plan administered by MSRS. The MSRS Correctional Employees Retirement Plan's funding ratio dropped from 92 percent in 2005 to 83 percent in 2006 because of changes in mortality, employee turnover, disability incidence, and retirement rates.

Deficits in the PERA, MSRS, and TRA pension plans amounted to $6.7 billion.

Among the three smaller MSRS specialty plans, funding ratios were low because the state has used or is using a "pay-as-you-go" plan instead of prefunding the plans. The largest specialty plan, the judges plan, had a funding ratio of 75 percent as of July 1, 2006. Until 1973, it was largely a pay-as-you-go system, meaning that the state paid pension benefits as the annuities came due. Between 1973 and 1991, the plan was partially prefunded. The employees paid their share while they worked, but the state paid its share upon each judge's retirement.[5] In 1991, the state began prefunding the plan in the same way it does for the major statewide plans, that is, making regular contributions during the employees' careers. For the Legislators Retirement Plan, the state paid its share of the pension cost upon retirement until 2004, when it switched to pay-as-you-go funding. The Elective State Officers Plan also uses pay-as-you-go funding. While a sizeable portion of the liabilities for these specialty plans is not funded, the combined deficit in these plans is small compared with the unfunded liability in the much larger State Employees Retirement Plan.

The total unfunded liability—or deficit—reported for the statewide retirement plans was about $6.7 billion, most of which was in the PERA Public Employees Retirement Plan for local government employees ($4.2 billion). These deficits, however, only include deficits in the basic funds; they do not include the large deficit of the Postretirement Fund, which had a $4 billion deficit as of July 1, 2006. This $4 billion deficit is about 8 percent of the total liabilities of pension plans that participate in the Postretirement Fund. The Postretirement Fund's funding ratio was about 85 percent.

These deficits do not include a $4 billion deficit in the Postretirement Fund.

Benefit increases for Minnesota's Postretirement Investment Fund members (based in part on stock market gains in the 1990s), in combination with later stock market declines, created the fund's large deficit. The Postretirement Fund benefit formula, established in 1992, gives two types of benefit increases to retirees. The first is an inflation-based increase equal to the change in the consumer price index for wage earners (CPI-W) up to a maximum of 2.5 percent.[6] The second is based on investment gains that exceed the amount the fund must earn to pay the retirees' benefits, including the inflation-based increase. Typically, the threshold is 8.5 percent per year, but it is less if inflation is under 2.5 percent.[7] The formula smooths investment gains and losses over a five-year period. If the fund has a deficit, no investment-based increase can be given. During the 1990s, the Postretirement Fund built up large surpluses as

[5] Beginning in 1973, employees (judges) made contributions to the retirement fund during their careers.

[6] In fiscal years 1993-1997, the postretirement benefit formula's inflation component had a cap of 3.5 percent. In FY 1998, it was reduced to 2.5 percent to partially offset the cost of increasing the normal retirement benefit from 1.5 to 1.7 percent of high-five average salary per year of service.

[7] The threshold equals 6 percent plus the inflation adjustment.

The legislatively-established formula to increase benefits after retirement is based on inflation and investment returns.

investment earnings consistently exceeded the threshold of 8.5 percent. By 1999, it had an estimated surplus of $4 billion. Because of the large investment earnings, the postretirement formula gave permanent annual benefit increases averaging 9.2 percent during 1996-2001. But when the stock market declined after 2000, benefits remained at the increased levels; in fact, they increased during this period because of adjustments due to inflation. As a result, the fund went from a $4 billion surplus in 1999 to a $5 billion deficit in 2003.

The funding ratios for each of the statewide retirement plans are based on the retirement plan's basic fund and the plan's portion of the Postretirement Fund. When we reviewed the method for calculating the funding ratios, we found that:

- **The funding ratios widely reported for the statewide retirement plans make the plans appear better funded than they really are.**

The funding ratio calculations do not properly value the Postretirement Fund's assets. Statement Number 25 of the Governmental Accounting Standards Board states that pension fund assets should be valued on the basis of a market-related value.[8] The calculations used by Minnesota's statewide pension plans, however, are based on the assumption that the Postretirement Fund is fully funded even though it really has a deficit estimated to be $4 billion as of July 1, 2006. Normally, funding ratios equal assets divided by the liabilities. The funding ratio calculation used by Minnesota's statewide plans, however, puts the Postretirement Fund's liabilities in both the numerator and the denominator. Upon an employee's retirement, the assets put into the Postretirement Fund equals the estimated liabilities, but in subsequent years, the funding ratios do not recognize any changes in asset values due to unusually strong or weak investment returns.

However, no investment-based increase may be made to pension benefits as long as the Postretirement Fund has a deficit.

The rationale for calculating the funding ratios in this way is to make them consistent with the way deficits are addressed in *Minnesota Statutes*. *Minnesota Statutes* address deficits in the Postretirement Fund in a different way than in basic retirement funds.[9] For basic retirement funds, deficits are to be remedied by increasing employer or employee contributions. *Minnesota Statutes* require actuaries to determine the amount of contributions necessary for the basic fund to be fully funded by a designated target date.[10] Statutes contain no such provision for the Postretirement Fund. Instead, deficits in the Postretirement Fund are restored only by achieving investment returns that exceed 8.5 percent and by retaining those excess earnings within the fund instead of giving investment-based benefit increases to retirees.

The problem with this rationale is that there is no mechanism in place to ensure that the Postretirement Fund will achieve or maintain full funding. It is misleading to characterize the Postretirement Fund as fully funded just because

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[8] Governmental Accounting Standards Board, *Statement No. 25 of the Governmental Accounting Standards Board, Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans* (Norwalk, CT: Governmental Accounting Standards Board, November 1994), Paragraphs 36-37.

[9] In addition, the Actuarial Standards for the Legislative Commission on Pensions and Retirement require actuaries to set the value of Postretirement Fund assets equal to the fund's liabilities.

[10] *Minnesota Statutes* 2006, 356.215, subd. 11.

Eliminating the deficit within 10 years will require the Postretirement Fund to earn an average of 11 percent annually.

the Legislature intended the Postretirement Fund to be self correcting. Under current law, the only mechanism to protect the Postretirement Fund is a provision that the benefit formula not give investment-based increases when the fund has a deficit. This helps protect the fund from creating even larger deficits in the future, but does not ensure that the fund will reduce its existing deficit. Restoring the Postretirement Fund to full funding is problematic because the fund needs to earn an average return of more than 8.5 percent for an extended time period to eliminate the deficit. Actuaries for TRA estimated that to eliminate the Postretirement Fund deficit within ten years, the Postretirement Fund would have to earn at least 11 percent per year.[11] While this is possible, the director of the State Board of Investment and fund actuaries do not think it is likely. In fact, actuaries for the major statewide plans have proposed reducing the assumed rate of return for pension investments from 8.5 to 8.25 percent.

We think reporting the financial condition of retirement plans should be kept separate from how deficits are funded.

RECOMMENDATION

To properly reflect actual financial conditions, the Legislature should require that funding ratios for the TRA, PERA, and MSRS retirement plans value Postretirement Fund assets on the basis of market-related values.

To accomplish this change, the Legislature should revise the statutes pertaining to how the Postretirement Fund's assets are valued in retirement plans' funding ratios. Furthermore, the Legislative Commission on Pensions and Retirement should change its actuarial standards to direct actuaries to value Postretirement Fund assets at market value. Changing the statewide retirement plans' valuations to reflect the Postretirement Fund deficit would make them consistent with governmental accounting standards. It would also reduce their current funding ratios. To estimate this effect for individual plans, we recalculated the July 1, 2006, funding ratios for the six largest statewide plans to include the Postretirement Fund deficit, as shown in Table 3.3. By reflecting the deficit, the statewide plans' 2006 funding ratios would decline from 6 to 10 percentage points. The overall funding ratio for Minnesota's statewide defined benefit plans would change from 87 to 80 percent.

Sufficiency of Contributions to Pension Plans

As stated earlier in this chapter, the second indicator of a pension plan's financial condition is whether contributions from employees, employers, and other sources, if any, are sufficient for the pension plan to reach full funding by a target date designated in statute. If contributions are deficient, the pension plan's future contribution requirements will likely need to be higher to meet its target full-funding date. To determine whether contributions are sufficient, we examined

[11] Letter from Buck Consultants, a consulting actuary for the Teachers Retirement Association, to Laurie Fiori Hacking, Executive Director of the Teachers Retirement Association, *Analysis of Post Fund Deficit*, April 11, 2006.

Table 3.3: Impact of Recognizing Postretirement Fund Deficit on Statewide Pension Plan Funding Ratios as of July 1, 2006

	Funding Ratio	
	Original	Revised
Public Employees Retirement Association		
Public Employees Retirement Plan	75%	68%
Public Employees Police and Fire Plan	95	88
Teachers Retirement Association Plan	92	82
Minnesota State Retirement System		
General State Employees Retirement Plan	96	90
State Patrol Retirement Plan	96	88
Correctional Employees Retirement Plan	83	77

NOTE: Unlike the original funding ratios, the revised funding ratios recognize the Postretirement Fund's deficit because they value the Postretirement Fund assets at market value. Currently, actuaries use a five-year smoothing method to value basic fund assets when calculating funding ratios. The above "original" and "revised" figures are both based on this method for basic fund assets. If instead, the funding ratios valued basic fund assets at market value, the above funding ratios would increase by 2 to 4 percentage points.

SOURCES: Office of the Legislative Auditor, analysis of MSRS, TRA, and PERA actuarial valuations and Dave Bergstrom, MSRS Executive Director, Laurie Fiori Hacking, TRA Executive Director, and Mary Most Vanek, PERA Executive Director, memorandum to MSRS Board of Directors, PERA Board of Trustees, and TRA Board of Trustees, *Minnesota Post Retirement Investment Fund*, December 5, 2006.

current contribution levels and changes in those levels recently enacted into law. We reviewed how the amount contributed by the employer and employee—typically expressed as a percentage of payroll—compares with the amount determined by actuaries as necessary to achieve full funding by the target date. We found that:

Recognizing the Postretirement Fund's deficit would lower the pension plans' funding ratios by 6 to 10 percentage points.

- **Increased employer and employee contributions enacted into law during 2005 and 2006 are projected to nearly restore the basic statewide pension funds to fully funded status by 2037 or earlier, but they will not address the Postretirement Fund deficit.**

In 2005, the Legislature increased contributions to fully fund the basic funds of the Public Employees Retirement Plan and the Public Employees Police and Fire Plan by about 2031 and 2020, respectively.[12] Employer and employee contribution increases to the Public Employees Retirement Fund are being phased in and will reach 13 percent in 2010. After the phase-in period, the total contributions will be slightly higher than the amount needed to reach full funding by 2031, as shown in Table 3.4. Contributions for the Public Employees Police

[12] Fully funded target dates, specified in *Minnesota Statutes*, range from 2020 to 2037 for Minnesota's major statewide retirement plans. *Minnesota Statutes* 2006, 356.215, subd. 11 provides a procedure for extending the target date if contribution requirements increase due to a change in assumptions, benefits, or actuarial method used to calculate contribution requirements.

