TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director

RE: S.F. 2272 (Betzold, Skoglund); H.F. xxx: Legislators Coordinated Retirement Plan; Removing the Requirement that Members of the Legislators Coordinated Retirement Plan Must Pay the Employer Social Security Contributions

DATE: May 6, 2005

General Summary of S.F. 2272 (Betzold, Skoglund); H.F. xxx

S.F. 2272 (Betzold, Skoglund); H.F. xxx revises a Social Security coverage statute, Section 355.629, Subdivision 3, to remove a requirement that the Legislators Coordinated Retirement Plan member had to pay the Social Security employer contribution, in addition to the employee Social Security contribution.

Historical Information on Retirement Coverage for Legislators

The Legislators Retirement Plan, governed by Minnesota Statutes, Chapter 3A, was enacted in 1965. It is the successor to the Public Employees Retirement Association as the retirement coverage for members of the Legislature. During the 1960s, the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General) was a basic plan and no contributions were made into the federal Social Security program for the covered service. PERA-General used a career average salary and had back-loaded accrual rates, heavily favoring long-time employees. A member received one percent of career average salary for each of the first ten years of service, two percent of career average salary for each of the next ten years, 2.5 percent for each year between 20 and 30 years of service, and three percent for each year over 30 years of service. The decision in 1965 to create a separate Legislators Retirement Plan probably stems from recognition that the back-loaded PERA-General Plan was not well suited to provide legislative retirement coverage, since the typical legislator would not be providing many decades of service. Another factor may have been that legislative salaries were very low, consistent with the notion that legislative service was part-time and a civic duty, rather than a career. Like its predecessor, the new Legislators Retirement Plan was a basic program (a plan under which members do not pay into Social Security due to the employment, and will not receive future Social Security benefits due to that employment).

From 1965 to 1977, to provide a reasonable benefit level in dollar terms given the minimal legislative salaries of that time, the Legislators Retirement Plan provided a retirement benefit of five percent of the average monthly salary received during the final term of office for the first eight years of service, and an additional 2.5 percent per year for each year beyond eight. For those who left service and were too young to draw a benefit, the annuity augmented at five percent per year. The surviving spouse was entitled to a benefit equal to half the legislator's benefit, and a benefit was also provided to surviving children. The retired plan members participated in the Minnesota Adjustable Fixed Benefit Fund, a forerunner of the current Minnesota Post Retirement Investment Fund.

Beginning with the 1979 Legislative Session, the maximum benefit accrual rate for any new legislative service was lowered to 2.5 percent. This lower accrual rate was adopted in recognition of the changing nature of legislative work. As legislative salaries increased in recognition that legislative work was becoming more like a full-time occupation, the Legislature recognized that it needed to revise the benefit accrual rates downward to compensate for that revised salary policy. The legislative salary for pension purposes was redefined to exclude any additional compensation for leadership positions. A 20-year cap on creditable service was also imposed. The Legislators Retirement Plan was revised in 1978 and 1979 to use the high-five average salary rather than the average salary in the final term in office and the normal retirement age was increased from age 60 to age 62, with age 60 becoming the earliest age for retirement with a reduced annuity. Vesting for a retirement annuity was reduced from eight years to six years. In 1989, the definition of salary was changed to include regular and special session per diem payments, the deferred annuity augmentation rates were revised to three percent per year up to the year in which the ex-legislator becomes age 55, and five percent per year thereafter, the reduction factors for early retirement were revised to require a more substantial penalty, and the 20-year cap on service credit was removed. Members who were no longer accruing service credit because their service exceeded 20 years were authorized to again begin accruing service credit. The 1989 removal of the Legislative Plan service credit cap was made retroactive in 1992. Long-term legislators, including those in deferred status, with uncredited service prior to June 2, 1989, were authorized to purchase service credit for the uncredited period and the affected legislators were required to contribute nine percent of salary received during the uncredited period plus six percent interest from the midpoint of the period of uncredited service to the date of payment. Payment had to be received prior to retirement or by January 1, 1994, whichever was earlier.