Table 3.4: Sufficiency of Employee and Employer Contributions for Statewide Pension Plans as of July 1, 2006

	Target Date for Full Funding	Contributions Required for Full Funding	Scheduled Contributions		Funding Adequacy After Phase In
			Current	After Phase In	
Public Employees Retirement Association					
Public Employees Retirement Plan	2031	12.90%	11.76%	13.00%	0.10%
Public Employees Police and Fire Plan	2020	25.57	18.50	23.50	-2.07
Local Government Correctional Employees Retirement Plan	2023	12.68	14.58	14.58	1.90
Teachers Retirement Association Plan	2037	12.11	11.31	11.85	-0.26
Minnesota State Retirement System					
General State Employees Retirement Plan[a]	2020	10.11	8.00	10.00	-0.11
State Patrol Retirement Plan	2036	26.69	21.00	26.00	-0.69
Correctional Employees Retirement Plan	2020	23.34	13.67	20.70	-2.64
Judges Retirement Plan	2020	30.73	28.09	28.5	-2.23
Legislators Retirement Plan	Uses pay-as-you-go funding				
Elective State Officers Retirement Plan	Uses pay-as-you-go funding				

NOTE: Contributions are shown as a percentage of salary. Negative numbers are deficiencies. Contributions are scheduled to increase over time in some plans, and "After Phase In" represents the contributions after the scheduled increase is complete.

[a] Figures for the General State Employees Retirement Plan include results for the Military Affairs Retirement Plan, the Transportation Department Pilots Retirement Plan, and the State Fire Marshal Division Arson Investigator Retirement Plan.

SOURCES: Office of the Legislative Auditor, analysis of actuarial valuations for plans administered by PERA, TRA, and MSRS; http://www.commissions.leg.state.mn.us/lcpr/valuations.htm.

and Fire Plan are scheduled to reach 23.5 percent in 2009, slightly below the 25.6 percent required to achieve full funding by 2020.

In 2006, the Legislature raised contribution rates for the MSRS State Employees Retirement Plan and the Correctional Employees Retirement Plan to eliminate their deficits by about 2020. The 2006 valuation, released on December 1, 2006, indicates that the Correctional Plan's contributions will be about 2.6 percentage points short.

For TRA, employer and employee contributions as of July 1, 2005, were about 1 percent of payroll higher than necessary to maintain full funding. Because TRA acquired a deficit after its July 1, 2006, merger with the Minneapolis Teachers' Retirement Fund Association, the Legislature used a variety of funding sources to help eliminate the deficit in TRA's basic fund by 2037. The Legislature raised employer contribution rates for school districts by 0.5 percent of payroll and redirected money from the state and Minneapolis schools that was previously used to help the Minneapolis Teachers' Retirement Fund Association. In addition, almost half of TRA's previous excess contributions (0.43 percent of payroll) were used to help eliminate the deficit.[13]

[13] The remaining portion of its excess contributions were used to help finance an increase in the retirement benefit from 1.7 percent to 1.9 percent of average high-five salary per year of service after July 1, 2006. Employee contributions were also increased from 5.0 to 5.5 percent of salary to help finance this benefit improvement.

Actuaries estimate that the increases in employee and employer contribution rates will likely bring the statewide basic funds to fully funded status, but as we discussed earlier in this chapter, there is no mechanism to ensure that the Postretirement Investment Fund will become fully funded.

Actuaries use economic and demographic assumptions to estimate pension funds' financial conditions.

Reasonableness of Assumptions

The accuracy of the funding ratios and contribution requirements estimated by actuaries depends on the reasonableness of the underlying economic and demographic assumptions they use to make these estimates. Table 3.5 lists the type of assumptions used by actuaries. Economic assumptions involving the rate of return on retirement fund investments, salary increases, and payroll growth are set in statute and can be changed only by changing the law. Changes in demographic assumptions must be approved by the Legislative Commission on Pensions and Retirement. Actuaries annually review the assumptions when they prepare their valuation reports for the pension plans. For the three major statewide plans, actuaries conduct more thorough reviews every four years that compare actual experience with the plan's demographic and economic assumptions. Actuaries conduct these more thorough experience studies on an "as needed" basis for the other plans.

Table 3.5: Economic and Demographic Assumptions Used in Valuing Pension Funds

Economic Assumptions[a]	Demographic Assumptions[b]
• Payroll growth	• Mortality rates for retirees, employees, and disabled participants
• Future salary increases	• Retirement rates
• Rate of return on investments	• Rates of withdrawing from the workforce
	• Disability incidence rates
	• Rates of marriage; presence and age of beneficiaries
	• Selection of optional forms of annuities

[a] Economic assumptions can only be changed by modifying *Minnesota Statutes*.

[b] Demographic assumptions can be changed by the Minnesota Legislative Commission on Pensions and Retirement.

SOURCES: *Minnesota Statutes* 2006, 356.215, subd. 8, 9, and 18; The Segal Group, *Public Employees Retirement Association of Minnesota Actuarial Experience Study for the period July 1, 2000 through June 30, 2004* (Englewood, CO: The Segal Company, November 2005), 6-51.

Recent experience studies did not find major problems with the economic and demographic assumptions used in actuarial valuations of Minnesota's major statewide funds, but the funds' actuaries proposed some adjustments. While they indicate that some of the assumptions used in the actuarial valuations need to be changed, the overall effect of making changes proposed by the funds' actuaries is mixed. Adopting the economic assumptions proposed by the funds' actuaries would raise contribution requirements by 1.3 percent of payroll for TRA and 0.3 percentage points for the Public Employees Retirement Plan, and reduce

contribution requirements for the State Employees Retirement Plan by 0.7 percentage points. Adopting the demographic assumptions proposed by the funds' actuaries would have a minor effect for TRA and reduce contribution requirements by 0.4 percentage points for the PERA Public Employees Retirement Plan. Actuaries did not analyze the effects of adopting proposed demographic assumptions for the State Employees Retirement Plan.

POSTRETIREMENT BENEFIT FORMULA

Pension policy in Minnesota has traditionally tried to protect retirees from the effects of inflation.

Because Minnesota's formula for postretirement benefit increases contributed to the large deficit in the Postretirement Fund, we examined the formula based on three criteria: (1) how well it protects the fund's financial condition; (2) how well it protects retirees from inflation; and (3) how equitably it treats different retiree cohorts. These criteria are based in part on the pension policy principles adopted by the Legislative Commission on Pensions and Retirement. Specifically, the Commission's principles on postretirement benefit adequacy state that postretirement benefit increases should "replace the impact of economic inflation" and be "funded on an actuarial basis."[14] We found:

- **The Postretirement Fund's benefit increase formula caused a large deficit, did not align benefit increases with inflation, and created large inequities between retiree cohorts.**

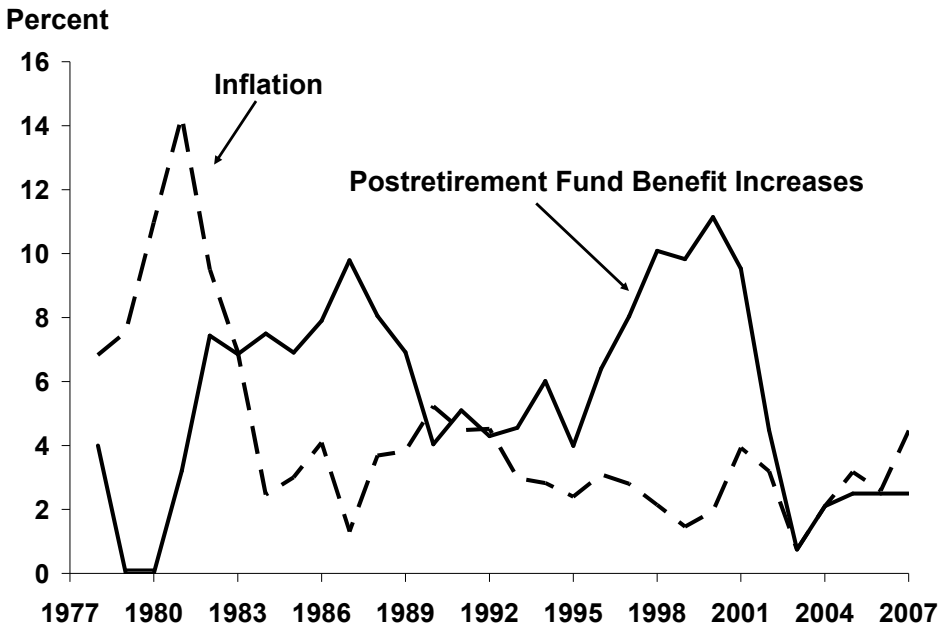
By giving large, permanent benefit increases when the stock market temporarily did very well, the benefit formula caused large deficits in the Postretirement Fund. In part, the problem results from using a five-year time frame to measure investment performance. According to the director of the State Board of Investment, five years is too short a time period to give permanent benefit increases. Stock market returns can fluctuate greatly among five-year intervals. More importantly, under the postretirement formula, benefits are increased when investment earnings are high, but benefits are not reduced when investment earnings are negative. By not retaining enough earnings during the good years to offset the bad years, the postretirement formula put the fund at risk for developing large deficits.

Minnesota has also allowed retirees to benefit from good investment performance, but benefits have not been reduced during bad years.

The Minnesota Postretirement Fund's benefit increases have been poorly aligned with inflation, as shown in Figure 3.2. From 1984-89 and 1997-2001, benefit increases consistently exceeded inflation by 3 to 9 percentage points. In contrast, inflation was high between 1978 and 1982, but benefit increases were much smaller. Because retirees do not receive any investment-based increases if the Postretirement Fund has a deficit, the only benefit increases they have received after 2002 has been from the formula's inflation component. Because the inflation component has a cap of 2.5 percent, and inflation has exceeded 2.5 percent in the last three years ending June 2006, recent benefit increases have lagged behind inflation. For example, inflation was 4.47 percent from June 2005 to June 2006, the time period used to determine the inflation benefit increase in January 2007. The benefit increase for January 2007 will be 2.5 percent, about 2 percentage points less than inflation. As long as inflation remains above 2.5 percent, benefits will fall further behind inflation because benefit increases will remain capped at 2.5 percent as long as the Postretirement Fund has a deficit.

[14] Principle II.C.8 from: Legislative Commission on Pensions and Retirement, *Principles of Pension Policy* (St. Paul, December 1996).

Figure 3.2: Postretirement Fund Benefit Increases Compared with Inflation, 1978-2007



NOTE: Inflation is measured by the Consumer Price Index, Urban Wage Earners and Clerical Workers (not seasonally adjusted) from June to June. The Postretirement Fund benefit increase for 2007 is based on changes in the Consumer Price Index between June 2005 and June 2006.

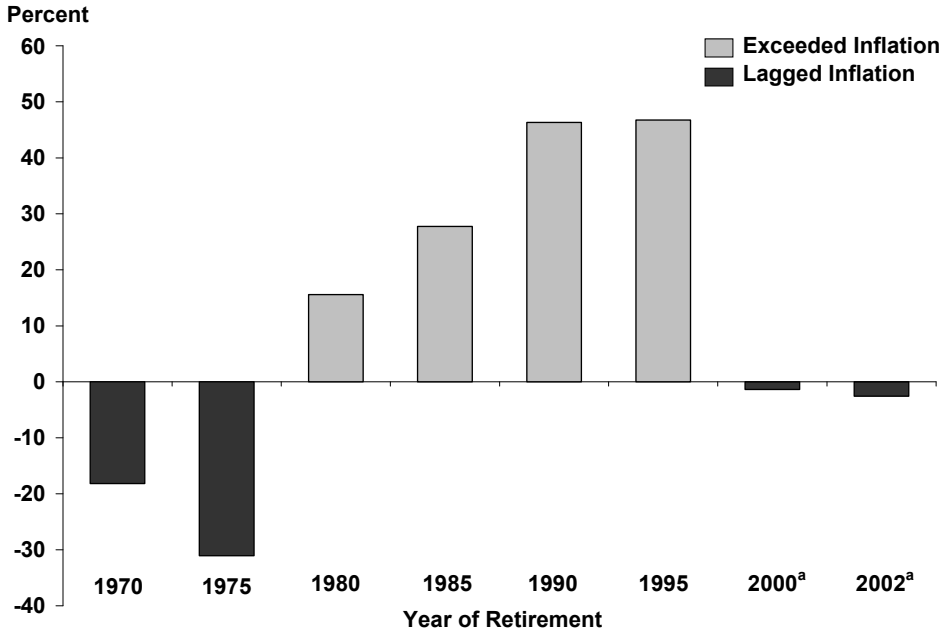
SOURCE: Office of the Legislative Auditor, analysis of data downloaded from: Bureau of Labor Statistics, *Consumer Price Index – Urban Workers and Clerical Workers* (Washington, D.C.: U.S. Department of Labor); http://www.bls.gov/cpi/; accessed November 21, 2006.

Employees retiring after July 1, 2001, have not received investment-based pension increases and will not as long as there is a deficit.

The misalignment of inflation and benefit increases has created large inequities among retiree cohorts from Minnesota's statewide retirement plans. Figure 3.3 illustrates how the value of retirement benefits, after adjusting for inflation, changed 10 years following retirement for different retiree cohorts. While the inflation-adjusted value of benefits increased by nearly 50 percent for some cohorts, it declined for employees who retired in the early 1970s or between 2000 and 2002.[15] One reason for these differences is that retirees received benefit increases far above inflation for six straight years from January 1996 to January 2001. During this period, benefit increases averaged 9.2 percent per year, while inflation averaged 2.6 percent per year. In contrast, employees who retired or will retire after July 1, 2001, have not received any investment-based increases and will not as long as the Postretirement Fund has a deficit. Because of the size of the deficit, this could be a long time. Until the deficit is eliminated, retirees will only receive inflation-based increases up to 2.5 percent per year. As a result, benefits will fall behind inflation if annual inflation exceeds 2.5 percent.

[15] A Pension Commission study found that the change in value of pension benefits also varied greatly among retiree cohorts for time periods other than 10 years after retirement. See: Ed Burek, Deputy Director, Legislative Commission on Pensions and Retirement, memorandum to commission members, *Minnesota Combined Investment Funds and Minnesota Post Retirement Investment Fund Structure and Transfers: First Consideration*, August 23, 2006.

Figure 3.3: Extent to Which Benefits of Postretirement Fund Participants Exceeded or Lagged Inflation, 10 Years After Retirement



The value of benefit increases for employees retiring in 1990 and 1995 greatly exceeded inflation, but it declined for retirees in the mid-1970s and 2000.

NOTE: Positive figures represent the percentage by which benefits 10 years after retirement exceed the initial retirement benefits after adjusting for inflation. Negative numbers represent the percentage by which benefits are less than the initial benefit amount after adjusting for inflation.

[a] Figures for 2000 and 2002 are based on benefit increases as of January 2007. Because under existing law, benefit increases between 2007 and 2012 are not likely to exceed inflation, the actual 10-year change in benefits relative to inflation will likely lag inflation as much or more than the figures shown for these two cohorts. The figures for 2000 and 2002 are based on calculations by the Office of the Legislative Auditor.

SOURCE: Office of the Legislative Auditor, analysis of data from Larry Martin, Executive Director, Legislative Commission on Pensions and Retirement, memorandum to commission members, *Investment Based Post-Retirement Adjustment Mechanism Structure and Teacher Retirement Benefit Provision Comparison: Second Consideration*, November 8, 2006, 6-7.

The annual benefit increases during the late 1990s greatly exceeded average public employee salary increases as well as inflation. As a result, the Postretirement Fund benefit increases created inequities between some employees who retired early and those who kept working. Normally, pension formulas are based on the principle that the longer an employee works (and the longer the employee makes contributions to the pension fund), the higher the pension benefit should be. In fact, some employees who retired during the mid-1990s received higher benefits than if they had kept working a few more years. For example, the 2000 retirement benefit for a state employee who retired under the Rule of 90 at age 60 with 30 years of experience on July 1, 1996, would be

about 11 percent higher than if the same employee retired three years later. This 11 percent advantage would persist for the rest of the retiree's life.[16]

In 2006, the Legislature imposed an overall 5 percent cap on benefit increases for retirees participating in the statewide retirement plans and the St. Paul Teachers' Retirement Association. The cap will become effective in 2010. The 5 percent cap includes the inflation component of postretirement benefit increases, which cannot exceed 2.5 percent. As a result, if inflation is 2.5 percent or higher, the 5 percent cap means that the investment-based benefit increase cannot exceed 2.5 percent.

- **By capping future postretirement benefit increases, the 2006 Legislature has helped avoid future Postretirement Fund deficits, but the caps will not solve the current deficit.**

Actuaries for TRA ran simulations to find out what would have happened if the 5 percent cap had been in place since 1994. They found that the Postretirement Fund would not have the large deficit it has today. With a 5 percent cap, the fund would have reached a low point in 2003, with a deficit of about $1 billion. By 2004, the fund would have had a surplus of $500 million instead of the actual deficit of $4.5 billion.

To avoid future deficits, the Postretirement Fund would need to attain greater than 8.5 percent investment returns each year over the long term.

While these results indicate that the 5 percent cap can reduce the risk of future deficits in the Postretirement Fund, it will not eliminate the risk placed on the fund by investment-based benefit increases. When actuaries determine the funding needs of pension plans, they do not take into account the potential for future investment-based increases. The Postretirement Fund must earn an average of about 8.5 percent per year to avoid deficits if no investment-based increases are granted. If the fund gives out investment-based increases in the future, the fund will need to achieve a long-term average return greater than 8.5 percent to avoid creating deficits in the future.

It is also important to recognize that future stock market cycles may not follow the recent pattern. For example, if the stock market had declined more gradually from its 2001 high to its current level instead of the steep decline followed by the recovery, investment-based benefit increases could have continued for a longer time period, resulting in a larger Postretirement Fund deficit than it has today.

The 5 percent cap on postretirement benefit increases will not affect the current deficit since it does not change benefit increases already given and will not affect future increases until the current deficit is eliminated. As we discussed earlier in this chapter, benefit increases were already limited to 2.5 percent when the fund had a deficit. We describe options to address the current deficit in the following section.

[16] To make this estimate, we assumed that the employee would have received the same salary increase as received by typical state employees with similar age and experience during this time period. We also included the extra credit that would be received for working an additional three years.

In addition, the 5 percent cap will not solve the misalignment of investment-based increases with inflation. Future benefit increases may exceed inflation in some years, while in other years they may fall short of inflation.

Options to Address Problems with the Postretirement Fund

Solving the deficit will require adding resources or reducing benefit increases.

There are several options for addressing the problems with the Postretirement Fund. These options involve both financial and benefit design issues. The financial issues involve whether and to what extent resources should be increased to reduce the fund's deficit and whether the level of benefit increases provided to retirees should be reduced. Litigation concerns constrain options that reduce pension benefits or reduce increases that otherwise would be given. According to the House of Representatives' Research Department, the Minnesota Supreme Court "ruled that public employees have a protectable entitlement to their pension, but that this is subject to legislative modification in the public interest."[17]

When balancing the retirees' entitlement to their pension benefits against the public interest, the courts have said that they consider what was promised, the degree to which retirees can reasonably rely on the benefits promised, and whether an injustice is created by changing the benefit.[18] In one case, the state changed the pension eligibility criteria for elected officials of the city of Minneapolis, making a 48-year-old retiree ineligible for benefits until reaching age 60, though he had been receiving retirement benefits for nearly 10 years. The Minnesota Supreme Court disallowed this eligibility change for persons already retired.[19] It noted that the state's interest in changing the eligibility requirements was not sufficient to dishonor a promise to pay a pension to a person already retired. In another case, the Supreme Court upheld a reduction in a supplemental pension benefit increase that had been given to Duluth firefighters in the previous year. The Court noted that there was no evidence that the city promised to maintain the previous year's benefit level or that retirees relied on that level.[20]

It can be argued that the 5 percent cap established by the 2006 Legislature is reasonable because retirees could not rely on investment-based benefit increases that would likely not have occurred for many years under the pre-2006 formula. In addition, the cap is arguably in the public interest because it helps protect the fund from large swings in the stock market and may reduce inequities among retiree cohorts. In contrast, taking away the benefit increases that have already been granted is questionable because the retirees have already received the

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[17] Mark Shepard, Legislative Analyst for the Minnesota House of Representatives' Research Department, memorandum to members of the Ways and Means Committee of the House of Representatives, *Legal Issues Relating to Employer Modification of Public Pension Plans*, February 13, 2004.

[18] *Ibid.*

[19] Larry J. Christensen v. Minneapolis Municipal Employees Retirement Board, 331 N.W.2d 740 (Minnesota Supreme Court, March 18, 1983).

[20] Duluth Firemen's Relief Association v. City of Duluth, 361 N.W.2d 381 (Minnesota Supreme Court, 1985).

benefit increases, have been told that the increases are permanent, and may now be relying on them.

In addition, changes involving reasonable tradeoffs are more likely to meet the court's legal standard. For example, reductions in investment-based increases in exchange for improved security of the pension fund and a modest improvement in the inflation-based component would more likely meet the legal standard than simply eliminating investment-based increases.

Regarding benefit-design issues, there are various ways to modify the investment-based component of the postretirement formula, but investment-based mechanisms have fundamental shortcomings within a defined benefit retirement system. First, they do not relate benefit increases to inflation. By giving out increases based on investment performance, they detract from the ability of the formula to focus on protecting retirees from inflation. Second, investment-based increases usually mean that the retirement plan takes the risk of market downturns while retirees benefit from market upswings. One way to modify the investment component is to expand the time interval over which investment earnings are measured would smooth out some of the fluctuations in investment performance that occur with the existing 5-year smoothing period. Alternatively, investment-based increases could be one-time bonuses instead of permanent increases. This means that investment returns exceeding a given threshold would be reflected in the next year's benefits, but they would not carry over to additional years. Under either of these approaches, however, the retirement plans would still face the risk from poor market returns while retirees benefit from strong market returns.

Next, we discuss several options for addressing the deficit in the Postretirement Fund.

Leave the Postretirement Fund as it is. This option puts the burden of dealing with the deficit on future Legislatures as well as future employees, employers, and taxpayers. The deficit could go away if, for an extended period, the stock market does much better than the 8.5 percent return actuaries assume. Or, the deficit could get worse, putting an even greater burden on future employees and employers.

Add resources to reduce the Postretirement Fund's deficit. Additional resources could come from the state or from employee and employer contributions. This option could be expensive, but starting now would help avoid placing the burden entirely on future employers and employees. In effect, this option may also increase benefits to retirees by making them eligible for investment-based increases sooner than they would under current law.