Recent Developments in Pension Coverage for Legislators

a. 1997 Revision of the Legislators Retirement Plan Accrual Rates. In 1997, the annual benefit accrual rate for the Legislators Retirement Plan was revised due to a bill that revised the operation of the State Board of Investment Post Retirement Fund, which invests the assets of retired legislators. The Post Fund was revised to assume that assets of the fund will earn at least six percent annually prior to payout, rather than at least five percent. This lowers the reserves needed support any given level of annuity, but tends to lessen post-retirement adjustments generated by the fund by approximately one percent per year. The bill included language revising the accrual rate or rates for the Legislators Retirement Plan as necessary to hold the legislative members harmless under these Post Fund changes.

b. 1997 Pension Coverage Changes for New Legislators. A significant change also occurred in 1997 for all newly elected legislators. Members first elected after 1997 are not covered by the Legislators Retirement Plan. Rather, they are given coverage under the Unclassified State Employees Retirement Program of the Minnesota State Retirement System (MSRS-Unclassified), a defined contribution plan, which for a few decades had provided coverage for many legislative employees other than legislators. MSRS-Unclassified is coordinated with Social Security, giving these post-1997 legislators Social Security coverage for their legislative service. Members contribute four percent of salary to MSRS-Unclassified, and the employer (the Legislature or the State) contributes another six percent of salary to that plan, for a total of ten percent of pay. The employee also contributes to Social Security (the Social Security Old Age, Survivors, and Disability Insurance Program) and to Medicare, and the employer makes corresponding contributions to those federal programs. The contributions to Social Security are 6.2 percent matching employee/employer contributions, and another 1.45 percent matching contributions are made to the Medicare program.

c. 1997 First Social Security Referendum for Existing Legislators. Legislators elected in 1997 or earlier were given an option to obtain Social Security coverage through a Social Security referendum. The options were to retain Legislators Retirement Plan coverage and not be covered by Social Security, or to elect Social Security coverage, in which case the individual would receive Social Security coverage, receive a deferred annuity from the Legislators Retirement Plan based on the service rendered under that plan prior to the Social Security coverage election, and for prospective coverage be placed in the Unclassified Plan. Thus, those electing the Social Security coverage were transferred prospectively from the defined benefit plan (Legislators Plan) to a defined contribution plan (MSRS-Unclassified).

d. 2002 Second Social Security Referendum. A few years later, some of the pre-1997 legislators who declined Social Security coverage in the election authorized in 1997, and thus stayed in the Legislators Retirement Plan, sought to revise the Legislators Retirement Plan to create a coordinated defined benefit program within the Legislators Retirement Plan, through a second Social Security coverage referendum. The bill, S.F. 1863 (Rest); H.F. 1896 (Skoglund), authorized a second Social Security referendum for those still covered by the Legislators Retirement Plan, including up to five years of retroactive Social Security coverage. Legislators electing Social Security coverage in this second referendum would remain in the Legislators Retirement Plan, and although they would be deemed to be members of a new Coordinated Legislators Retirement Plan, that new program would provide benefits identical to the then existing Legislators Retirement Plan, which is a basic program, despite also having the Social Security coverage for the legislative employment.

   S.F. 1863 (Rest); H.F. 1896 (Skoglund) was controversial. It broke from past policy by not downsizing benefit levels in any newly created Coordinated Program compared to the prior Basic Program. Basic programs typically provide a larger benefit (by use of a larger benefit accrual rate) than comparable coordinated programs. A basic program benefit is set high because it is assumed that the individual will not have Social Security coverage, and thus the benefit from the plan may be the only source of income in retirement other than that derived from personal savings. In contrast, coordinated programs are designed under an assumption that there will be three income sources in retirement: Social Security benefits, benefits from the coordinated retirement plan, and income derived from personal savings. Coordinated plans are designed to produce a benefit which, in combination with Social Security benefits, provides income comparable to that provided by a basic program without Social Security coverage. Because the coordinated program provides a lower benefit than a corresponding basic program, the contribution rates and cost of the program are correspondingly lower.