Combine the Postretirement Fund with the basic funds. Under this option, the Postretirement Fund would be split into parts corresponding to the basic funds from which each retiree's assets were transferred. These parts would be merged with the corresponding basic fund, so that each of the merged funds would contain assets for both active employee and retired members. This option would increase the contributions necessary for each of the statewide retirement plans to become fully funded. By itself, this option would not affect the deficit or retirees' benefit increases. But if the Legislature increases contributions to match the higher contribution requirements, the deficit will be reduced and may

make retirees eligible for investment-based increases sooner than they would under the current fund structure. Because the postretirement formula is based on the financial performance of the Postretirement Fund, eliminating the Postretirement Fund would require modifying the investment-based part of the formula.

Reduce benefits for current retirees. This option could reduce the deficit, but, as suggested above, its legality is questionable because it would take back benefit increases that retirees have already received.

RECOMMENDATION

The Legislature should develop a plan to fully fund the Postretirement Fund and replace the investment-based benefit increases for retirees with an enhanced inflation-based formula.

The overall long-term goal should be to protect the fund's financial condition and treat retirees equitably while protecting them from inflation. This requires removing investment-based benefit increases from the benefit formula. A plan to fully fund the Postretirement Fund could include employer or employee contributions, additional state appropriations, or retiree benefit reductions.

The state's goal should be to guard the Postretirement Fund's financial condition and protect retirees from inflation.

Implementing these recommendations as a package has the advantage of potentially being more acceptable to a wider range of groups than any change by itself. For example, retirees would receive enhanced security and improved chances for near-term benefit increases in exchange for investment-based increases. Employers would have a reduced risk of future deficits in exchange for more contributions up front. Whether courts would approve any particular tradeoff is not known, but a package including these tradeoffs would more likely meet courts' legal standards than a reduction in benefits by itself.

Eliminating the formula's investment-based component and enhancing the inflation adjustment would refocus benefit increases on the goal of protecting retirees' benefits from inflation. Replacing the investment-based component with an enhanced inflation component is the most efficient way to align benefit increases with inflation. One way to enhance the inflation component is to allow savings that occur when inflation is below the cap to be carried forward so that the savings can be used when inflation exceeds the cap. For example, if annual inflation was 1, 3, and 4 percent for three consecutive years, retiree benefits would increase by 1, 2.5, and 2.5 percent under the current formula. But under this enhanced formula, benefits would increase by 1 percent during the first year, with 1.5 percentage points being carried forward. During the second year, benefits would increase by 3 percent, including 0.5 percentage points of the amount carried forward. During the third year, benefits would increase by about 3.5 percent, including the remaining 1.0 percentage points of the amount carried forward. An advantage of this approach is that benefit increases would be more closely related to inflation (allowing increases to fluctuate below and above 2.5 percent) while keeping the average size of the increases within 2.5 percent.

Another way to enhance the inflation formula is to base the benefit increase on a percentage of the CPI increase. Instead of compensating for the full increase in inflation up to 2.5 percent, this option would increase benefits by a percentage of

the CPI increase, but with a higher cap. For example, benefits might be increased by 80 percent of the CPI increase with a maximum benefit increase of 4 percent. Compared with the current inflation formula, this option would give smaller adjustments when inflation is low and larger adjustments when inflation is high. As a result, the formula would make larger benefit increases when most needed, that is, when inflation is high.

Replacing the investment-based portion of the postretirement formula with an enhanced inflation component, however, has risks of legal challenges. The Legislature could design the enhanced inflation component to be less expensive than the current two-part formula to reduce the risk of future deficits, but if the courts rule against the change, the total cost to the retirement plans may increase. For example, the statewide pension plans could pay higher inflation-based increases under a revised formula but be forced by a court decision to reinstate the investment component, increasing instead of decreasing the risk of pension fund deficits. In addition, losing the case would likely mean paying legal expenses for both sides.

The safest way to avoid legal challenges is to change the formula for postretirement benefit increases by applying the new formula to employees hired after the formula is changed. This change, however, would not affect benefits until the new employees retire, greatly delaying the time when the new formula would be widely used. On the other hand, the greatest risk of a legal challenge involves changes that reduce benefits for current retirees.

The Legislature should not add resources to the fund without also changing the benefit formula.

To help avoid legal challenges, the Legislature should not put more resources into the Postretirement Fund until it reforms the formula for postretirement benefit increases. This is because the risk of a legal challenge from changing the postretirement formula may depend on how close the benefits under a new formula compare with the benefits under the current formula. The larger the difference in benefits between the current formula and the new formula, the less likely that retirees will agree to the change and the more likely that the change would impair a benefit that retirees have relied upon. Currently, the investment-based component has little value to retirees because they are not likely to receive any investment-based increases for many years. In fact, under current law, many, if not most, current retirees may not get any more investment-based increases during their retirement. As we discussed earlier in this chapter, the statewide plans do not give investment-based benefit increases until the Postretirement Fund's deficit is eliminated. If, however, the Postretirement Fund's deficit is eliminated because of new funding sources and/or several years of large investment returns, the likelihood of receiving benefit increases from the investment-based mechanism would increase, making it more difficult to reform the postretirement formula.

FINANCIAL CONDITIONS OF LOCAL PENSION FUNDS

As with statewide pension funds, we examined the funding ratios of local pension funds and the adequacy of employer and employee contributions to these funds. We found that:

- **Minnesota's seven local pension funds are underfunded, but only the St. Paul Teachers' Retirement Fund is at risk for serious funding problems in the near term.**

Among local pension plans, the St. Paul Teachers' Retirement Fund has the lowest funding ratio and the largest deficit.

As of the most recent actuarial estimates (2005 or 2006, depending on the plan), the seven local pension plans had funding ratios ranging from 69 to 92 percent, as shown in Table 3.6. The St. Paul Teachers' Retirement Plan had the lowest funding ratio and the largest deficit ($420 million). In addition, the plan's contributions (16.3 percent of payroll) are well below the level (25 percent of payroll) necessary to eliminate the deficit by its 2021 target date, as shown in Table 3.7.

Table 3.6: Financial Status of Minnesota's Local Pension Plans, 2006

	Assets (in millions)	Liabilities (in millions)	Deficit (in millions)	Funding Ratio
Local Teacher Retirement Plans				
St. Paul Teachers' Retirement Plan	$939	$1,359	$420	69%
Duluth Teachers' Retirement Plan	271	322	51	84
Local General Employee Retirement Plans				
Minneapolis Employees Retirement Plan	1,490	1,618	127	92
Local Police and Fire Plans				
Minneapolis Police Relief Association	359	464	105	77
Minneapolis Firefighters' Relief Association	269	313	43	86
Virginia Fire Department Relief Association	2.8	3.0	0.2	92
Fairmont Police Relief Association	6.5	7.7	1.3	84
Total	$3,338	$4,086	$748	82%

NOTE: Figures for the St. Paul Teachers' Retirement Plan, Duluth Teachers' Retirement Plan, and Minneapolis Employees Retirement Plan are as of July 1, 2006. Figures for the Minneapolis Police Relief Association, Minneapolis Firefighters' Relief Association, Virginia Fire Department Relief Association, and Fairmont Police Relief Association are as of December 31, 2005. All plans are closed to new members except for the St. Paul Teachers' Retirement Plan and the Duluth Teachers' Retirement Plan.

SOURCE: Office of the Legislative Auditor, analysis of actuarial valuations for plans administered by: *St. Paul Teachers' Retirement Fund Association*, *Duluth Teachers' Retirement Fund Association*, and *Minneapolis Employees Retirement Fund*; http://www.commissions.leg.state.mn.us/lcpr/valuations.htm; Van Iwaarden, *Minneapolis Firefighters' Relief Association Special Fund*, *Minneapolis Police Relief Association Special Fund*, and *Fairmont Policemen's Relief Association* (Minneapolis, MN: Van Iwaarden, May and July 2006); Gabriel Roeder Smith & Company, *Virginia Fire Department Relief Association* (Chicago, IL: Gabriel Roeder Smith & Company, April 6, 2006).

Table 3.7: Sufficiency of Contributions to Active Local Pension Plans as of July 1, 2006

	Annual Contributions Required[a]	Current Annual Contributions	Adequacy of Contributions
St. Paul Teachers' Retirement Plan	25.0%	16.3%	-8.7%
Duluth Teachers' Retirement Plan	15.2	11.3	-3.9

NOTE: Contributions are shown as a percentage of salary. Negative numbers are deficiencies.

[a] Annual contributions required are those needed to reach full funding by designated target dates (2021 for St. Paul Teachers' Retirement Plan and 2032 for Duluth Teachers' Retirement Plan).

SOURCES: Office of the Legislative Auditor, analysis of The Segal Group, Inc., *St. Paul Teachers' Retirement Fund Association Actuarial Valuation and Review as of July 1, 2006,* (Englewood, CO: The Segal Company, November 8, 2006); The Segal Group, Inc., *Duluth Teachers' Retirement Fund Association Actuarial Valuation and Review as of July 1, 2006*, (Englewood, CO: The Segal Company, November 16, 2006).

Amounts contributed to the St. Paul Teachers' Retirement Fund are far below what is needed to eliminate its deficit.

The Duluth Teachers' Retirement Fund also has a deficit and a contribution deficiency but is in better shape than the St. Paul Teachers' Retirement Fund. As of July 1, 2006, the Duluth Teachers' Retirement Fund had a deficit of $51 million and a funding ratio of 84 percent. Its employee and employer contributions totaled 11.3 percent compared with the 15.2 percent needed to eliminate the deficit by 2032.

Two other plans had funding ratios below 85 percent—the Minneapolis Police Retirement Association Plan and the Fairmont Police Retirement Association Plan. Recently, the Minneapolis Police Retirement Plan's funding ratio has been improving, rising from 64.5 percent on December 31, 2003, to 77.3 percent on December 31, 2005. During this time, its deficit dropped from $165 million to $105 million. The Fairmont Police Retirement Plan funding ratio has been between 80 and 85 percent for the last four years. Its funding ratio declined slightly in 2004 because of a larger than anticipated benefit increase provided in 2004.

All five local pension plans that are closed to new members are generally on track to become fully funded. Each year, actuaries determine the contributions required for the local plan to reach full funding by the designated target date, which ranges from 2010 to 2020. The annual actuarial valuations indicate that the recent employer contributions have generally matched the required contributions for each of these closed plans.

Historically, the St. Paul Teachers' Retirement Fund has been poorly funded, largely due to its use of a pay-as-you-go approach from its beginning in 1909 to 1955 and having contribution deficiencies in all but four years since 1969. While its funding ratio made steady progress between 1970 and 2000, going from less than 20 percent fully funded in 1970 to 82 percent in 2001, the ratio declined to 69 percent in 2006.

The stock market decline and large postretirement benefit increases are the primary factors behind the recent decline in the St. Paul Teachers' Retirement Fund's funding ratio. The stock market decline during 2000-03 hurt the St. Paul Teachers' Retirement Fund along with other pension funds. Unlike many of the other pension funds, however, the St. Paul Teachers' Retirement Fund had not reached a 100 percent funding ratio after the stock market boom of the late

1990s, which cushioned the subsequent decline for other funds. The St. Paul Teachers' Retirement Plan also gave large, permanent postretirement benefit increases in four consecutive years beginning in 1998, ranging from 7 to 9.3 percent. The St. Paul Teachers' Retirement Plan gave these increases because the five-year average investment returns during the stock market boom exceeded the 8.5 percent threshold rate set in law.

The St. Paul fund did not reach a 100 percent funding ratio during the market boom, which cushioned the subsequent decline of other funds.

The St. Paul Teachers' Retirement Fund's postretirement benefit formula, large deficit, and contribution shortfall put the fund at risk for serious future funding problems. As with the state's Postretirement Fund, current law defines a two-part formula for postretirement benefit increases by the teachers' retirement plan for St. Paul (the same formula applies to the Duluth Teachers' Retirement Plan). Under the first part, retirees automatically receive a 2 percent increase every year regardless of what inflation was during the previous year. Under the second part, retirees receive an investment-based increase whenever the five-year average return exceeds 8.5 percent. Unlike the Postretirement Fund, however, these increases are given even if the fund has a large deficit. In fact, unless the St. Paul Teachers' Retirement Fund's return for fiscal year 2007 turns substantially negative, the fund will give retirees another investment-based increase in January 2008, despite the poor funding ratio.[21] For the past four years ending June 30, 2006, the fund earned an average annual return of about 11.5 percent. If the fund earns the same return in fiscal year 2007 as it did in the previous four years, it will give an increase of nearly 5 percent in January 2008 (an investment-based increase of nearly 3 percent and a fixed increase of 2 percent).[22] Despite the fund's deficit, investment-based increases would continue for four years after 2008 even if investment returns are just 8.5 percent in each of the years following fiscal year 2007. In this case, investment-based increases would gradually decrease from 4.3 percent in 2009 to 0.6 percent in 2012. While these are not huge increases, they are not anticipated by the actuarial estimates and would increase the unfunded liability of the St. Paul Teachers' Retirement Fund.

The permanent benefit increases given when stock markets do well reduce the ability of the fund to offset periods with low stock market returns. If its investments earn less than 8.5 percent, its deficit will likely grow. Normally, this would be offset by periods when the investment returns exceed 8.5 percent. Even when the 5 percent cap imposed by the 2006 Legislature becomes effective in 2010, investment returns must be above 11.5 percent to substantially improve the fund's financial condition. Thus, even if long-term investment returns meet the actuary's expectations of 8.5 percent, market fluctuations could result in larger deficits.

The Duluth Teachers' Retirement Fund will probably also pay an investment-based increase to retirees in January 2008. The investment return for the four

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[21] The St. Paul Teachers' Retirement Fund will not give an investment-based benefit increase in January 2007 because the average return for the five years ending June 30, 2006, was 8.2 percent, just below the 8.5 percent threshold.

[22] The exact increase will depend on the contribution deficiency—the difference between the contributions required to reach full funding by the target date and actual contributions from employees and the school district, plus state support. Currently, the contribution deficiency is 7.3 percent, meaning that retirees receive an increase of 92.7 percent (100 - 7.3) of the amount by which five-year average investment returns exceed 8.5 percent. For example, if investment returns average 11.5 percent, the benefit increase would be 92.7 percent of 3 percent, which equals 2.8 percent.

years ending June 30, 2006, averaged about 10.2 percent. If the fund earns this amount in fiscal year 2007 (it had already earned 6.8 percent during the fiscal year's first four months), retirees will receive a total benefit increase of about 3.7 percent (an investment increase of nearly 1.7 percent and a fixed increase of 2 percent). While this increase is not particularly large, future increases could be larger if the stock market continues to do well. Large increases in benefits mean additional difficulty becoming fully funded.

RECOMMENDATIONS

To reduce the risk of future local pension funding problems, the Legislature should change the postretirement benefit formula for the teachers' retirement funds in St. Paul and Duluth to disallow investment-based benefit increases when these funds have a large deficit.

The Legislature should consider replacing the postretirement formulas for the St. Paul and Duluth funds with formulas based on inflation. In addition, it should consider increasing contributions for the St. Paul Teachers' Retirement Fund to improve the fund's financial health.

Disallowing investment-based benefit increases when the funds have large deficits would prevent benefit increases from further eroding the funds' financial status. Current actuarial estimates of unfunded liability do not take into account any investment-based increases even though under existing statutes and likely market performance, increases are likely to occur in January 2008. While the Duluth Teachers' Retirement Fund's condition is not as bad as the St. Paul Teachers' Retirement Fund, it does not make sense to wait for the fund to deteriorate before correcting this problem.

Changing the benefit formula could help prevent eroding the financial status of the local teachers' plans.

Replacing the postretirement benefit formulas for the St. Paul and Duluth Teachers' Retirement Funds with formulas based on inflation could improve the funds' financial condition and better align benefit increases with inflation. To partially compensate retirees for the potential loss in investment-based benefit increases, the Legislature could adopt an inflation-based formula that is more generous than the current guaranteed 2 percent annual increase.[23] If this were combined with increased contributions to the fund, retirees (and future retirees) would gain increased pension security in exchange for somewhat smaller benefit increases. Such a tradeoff could make the benefit reduction more acceptable to retirees and the courts. One reason that members of the St. Paul and Duluth teachers' retirement plans might be willing to make such a tradeoff is that the local teachers' retirement plans have a different legal standing than the statewide pension plans. *Minnesota Statutes* provide that retirement annuities for a local teachers' retirement plan shall be prorated if its pension fund lacks sufficient resources to pay benefits in full.[24] Because the statutes consider the possibility of prorating promised benefits, members of the local teachers' retirement plans might be more willing to accept smaller benefit increases in exchange for improved funding of their retirement plan to avoid having their benefits prorated.

[23] The fixed 2 percent increase will often be less than the inflation component of the Postretirement Fund's formula increase, which is based on the increase in the CPI capped at 2.5 percent.

[24] *Minnesota Statutes* 2006, chapter 354A.09.

It should be noted that local teachers' retirement funds have not had such a shortfall, and courts have not ruled on what would happen if such a shortfall would occur.

In 2006, the St. Paul Teachers' Retirement Fund Association proposed replacing its entire postretirement increase mechanism for the inflation-based increase used by the Social Security system, but with a 5 percent cap.[25] The Association's proposal would have given up investment-based increases in exchange for a stronger inflation adjustment. It is not clear, however, whether this particular proposal is more or less costly than the current formula. It may be necessary to reduce the cap to contain benefit increases, thus protecting the fund against worsening financial conditions. One way to do this is to make the cap lower whenever there is a deficit or when the funding ratio is below a certain level (such as 90 percent).

The St. Paul Teachers' Retirement Fund's deficit has been growing even though investment returns have been strong.

It is also important to consider increasing contributions to the St. Paul Teachers' Retirement Fund. The fund's deficit has been growing even though investment returns have been strong. Now is a good time to examine ways to correct the fund's long history of funding deficiencies. Otherwise, the deficit may place a greater burden on future employees, employers, and taxpayers. By not dealing with the deficit now, there is a greater risk that the problem will become worse, making corrections all the more difficult. The most recent actuarial valuation indicates that contributions need to be raised by 8.7 percent of salary to become fully funded by 2021. This is a large increase, especially considering that St. Paul's employer contributions are already at least 2 percentage points higher, as a percentage of salary, than in other school districts.[26] The 2006 actuarial valuation estimated that if the target date were changed from 2021 to 2036, the contributions would need to be increased by 2.8 percentage points instead of 8.7 percentage points. Raising contributions by 2.8 percentage points is easier, but it would delay the date at which payments to amortize the deficit are no longer needed. Currently, payments to amortize the deficit include state aid of $3.4 million per year and employer and employee contributions of $12.6 million (5.4 percent of salary).[27]

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[25] One reason the St. Paul Teachers' Retirement Board made this proposal was because of its concern that the 5 percent overall cap established by the 2006 Legislature would not comply with Internal Revenue Service (IRS) regulations. IRS regulations allow flat percentage increases or investment-based increases, but not both. IRS regulations have a "grandfather" provision that allows both in the St. Paul Teachers' Retirement Fund's formula as long as the formula does not change. Because of the board's concern, the 5 percent cap is not scheduled to become effective until 2010 so that it can be modified if the IRS does not approve the 2006 Legislature's changes. Replacing the current formula with an inflation-based formula would be consistent with IRS regulations. (See: Joel Michael, Legislative Analyst from the Research Department of the Minnesota House of Representatives, memorandum to Representative Joe Mullery, *Federal tax rules and modifying the St. Paul TRA benefit formula*, December 20, 2005).

[26] In addition, St. Paul teachers pay contributions that are about ¼ of 1 percentage point higher than other teachers.

[27] *Minnesota Statutes* 2006, chapter 354A.12, subd. 3a. and 3c. require the state to give $2.967 million in state aid to the St. Paul Teachers' Retirement Fund Association per year until its funding ratio equals or exceeds TRA's funding ratio. *Minnesota Statutes* 2006, chapter 423A.02, subd. 3, requires the state to contribute an additional amount ($430,761 in fiscal year 2005) as long as the St. Paul school district contributes a supplemental contribution of $800,000 per year. This additional state aid is scheduled to terminate when the St. Paul Teachers' Retirement Fund becomes fully funded.

List of Recommendations

- The Legislature should amend *Minnesota Statutes* to allow local governments to establish trusts for funding other postemployment benefits (p. 32).

- To properly reflect actual financial conditions, the Legislature should require that funding ratios for the TRA, PERA, and MSRS retirement plans value Postretirement Fund assets on the basis of market-related values (p. 45).

- The Legislature should develop a plan to fully fund the Postretirement Fund and replace the investment-based benefit increases for retirees with an enhanced inflation-based formula (p. 55).

- To reduce the risk of future local pension funding problems, the Legislature should change the postretirement benefit formula for the teachers' retirement funds in St. Paul and Duluth to disallow investment-based benefit increases when these funds have a large deficit (p. 60).

- The Legislature should consider replacing the postretirement formulas for the St. Paul and Duluth funds with formulas based on inflation. In addition, it should consider increasing contributions for the St. Paul Teachers' Retirement Fund to improve the fund's financial health (p. 60).

National Comparisons

APPENDIX

National comparisons of retirement benefits are frequently made when debating what benefits should be provided to public employees. It is important to recognize that retirement benefits are just a part of employee compensation. Our study does not address other aspects of employee compensation, including how overall compensation for Minnesota's public employees compares with other states or the private sector, or what is the appropriate balance among salary, health care for active employees, retiree health care, and pension benefits. We did not examine the adequacy of benefits or how retirement benefits affect employee recruitment and retention. Legislators also need to consider these other factors when making policy decisions involving pensions and other postemployment benefits in Minnesota.

This appendix compares Minnesota with others in three ways. One is how Minnesota compares with other states on retiree health care for state employees. A second compares Minnesota's major statewide pension funds with public pension funds in other states. The third is Minnesota's public pensions in comparison with those in the private sector.

We obtained information for comparisons from several national studies. For the first section of this appendix, we analyzed data on health insurance for public retirees using data from one national study of state employee benefits and a second study that was specific to state government retiree health benefits. Although we had hoped to compare states' "other postemployment benefits" (as defined by the Governmental Accounting Standards Board), comprehensive national data were not available with state-by-state measures of liabilities for these benefits. In the second section of the appendix, we compare Minnesota's public pension plans with those in other states using two national surveys of public pension plans and a third study conducted by Minnesota's Legislative Commission on Pensions and Retirement comparing teacher retirement plans around the nation. The final section compares public and private sector pension plans. For this, we analyzed data from the Bureau of Labor Statistics in the U.S. Department of Labor as well as a national compensation survey conducted by that bureau.