   In all prior cases where the Legislature has created coordinated programs, the coordinated program provided considerably lower benefits than the corresponding basic program, in recognition that individuals would be receiving Social Security benefits in retirement due to that coordinated employment coverage. Coordinated programs were created in nearly all general employee Minnesota public pension plans in the 1960s or 1970s, or earlier. All new employees hired after the coordinated program was established are enrolled in the new coordinated program. Existing employees at the time of the coordination typically had a Social Security referendum. In some cases, these were individual referendums, where each employee

receives the type of coverage he or she chooses in the election. In other cases, the referendum was by majority vote. If a majority voted for Social Security coverage, all would receive that coverage and be placed in the coordinated program. If a majority was not achieved, none would receive the Social Security coverage. The General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), covering most state employees, has been a coordinated plan from its beginning. PERA-General started as a basic plan, but was coordinated decades ago. At most a few basic members remain in that plan. Similar patterns were followed in the Teachers Retirement Association (TRA), the first class city teacher retirement plans, and the Minneapolis Employees Retirement Fund (MERF). (The Coordinated Program in MERF was moved to PERA-General in the early 1980s. The current MERF coverage group is the remaining basic members.)

If there is any model for the treatment that was proposed in S.F. 1863 (Rest); H.F. 1896 (Skoglund), it was the present Judges Retirement Plan. However, when that plan was first coordinated it did not provide treatment comparable to that prescribed for the Legislators Retirement Plan in S.F. 1863 (Rest); H.F. 1896 (Skoglund). When a Coordinated Judges Plan was created, the plan had an offset provision. The accrual rates used to compute the annuity were identical in the old basic plan and new coordinated plan, but for the coordinated retirees 7.5 percent of the amount that the judge received from Social Security was to be deducted (offset) from the computed Judges Retirement Plan benefit, and the judge was to be paid only the net amount. The offset created the same effect as providing lower accrual rates in a coordinated plan compared to the corresponding basic plan and using no offset. Over time this system in the Judges Retirement Plan was changed. Due to amendments to the Judges Retirement Plan passed by the Legislature over a few decades, the offset was changed from a 7.5 percent offset to a 50 percent offset, and in 1992 the remaining offset was repealed. The current Judges Retirement Plan would provide an identical benefit to comparable individuals, whether they were basic or coordinated, although I believe there are no basic plan active judges remaining.

The Commission first heard S.F. 1863 (Rest); H.F. 1896 (Skoglund), on April 2, 2001. An issue that the Commission discussed is whether allowing legislators an option to obtain Social Security coverage during the current term of office amounted to an increase in compensation and violated Article IV, Section 9, of the Minnesota Constitution, which states "The compensation of senators and representatives shall be prescribed by law. No increase of compensation shall take effect during the period for which the members of the existing House of Representatives may have been elected" An argument could be made that the future Social Security benefits could be considered as current compensation that is being deferred. Similarly, the portion of Social Security contributions paid by the employer on behalf of the employee could be considered to be an increase in compensation that is channeled into Social Security contributions before being received by the employee. However, the employee contributions paid by the individual might be considered as a compensation reduction, which offsets the compensation-increase effect of employer-paid employer contributions. The Commission received conflicting advice on this compensation issue. A Senate Counsel staff opinion concluded that electing Social Security would not constitute an increase in compensation. In contrast, a House Research document concluded that the case mentioned in the Senate Counsel opinion was substantively different than the proposed legislation, and that a court could conclude that inclusion in Social Security was an increase in compensation. Some Commission members also noted the fiscal cost to the state due to employer contributions that would be required by the Social Security coverage. The bill was laid over. At the Commission's next meeting, on April 6, 2001, the Commission recommended S.F. 1863 (Rest); H.F. 1896 (Skoglund) to pass, but recommended that it not be included in the Commission's omnibus pension bill. S.F. 1863 (Rest); H.F. 1896 (Skoglund) did not pass the Legislature that year.

In 2002, an amendment derived from S.F. 1863 (Rest); H.F. 1896 (Skoglund) was offered by Representative Phyllis Kahn in the House State Government Finance Committee. The amendment included a revision requiring legislators electing Social Security coverage under the referendum to pay both the employee and employer contributions required by Social Security. This removed any impact on the state budget, and it may have avoided the issue of whether electing Social Security created an increase in compensation for sitting legislators. The language did not appear in any Senate bill, but it was added to the final conference committee report for the Omnibus Pension Bill and enacted as Laws 2002, Chapter 392, Article 15.