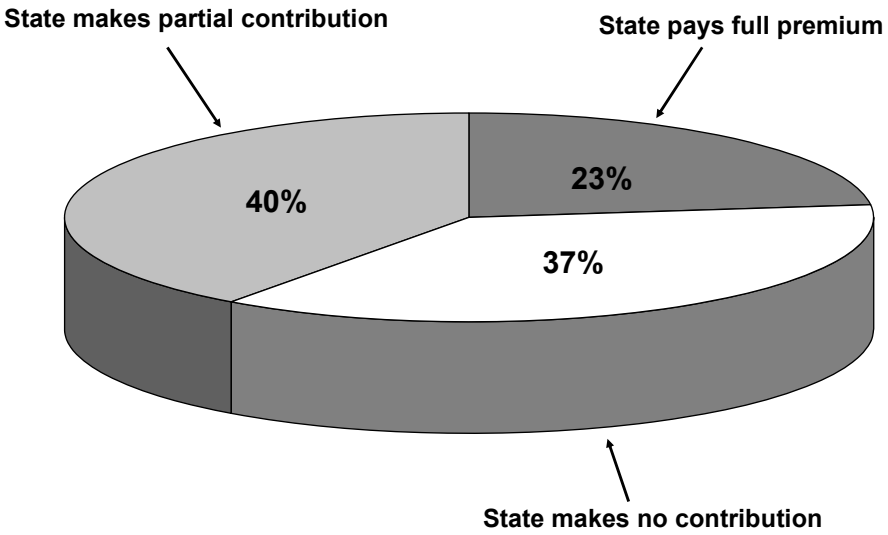
RETIREE HEALTH CARE COMPARISONS

Compared with other states, Minnesota appears to spend less on retiree health care. Incomplete data, however, make possible only certain nationwide comparisons.

Share of States Offering Employer-Paid Retiree Health Care

According to a 2006 study of all 50 states, 63 percent of states paid some or all of the health care premiums for retired state employees under 65 years of age, when comparing benefit plans covering the largest number of employees.[1] The proportion of states by their contributions to retired state employee health care premiums is shown in Figure A.1. As indicated in Chapter 2, Minnesota pays health care premiums for only a small percentage of state workers; for the benefit plans covering the largest number of Minnesota state employees, the state does not pay for retiree health care. Consequently, in Figure A.1, Minnesota is included among the 37 percent of states making no state contribution towards retirees' premiums.

Figure A.1: Proportion of States by Contribution to Health Care Premiums for Retired State Employees up to Age 65, 2006



NOTE: Data are for single coverage in the retiree health plans covering the largest group of state employees, and they represent benefits in effect on January 1, 2006. Because Minnesota does not pay retiree health care for its largest group of employees, it is counted among the states that make no contribution. Some states were counted in more than one category if they contributed different amounts based on years of service, date of hire, or plan choice.

SOURCE: Office of the Legislative Auditor, analysis of Workplace Economics, Inc., *2006 State Employee Benefit Survey* (Washington, D.C.: Workplace Economics, Inc., 2006), 74-88.

[1] Office of the Legislative Auditor, analysis of Workplace Economics, Inc., *2006 State Employee Benefit Survey* (Washington, D.C.: Workplace Economics Inc., 2006), 74-88. States were asked to report benefits as of January 1, 2006, and data are for single health coverage only.

State Employees Eligible for Retiree Health Care

Based on our analysis of a 2004 report, Minnesota ranked among the lowest of comparable states in the share of state employees eligible for employer-paid retiree health care in 2001.[2] At 1 retiree for every 100 full-time equivalent (FTE) state employees, Minnesota ranked 33rd lowest out of 39 states in its proportion of retirees eligible for retiree health care.[3] In comparison, Wisconsin ranked 30th out of 39 states with 12 retirees per 100 FTE state employees eligible for health care. State employees in Wisconsin receive retiree health care based on the amount of unused sick leave the retiree has accumulated upon retirement, which is converted to an amount used to pay health care premiums.

State Retiree Health Care Costs

Minnesota also ranks among the lowest of comparable states in total annual expenditures for retired state employees' health insurance. Because data were not available for all 50 states, we analyzed 38 states with data on the annual cost of retiree health care for state employees. Unlike the earlier analysis on the share of states offering employer-paid retiree health care, which covered only the largest employee groups, this analysis includes retiree health care spending for all employee groups. Among the 38 states, the average annual cost of retiree health care was $816 per FTE state employee in 2001. Minnesota paid considerably less than the average at $86 per FTE state employee, ranking it 30th among the 38. By comparison, Wisconsin paid $1,066 in annual retiree health care per FTE state employee and ranked 14th out of 38 states.

Minnesota's rankings in comparison to Wisconsin and other states on both the share of employees eligible for employer-paid retiree health care and the cost of retiree health care are summarized in Table A.1.

Anticipated Changes

For some of the small number of Minnesota state employees eligible for retiree health care benefits, the state has capped the amount it will pay for retiree health insurance. For another small group, the state increased the number of years of service required to become eligible for the benefit. The state is not, however, anticipating large changes to its retiree health care benefit. Similarly, many states have made changes to reduce their liabilities for retiree health care, but most are not likely to terminate the coverage. According to a 2003 study, only 1 out of 39 states considered it likely that they would terminate retiree health coverage for

[2] To conduct this analysis, we used data from a national study of retiree benefits. See Workplace Economics, Inc., *State Government Retiree Health Benefits: Current Status and Potential Impact of New Accounting Standards* (Washington D.C.: AARP Public Policy Institute, 2004).

[3] FTE state employees were used as a comparison because no state-by-state data were available on the number of state retirees. Only 39 states were included because available data for some states included incomparable groups such as teachers (who were not state employees) or university employees.

Table A.1: Retired State Employee Health Care in Minnesota and Wisconsin Compared With Select Other States, 2001

	Number of Eligible Retirees per 100 FTEs	Rank (out of 39)	Annual Cost per FTE	Rank (out of 38)
Select States' Average	25	--	$816	--
Minnesota	1	33	86	30
Wisconsin	12	30	1,066	14

NOTE: Some states were eliminated from the comparison because available data included employees other than comparable state employees, such as teachers or university employees.

SOURCE: Office of the Legislative Auditor, analysis of AARP Public Policy Institute, *State Government Retiree Health Benefits: Current Status and Potential Impact of New Accounting Standards* (Washington, D.C.: AARP, July 2004), 72-99.

state employees in the succeeding three years.[4] No state indicated that it had terminated subsidies for future retirees' health benefits, although 24 of the states responding to a question on changes to coverage reported having increased in the past two years the amounts that retirees pay for their health plans.

PUBLIC PENSION PLAN COMPARISONS

To compare Minnesota's statewide pension plans with public pension plans in other states, we used two national surveys of public pension plans and a recent survey of statewide teacher retirement plans by the Minnesota Legislative Commission on Pensions and Retirement.[5] For the first national study, the Wisconsin Legislative Council surveyed statewide public pension plans from all 50 states in 2004.[6] The second study, the 2005 Public Fund Survey sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement, covered most of the nation's largest pension systems for public employees.[7]

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[4] Jack Hoadley, *How States Are Responding to the Challenge of Financing Health Care for Retirees* (The Henry J. Kaiser Family Foundation, September 2003), 35; http://www.kff.org/medicare/upload/ How-States-Are-Responding-to-the-Challenge- of-Financing-Health-Care-for-Retirees-PDF.pdf; accessed September 8, 2006.

[5] The Pension Commission survey is found in: Lawrence Martin, Executive Director of the Minnesota Legislative Commission on Pensions and Retirement, memorandum to members of the Pension Commission, *Mandated Commission Study: Investment Based Post-Retirement Adjustment Mechanism Structure and Teacher Retirement Benefit Provision Comparison: Second Consideration*, November 8, 2006.

[6] Wisconsin Legislative Council, *2004 Comparative Study of Major Public Employee Retirement Systems* (Madison: Wisconsin Legislative Council, December 2005).

[7] National Association of State Retirement Administrators, *Public Fund Survey Summary of Findings for FY 2005* (Washington D.C.: National Association of State Retirement Administrators, September 2006).

To avoid distortions in our comparisons, we restricted our comparisons to benefit plans that, as in Minnesota, are coordinated with social security. Public retirement plans for employees who are not eligible for social security tend to pay much higher benefits than plans coordinated with social security. We also excluded specialized plans, such as police and fire retirement plans and local pension plans administered by individual cities, counties, or school districts. These plans were not included in the national surveys conducted by the Wisconsin Legislative Council or the Minnesota Legislative Commission on Pensions and Retirement.

Collectively, the three national studies may represent the best available summary information on state pension plans, but they have a number of data limitations and are not complete. The Wisconsin study and the Public Fund Survey tended to overlook some complicating factors that affect retirement benefits, such as differences based on hire date or retirement date. The survey by the Legislative Commission on Pensions and Retirement was more thorough than the other two national surveys, but it looked only at teacher retirement plans. When feasible, we compared the results of the surveys to determine whether the results of the national studies are misleading. The Pension Commission study noted many other limitations in national comparative data. For example, the study found that it was difficult to identify all of the provisions that affect pension benefits in each state. In addition, the national studies did not consider several factors that affect cost, including portability of benefits among different pension plans and policies regarding members who terminate employment but are not eligible to receive retirement benefits.[8]

Initial Pension Benefits

Because a person's benefits from a defined benefit pension plan can change over time, we analyzed both the initial benefit at retirement and benefit increases through the duration of retirement. The initial benefit depends on a variety of factors, as listed in Table A.2.

Minnesota's initial pension benefits for most public employees appear to be less generous than the national average. One of the key determinants of the initial benefit is the "multiplier." The benefit multiplier is the percentage that is multiplied by the retiree's final salary and years of service to obtain the initial retirement benefit. The lower the multiplier, the lower would be the amount of the retiree's initial benefit. In several states, the multiplier varies by such factors as length of service or date of hire.[9] When we made national comparisons, we computed the national average in two different ways to reflect the variation in these methods. First, we analyzed the *lowest* multiplier commonly used by a plan and found that the national median multiplier for plans was 1.82 percent, as

[8] The Minnesota Pension Commission survey also looked at factors not included in the other two surveys, including (1) the extent of items excluded from final average-salary calculations used to determine pension benefits and (2) normal cost—the amount that must be obtained in the current year to pay for future benefits attributable to the current year's operations.

[9] Some pension plans allow employers to choose the multiplier within a specified range. The national studies indicated the range but not the average of multipliers used in these plans.