<u>Reasons for Wanting Social Security Referendum in 1997 and 2002</u>

Social Security coverage was desirable to some members in order to obtain or increase future Social Security benefits, and to avoid or minimize reductions in Social Security benefits that might otherwise occur. Two causes of Social Security benefit reduction, which can be minimized or avoided by transferring into a coordinated program for legislators, are discussed in attachments from the Social Security Administration. The first is the Windfall Elimination Provision. Social Security replaces a high percentage of earnings for low income workers. Some individuals who are not low income workers may appear to be low income when Social Security earnings records are reviewed, simply because much of an individual's earnings were not in

Social Security-covered employment. The Windfall Elimination Provision was intended to avoid a windfall to this group. The Government Pension Offset is the other provision discussed in the attachments. This provision reduces or eliminates the Social Security surviving spouse benefit that would otherwise be provided to a surviving spouse if that survivor was covered by a government plan that was not coordinated with Social Security. At the time of the 1997 and 2002 referendums, the Government Pension Offset could be avoided if the individual was covered for the give employment by a coordinated plan on the final day of service. More recently, that Social Security provision has been revised to require a longer period of coordinated plan coverage to avoid the Government Pension Offset.

Discussion and Analysis

S.F. 2272 (Betzold, Skoglund); H.F. xxx revises a Social Security coverage statute, Section 355.629, Subdivision 3, to remove a requirement that the Legislators Coordinated Retirement Plan member had to pay the Social Security employer contribution in addition to the employee Social Security contribution. The bill revises the compromise passed by the 2002 Legislature, which was derived from 2001 S.F. 1863 (Rest); H.F. 1896 (Skoglund).

The proposed legislation raises several pension and related public policy issues, as follows:

1. Consistency with Minnesota Constitution: Impact on Compensation. The issue is whether the bill violates Article IV, Section 9, of the Minnesota Constitution, which states in its entirety "The compensation of senators and representatives shall be prescribed by law. No increase of compensation shall take effect during the period for which the members of the existing House of Representatives may have been elected." Minnesota Statutes currently require that the legislators covered by the Coordinated Program of the Legislators Retirement Plan must pay not only the Social Security employee contribution, but also the Social Security employer contribution. The bill would revise this by having the employer pay the Social Security employer contribution, and since the bill has no effective date provision, it would be come effective on August 1, 2005. The bill would certainly increase the net pay of the applicable legislators. If the Commission concludes that the bill does violate or may violate the Minnesota Constitution, one solution is to add an effective date delaying implementation until after the next House member general election.

2. Budget Implications for Legislature. The bill would shift a financing burden from the individual to the House and the Senate, and therefore has implications for the Legislature's budget. According to MSRS, five active House members and five active Senate members are in the Coordinated Legislators Retirement Plan. Given an average salary of $38,429, according to the most recent actuarial valuation, the Social Security employer contribution (6.2 percent of pay) is $2,383 per covered member, or a total of $11,913 for the House and $11,913 for the Senate. Under the bill, this amount per year is shifted from the employees to the employer. In the future, the amount would diminish as covered individuals retire. It would increase if salary increases, or if Social Security contribution rates are increased.

3. Reversal of a Prior Agreement. The bill reverses a compromise reached in 2002 when the Coordinated Legislators Retirement Plan was created. Staff can not know the specific reasons why the enacting law was structured with the provisions it contained; we can only provide likely considerations. The 2002 provisions (Laws 2002, Chapter 392, Article 15) were effective the day following final enactment, rather than after the next general election of the House. The Legislature may have been concerned that electing Socials Security coverage in general, or any employer-paid contributions to Social Security, could be viewed as a somewhat disguised increase in compensation, in violation of the constitutional provision prohibiting compensation increases prior to the next House election. That concern could be removed by having the employee cover the employer contribution, which was required in that legislation. Another reason for having the employee pay the employer contribution would be to avoid any impact on the budget of the Legislature. And finally, the Legislature may have concluded that the employee pick-up of the employer contribution was a reasonable price for the Coordinated Program legislators to pay for the unusual treatment of not downsizing Coordinated Program benefits compared to the Basic Plan, and for the advantages of getting Social Security coverage despite remaining in a generous defined benefit plan.