Table A.2: Key Factors that Determine Initial Pension Benefits

Factor	Description
Benefit Multiplier	Percentage that is multiplied by the retiree's final salary and years of service to obtain the initial retirement benefit; the multiplier may vary by years of service
Time Period for Determining Final Salary	Number of years' worth of salary that are averaged to obtain the final average salary
Normal Retirement Age	Age at which employees can retire and receive the retirement benefit without any reduction for retiring early; normal retirement age may vary with years of service
Early Retirement Reduction Factors	Amount that benefits are reduced if an employee retires before reaching the normal retirement age—typically expressed as a percentage of benefit per year that the normal retirement age exceeds the employee's age at retirement
Vesting Period	Number of years worked after which employees qualify for retirement benefits

SOURCE: Office of the Legislative Auditor.

shown in Table A.3.[10] The second computation was based on the *average* multiplier for a retiree with 30 years of service, and the national median was 2.0 percent.[11] Minnesota's normal benefit multiplier of 1.7 percent is lower than the national median under both methods.[12]

Minnesota also appears to use a less generous method to measure the employee's salary that will be used to calculate the retirement benefit. Minnesota uses the annual average of the highest five consecutive years of an employee's salary to determine retirement benefits. Most plans in other states use three years; no plan uses more than five years.[13] Because salaries tend to increase over an employee's career, computing an average salary over five consecutive years instead of three years tends to result in lower average salaries.

[10] This is based on our analysis of data from the Wisconsin Legislative Council, *2004 Comparative Study of Major Public Employee Retirement Systems*. The Pension Commission study reported additional details about the multipliers used by some pension plans included in the Wisconsin study. In these cases, we adjusted the multiplier, as appropriate.

[11] For retirees with less than 30 years of service, the median multiplier would be between 1.82 and 2.0 percent.

[12] The multiplier of 1.7 percent is the most common multiplier used by Minnesota's statewide pension plans. Employees hired before July 1, 1989 who retire before age 65 may use a benefit tier with a 1.2 percent multiplier for the first ten years of service. Retirees who qualify for the Rule of 90 often use this tier to avoid the typical penalty for retiring early. A few employees who are ineligible for Social Security but qualify for the basic plan use higher multipliers. The 2006 Legislature increased the Teacher Retirement Association's multiplier to 1.9 percent, but it only applies to service after July 1, 2006. Minnesota's multiplier is also below the national mean, regardless of whether we weighted funds by the number of plan participants.

[13] This is based on our analysis of data in the study by the Wisconsin Legislative Council, *2004 Comparative Study of Major Public Employee Retirement Systems*.

Table A.3: Frequency of Multipliers Used to Calculate Pension Plan Benefits, Nationwide, 2004-06

Multiplier	Number of Plans Based on Average Multiplier [a]	Number of Plans Based on Lowest Multiplier [b]
2.5 to 3.0	3	3
2.3 to 2.4	2	2
2.1 to 2.2	3	2
2.0	24	21
1.8 to1.9	8	8
1.7	11	15
1.5 to 1.6	8	6
1.0 to 1.4	3	9
Total	62	66

NOTE: The benefit multiplier is the percentage that is multiplied by the retiree's final salary and years of service to obtain the initial retirement benefit. The "average multiplier" represents the average multiplier used for each year of service for a retiree with 30 years of service. The "lowest multiplier" is the lowest commonly used multiplier. Multipliers were rounded to the nearest one-tenth of one percent.

[a] Based on the average multiplier for a retiree with 30 years of service, the national median was 2.0 percent.

[b] Based on the lowest multiplier used for states' plans, the national median was 1.82 percent.

SOURCES: Office of the Legislative Auditor, analysis of Wisconsin Legislative Council, *2004 Comparative Study of Major Public Employee Retirement Systems* (Madison, WI: Wisconsin Legislative Council, December 2005), 24-25; Lawrence A. Martin, Executive Director of the Minnesota Legislative Commission on Pensions and Retirement, memorandum to commission members, *Mandated Commission Study: Investment Based Post-Retirement Adjustment Mechanism Structure and Teacher Retirement Benefit Provision Comparison: Second Consideration*, November 8, 2006, D1-D39.

Minnesota's benefits are also less generous because it applies larger benefit reductions for retiring before age 65. Two pension provisions affect how benefits are reduced when retiring before age 65: the "normal retirement age" and "early retirement reduction factors." The normal retirement age is the age at which employees can retire and receive the formula-based benefit without any reduction for retiring early. Minnesota's normal retirement age is 65 or higher (it can be as high as 66 for employees hired after July 1, 1989), but about half of the retirement plans in other states had normal retirement ages of 60 or less, provided the employee had at least 10 years of service. No other plan had a normal retirement age over 65. [14]

Early retirement reduction factors are the percentages by which pension benefits are reduced for retiring prior to the normal retirement age. Often they are expressed as a percentage for each year the employee's retirement age is below the normal retirement age. These factors are hard to compare because some states use complex schedules based on the actuarial cost of retiring early. Minnesota's early retirement reduction factors appear to be lower than those in

[14] The normal retirement age comparisons are based on our analysis of data from: Wisconsin Legislative Council, *2004 Comparative Study of Major Public Employee Retirement Systems*. The Pension Commission survey supports this conclusion.

most other states, meaning Minnesota employees receive a smaller penalty for retiring before the normal retirement age than employees from most other public retirement plans.[15] But, our analysis of the combined effects of these early retirement reduction factors and normal retirement ages indicates that the advantage Minnesota's early retirees get from smaller reduction factors does not offset the disadvantage from being in a pension plan with a higher normal retirement age.

Another way in which Minnesota's benefits are less generous than public pension plans in most other states is that Minnesota is one of 10 states that does not exempt pension income from state income taxes. Eleven states exempt all pension income from income taxes; 22 states partially exempt pension income; and 7 states have no income tax.[16]

One way in which Minnesota's plans are more generous than plans in other states is that they have a shorter vesting period. Minnesota employees can receive retirement benefits after only three years of service, while about half of the plans in other states require five years. This factor is not as significant as the normal retirement age because benefits for retirees with fewer than five years of service are much smaller than benefits for retirees with longer service; thus, they do not have as much of an impact on overall cost.

Benefit Increases During Retirement

The second aspect to comparing pension benefits is how benefit amounts increase over time. During retirement, benefits may be increased based on a variety of methods, including a fixed annual increase, an increase based on the consumer price index (CPI), ad hoc increases made by the state Legislature and, in a few cases, increases based on investment earnings beyond a designated level.

In the past, Minnesota's benefit increases after retirement were substantially more generous than those in other states, but since 2002 this has no longer been the case. Minnesota's statewide retirement plans gave six postretirement benefit increases from 1996 to 2001 that averaged about 9 percent, much higher than increases in other states. As Table A.4 shows, most plans in other states had formulas with caps of 5 percent or less.[17]

Because retirees from Minnesota's statewide plans do not qualify for investment-based increases when Minnesota's Postretirement Fund has a deficit, Minnesota's benefit increases have been 2.5 percent or less since January 2003—lower than about half of the other plans that have a formula for benefit increases, as Table A.4 shows. Because of the size of Minnesota's Postretirement Fund's deficit, maximum increases of 2.5 percent will likely continue into the next decade and possibly much longer.

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[15] Lawrence Martin, *Investment Based Post-Retirement Adjustment Mechanism Structure and Teacher Retirement Benefit Provision Comparison,* 17.

[16] Lawrence Martin, *Investment Based Post-Retirement Adjustment Mechanism Structure and Teacher Retirement Benefit Provision Comparison,* 17-18.

[17] Wisconsin Legislative Council, *2004 Comparative Study of Major Public Employee Retirement Systems,* 30-31. When the Pension Commission study reported additional details about a pension plan's formula for postretirement increases, we made appropriate modifications to the formula.

Table A.4: Postretirement Benefit Increase Formulas for 65 Large Pension Plans in Other States Compared With Minnesota's Inflation-Based Formula, 2004-06

	Number of Plans	Percent of Plans
Higher than Minnesota		
CPI rate with cap of 3 to 5 percent	12	
2.5 to 4.5 percent depending on service and salary level	1	
Fixed at 3 to 3.1 percent	10	
Fixed at 2.5 percent	1	
Subtotal	24	37%
Same as Minnesota		
CPI rate with 2.5 percent cap[a]	1	2%
Mixed (may be higher or lower than Minnesota)		
60 to 75 percent of CPI rate with no cap	3	
50 to 80 percent of CPI rate with cap of 4 to 5 percent	4	
CPI rate with cap of 6 percent, conditional on funding status	1	
1.5 to 3 percent, depending on financial status	1	
Subtotal	9	14%
Generally lower than Minnesota		
Fixed at 2 percent	2	
Fixed at 2 percent after 5 years of retirement	1	
CPI rate with 2 percent cap	1	
3 percent with $300 cap	1	
50 percent of CPI rate with 3 percent cap[b]	2	
One-time bonus with 3 percent cap, based on favorable financial results	1	
Subtotal	8	12%
Other		
Ad hoc only	17	
Not clear whether higher or lower than Minnesota	6	
Subtotal	23	35%
Grand Total	65	100%

NOTE: The table compares postretirement formulas for pension plans in other states with Minnesota's inflation-based postretirement benefit formula (CPI rate with a cap of 2.5 percent) but excludes Minnesota's investment-based formula. Because Minnesota's postretirement formula does not allow investment-based increases when its Postretirement Fund has a deficit, retirees will likely qualify only for the inflation-based increase into the next decade. Comparisons are of 65 plans in which retirees are eligible for social security.

[a] If benefits in Nebraska fall below 75 percent of the purchasing power of the initial benefit, the benefit is raised to the 75 percent amount.

[b] Retiree must be 62 years of age and retired for five years or 55 years of age and retired for ten years. Postretirement increase applies to first $18,000.

SOURCES: Office of the Legislative Auditor, analysis of Wisconsin Legislative Council, *2004 Comparative Study of Major Public Employee Retirement Systems* (Madison, WI: Wisconsin Legislative Council, December 2005), 30-31; Lawrence A. Martin, Executive Director of the Minnesota Legislative Commission on Pensions and Retirement, memorandum to Members of the commission, *Mandated Commission Study: Investment Based Post-Retirement Adjustment Mechanism Structure and Teacher Retirement Benefit Provision Comparison: Second Consideration*, November 8, 2006, D1-D39.

Pension Plan Funding Ratios

As explained in Chapter 3, the funding ratio—assets as a percentage of liabilities—is one of the key indicators of a pension plan's financial health. A funding ratio of 100 percent means that the fund has enough assets to pay all estimated liabilities accrued to date. The accuracy of funding ratio comparisons depends on the appropriateness of the economic and demographic assumptions used by actuaries for each plan. The extent to which these assumptions differ from plan to plan across states and their effect on the funding ratio comparisons are not known.

Minnesota's pension plans appear to have funded a smaller percentage of their liabilities than the national average.[18] As of July 1, 2006, Minnesota's statewide pension plans had an overall funding ratio of 80 percent, compared with an average of 87 percent for plans in other states (the median was 85 percent).[19]

PUBLIC AND PRIVATE SECTOR PENSION COMPARISONS

In this section of the appendix we compare certain features of pension plans in the private sector with those in the public sector. Comparisons are difficult because the private and public sectors tend to each use different pension types and calculate benefits differently. We looked at three aspects of each sector's pension plans: the types of plans commonly used, the costs of pension plan benefits, and consequences for unfunded pension plans.

Pension Plan Types

Pension plans in general, and defined benefit plans in particular, are more prevalent in the public sector than in the private sector.[20] Public sector employees are more likely than private sector employees to participate in a pension plan (of any type). According to the latest national data available from the Bureau of Labor Statistics, about 98 percent of full-time state and local government employees participated in pension plans in 1998.[21] In contrast, 60 percent of full-time private sector workers and 67 percent of workers in private

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[18] To calculate a funding ratio for Minnesota's statewide pension plans that is comparable to plans in other states, we used the actual market value of the Postretirement Fund assets instead of assuming that the fund was 100 percent funded. We restricted our comparisons to plans that used the same actuarial method used in Minnesota—the "entry age" method. Funding ratios for plans that use other methods may not be comparable with Minnesota's funding ratios. For example, plans that use the "aggregate cost" method are not comparable with Minnesota's pension plans because this method automatically produces a 100 percent funding ratio.

[19] The average for other states was based on the most recent valuations reported by the 2005 Public Fund Survey. Because most of these plans had valuation dates between June and December 2005, they were conducted prior to Minnesota's July 1, 2006 valuations. The funding ratio for Minnesota's statewide plans as of July 1, 2005 was 81 percent. One reason the funding ratio was lower in 2006 is that the 2006 valuations include the deficit acquired by TRA after the consolidation with the Minneapolis Teachers' Retirement Fund Association.

[20] Chapter 1 discussed the basic differences between the two major types of pension plans.

[21] Bureau of Labor Statistics, *Employee Benefits in State and Local Governments, 1998* (Washington, D.C.: U.S. Department of Labor, December 2000), 5.

establishments with 100 or more workers were pension plan members in March 2006.[22]

Public sector employees are also much more likely than private sector employees to participate in a defined benefit pension plan. In 1998 (the most recent year data were available), about 90 percent of full-time state and local government employees nationwide participated in defined benefit plans, while 14 percent were in defined contribution plans.[23] By comparison, private sector workers were far more likely to participate in defined contribution plans. Only about 23 percent of all full-time private sector workers and 33 percent of workers in private establishments with 100 or more workers participated in a defined benefit plan in March 2006.[24]

Similarly, in Minnesota, the vast majority of public employees participate in defined benefit plans. In Minnesota, statewide and local defined benefit plans cover general and other state employees, local government employees, police officers and firefighters, and teachers. As of July 1, 2006, there were about 444,000 active members and people receiving benefits in Minnesota's defined benefit plans. A limited number of state and local employees participate in defined contribution plans, many of whom participated in the State Board of Investment's Minnesota Supplemental Investment Fund.[25] As of July 1, 2005, 42,000 individuals participated in defined contribution or supplemental retirement savings plans invested in the Supplemental Investment Fund. While this count may not represent all public employees who participate in defined contribution plans, we believe it includes most.[26]

Pension Plan Benefits

Comparing private and public sector pension plans are complicated by the fact that the private sector makes greater use of defined contribution plans, which are not easily compared with defined benefit plans. Even within defined benefit plans, many private sector plans define benefits in ways that are difficult to compare with public sector benefits. As a result, it is not possible to make factor by factor comparisons with most private plans as we did when we compared Minnesota's public pension plans with other public pension plans.

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[22] Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2006* (Washington, D.C.: U.S. Department of Labor, August 2006), 7; http://www.bls.gov/ncs/ebs/sp/ebsm0004.pdf; accessed October 19, 2006.

[23] Bureau of Labor Statistics, *Employee Benefits in State and Local Governments,* 5. Some employees were members in both defined-benefit and defined-contribution plans.

[24] Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry, 2006,* 7.

[25] The Supplemental Investment Fund is the sole investment manager for all assets of the state's Unclassified Employees Retirement Plan, the Public Employees Defined Contribution Plan, the Hennepin County Supplemental Retirement Plan, and the Post Retirement Health Care Savings Plan. It is one of the investment options for the Individual Retirement Account Plan and College Supplemental Retirement Plan offered by Minnesota State Colleges and Universities.

[26] Excluded from the count are public employees, such as faculty at the University of Minnesota, who have defined contribution plans that are not part of the Supplemental Investment Fund. Also excluded are some employees with supplementary pension plans that are in addition to their primary defined benefit pension plans.

In a 2000 report, the Legislative Commission on Pensions and Retirement summarized studies that compared the benefits offered by private and public defined benefit plans.[27] It concluded that it was not clear whether private sector defined benefit plans were less or more generous than public pension plans. The study noted that public sector plans tended to have higher multipliers and larger postretirement increases, but public employees are much more likely to make significant contributions to their pension funds. This remains true today. In Minnesota's three major public pension plans, for example, employees pay between 40 and 50 percent of the cost of pension benefits, whereas in the private sector, only 3 percent of employees participating in defined benefit pension plans made contributions in 2006.[28]

Because of the limitations in comparing pension factors between private and public pension plans, employer contributions to pension plans is the best available measure to compare defined benefit plans with defined contribution plans, even though it also has limitations. We obtained contribution data for private pension plans from the National Compensation Survey conducted by the U.S. Bureau of Labor Statistics.[29] While these data are comprehensive, they have limitations. The amount of employer contributions is an appropriate measure of a pension plan's value for defined *contribution* plans, but the contributions in any one year are not necessarily a good measure of the value of a defined *benefit* plan. In some years the employer contributions to defined benefit plans may be too low to fully pay the benefits that have been promised; in other years, the contributions may be unusually high because they include an extra amount to pay off fund deficits. Thus, the contribution in any one year does not necessarily represent the average long-term contributions to the plan.

To make comparisons involving defined benefit pension plans, a better measure is the "normal cost," the amount that needs to be paid today to pay for future benefits attributable to the current year's operations, expressed as a percent of employee salaries. Normal cost is a better measure because it is not affected by whether the employer is paying off past deficits or is making insufficient contributions to meet the pension plan's ongoing costs. It tends to be more stable than actual employer contributions. We have data on normal costs for each public pension plan in Minnesota, but we have only employer contributions for the private sector pension plans, which may or may not include contributions to pay off deficits previously incurred. The extent to which the employers' share of normal cost for the private sector plans differs from the employers' contributions is unknown. As a result, we compare employer contributions in the private sector with both employer contributions and the employer's share of the normal cost for Minnesota's public pension plans. It is not clear which of the two measures for Minnesota's plans is more comparable with the private sector measure.

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[27] Legislative Commission on Pensions and Retirement, *The Comparability of Pension and Other Post-Retirement Benefits Between Public Sector and Private Sector Employees*, (St. Paul: January 2000).

[28] Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry, 2006*.

[29] U.S. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey: Employer Costs for Employee Compensation* (Washington, D.C.: U.S. Department of Labor, 2006); www.bls.gov/ncs/home.htm; accessed December 7, 2006.

Comparisons between Minnesota's public plans and the private sector are mixed and do not indicate that one sector clearly has higher employer costs than the other. Employer contributions for two out of Minnesota's three largest public pension plans were higher than the national average in the private sector, but all three were less than the average contribution by large private employers, as shown by Table A.5. The employer's share of normal cost for Minnesota's three largest pension plans was similar to the national average of employer contributions for the private sector.

Table A.5: Employer Costs of Minnesota's Major Public Pension Plans Compared With Private Sector Plans, 2006

	Employer's Contribution (Percent of Salary)	Employer's Share of Normal Cost Plus Expenses (Percent of Salary)[a]
Public Pension Plans		
Public Employees Retirement Plan (PERA)	6.0	4.2
Teachers Retirement Plan (TRA)	5.0	4.9
State Employees Retirement Plan (MSRS)	4.0	4.4
Private Sector Plans		
National average	4.5	--
Large Employers (500 + employees)	7.0	--
Midwest Employers	5.2	--

NOTE: Private sector figures are for the year ending June 30, 2006. Public sector figures are for July 1, 2006.

[a] Employer's share of normal cost is based on the employer's actual share of contributions as of July 1, 2006.

SOURCES: Office of the Legislative Auditor, analysis of data from U.S. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey* (Washington, D.C.: Bureau of Labor Statistics, 2006); http://www.bls.gov/ncs/home.htm; accessed December 7, 2006; The Segal Group, Inc., *TRA Actuarial Valuation, PERA Actuarial Valuation,* and *MSRS State Employees Retirement Fund Actuarial Valuation* (Englewood, CO: The Segal Company, 2006).

The figures for Minnesota's public pension plans do not include any defined contribution benefits that supplement these defined benefit plans. For example, most Minnesota state employees are eligible to receive matching contributions to a deferred compensation savings plan. The amount varies by bargaining group, but the American Federation of State, County, and Municipal Employees and the Minnesota Association of Professional Employees (the two largest employee bargaining groups) are eligible for matching contributions of $175 and $100 per year, respectively. Minnesota statutes authorize local governments to offer such benefits under certain conditions, but data are not available on the extent to which local governments offer them.[30]

[30] *Minnesota Statutes* 2006, 352.96, subd. 1-2, and 356.24, subd. 1 (a).

Unfunded Pension Plans

When defined benefit pension plans are in poor financial condition, consequences in the private sector differ from those in the public sector. Employees in companies with pension plans that have been severely underfunded over a number of years may lose some or all of their pension benefits if the companies go bankrupt. States and local governments, however, have a far smaller chance of bankruptcy because of their reliance on several tax bases, which are unlikely to disappear.[31] Private sector employees do not have that same level of security.

Certain economically distressed defined benefit pension plans in the private sector may pass their pension obligations to the Pension Benefit Guaranty Corporation, a federal corporation established to protect private workers' defined benefit pensions. To qualify, a financially distressed employer with an underfunded pension plan must prove in bankruptcy court that it cannot remain in business unless it terminates its pension plan. There are limits on the amount the Pension Benefit Guaranty Corporation will pay to retirees after taking over a pension fund, and the corporation does not pay cost-of-living increases to pensioners after the takeover. The Pension Benefit Guaranty Corporation will not fully guarantee benefit increases that were initially established or amended in the five years before the plans' demise.

The Pension Benefit Guaranty Corporation pays benefits according to the provisions of each plan up to a maximum, as set in federal law and adjusted each year. For plans terminated in 2006, benefits are guaranteed up to a maximum of $3,972 per month ($47,659 per year) for retirees at age 65. This maximum is lower for early retirees and higher for those retiring after 65. It is also adjusted when survivor benefits are available.

Even though the Pension Benefit Guaranty Corporation was established as a protection against workers' loss of benefits from defined benefit pension plans, its ability to fund its long-term obligations is uncertain.[32] Funding sources for the Pension Benefit Guaranty Corporation are (1) insurance premiums paid by businesses with defined benefit pension plans, (2) the assets of underfunded pension plans that businesses have terminated, (3) assets recovered during bankruptcy proceedings of businesses that had sponsored pension plans, and (4) investment returns on the Pension Benefit Guaranty Corporation's assets. A variety of factors, however, including the market's performance in the early 2000s, the threat posed to the Pension Benefit Guaranty Corporation's revenue base by the ongoing decline in the number of defined benefit pension plans, and the bankruptcy of numerous companies that transferred their pension obligations to the Pension Benefit Guaranty Corporation, have left the Corporation with a significant long-term deficit.

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[31] Although extremely rare, Minnesota counties, cities, towns, and certain special districts (but not school districts) may file for bankruptcy under *Minnesota Statutes* 2006, 471.831.

[32] Government Accountability Office, *Private Pensions: The Pension Benefit Guaranty Corporation and Long-Term Budgetary Challenges GAO-05-772T* (Washington, D.C.: Government Accountability Office, June 2005), 3.

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