4. Pressure for a Third Legislator Social Security Referendum. The issue is whether acting on the current bill is likely to lead to a third Social Security referendum by legislators. Some Legislators Retirement Plan members in 2002 may have decided not to elect Social Security coverage and become Coordinated Program members of the Legislators Retirement Plan because of the expense of paying both the Social Security employee and employer contributions, for a total contribution of 12.4 percent of pay, plus an additional amount for Medicare. If Coordinated Program members are no longer required to pay the Social Security employer contribution, then various Basic Plan legislators may be interested in another Social Security election under these more favorable proposed terms. There are approximately 77 legislators in the Legislators Retirement Plan Basic Program.

5. Possible Tension between Various Groups of Legislators. The issue is whether legislators elected before 1997, who voluntarily chose to transfer to MSRS-Unclassified in order to obtain Social Security coverage, will feel that the current proposal is unfair. At the time of the 1997-1998 elections between the basic Legislators Retirement Plan and the Social Security coordinated MSRS-Unclassified, getting Social Security coverage for the legislative employment required giving up defined benefit plan coverage and moving to a defined contribution plan. Some who elected in 1997-1998 to move to MSRS-Unclassified would not have made that election if they could have known that a few years later, in 2002, the options would change. In 2002, it became possible for legislators to obtain Social Security coverage for legislative employment while remaining in a generous defined benefit plan, with no downsizing of the accrual rates or eventual benefits despite the Social Security coordination. The one drawback to Legislators Retirement Plan coverage is that the individual must pay the entire Social Security contribution rather than having the employer pick up half of that cost. If the current bill is enacted, the coordinated Legislators Retirement Plan members will be paying for Social Security on the same terms as the legislators in MSRS-Unclassified, but the coordinated Legislators Retirement Plan members can be viewed as being in a considerably more generous Minnesota public plan than MSRS-Unclassified members. The total annual contribution to MSRS-Unclassified is ten percent of pay (four percent by the member and six percent by the employer). According to the 2004 Legislators Retirement Plan actuarial valuation, the normal cost of the Legislators Retirement Plan is 16.89 percent of pay. Some legislators may view the current situation as unfair, and the proposed bill, by removing some of the Social Security contribution burden on the coordinated Legislators Retirement Plan members, could be viewed as creating more unfairness rather than solving a problem. It is possible that given the 2002 enacted legislation and the present proposal, some legislators who elected MSRS-Unclassified coverage in 1997-98 may seek legislation to transfer coverage back to the Legislators Retirement Plan, along with prior service from the date they first became MSRS-Unclassified members.

Potential Amendments for Commission Consideration

Amendment LCPR05-290 adds an effective date, to be set by the Commission, for the bill. If the Commission is not concerned about the Minnesota Constitution compensation issue, the Commission could fill in the blank in the amendment with July 1, 2005, or some other suitable date close to the final enactment date. If the Commission is concerned about the Minnesota Constitution compensation issue, the Commission might choose a date of January 1, 2007, or some other suitable date following the next House general election.

Amendment LCPR05-291, an alternative to LCPR05-290, is a delete-all amendment downsizing the benefits in the Coordinated Legislators Retirement Plan by using an accrual rate consistent with that currently found in Minnesota public defined benefit coordinated general employee plans, and setting a Coordinated Legislators Retirement Plan employee contribution rate at five percent, rather than the current nine percent. A five percent contribution rate is the rate requested for MSRS-General in a contribution rate increase bill introduced this Session, S.F. 264 (Betzold, by request); H.F. 1757 (Smith). The Commission may conclude that this treatment is appropriate to establish the usual relationship between coordinated and basic plan benefits, particularly if the decision in 2002 to not downsize the plan was due to a desire to offset the heavy Social Security contribution burden placed on the new Coordinated Legislators Retirement Plan members by that legislation. Since that excess Social Security contribution burden is removed by the present bill and by this delete-all amendment, the Commission may conclude that a downsizing of the Coordinated Program benefit, for service after the excess Social Security contribution burden is removed, is a reasonable step. That action may also remove some of the pressure for another Social Security referendum, or for possible future legislation to allow those who chose MSRS-Unclassified to transfer into the Coordinated Legislators Retirement Plan. The amendment includes an effective date, with a specific date to be set by the Commission. This amendment clearly increases the current net compensation of the covered group, by shifting the Social Security employer contribution burden from the employee to the employer, and by reducing the coordinated member contribution rate to the Legislators Retirement Plan. Thus, the Commission may wish to choose an effective date occurring after the next House of Representatives general election.