

TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Lawrence A. Martin, Executive Director

RE: S.F. 436 (Betzold); H.F. 2115 (Smith): Transfer of Average Salary Definitions to Definition Sections

DATE: March 28, 2005

Summary of S.F. 436 (Betzold); H.F. 2115 (Smith)

S.F. 436 (Betzold); H.F. 2115 (Smith) amends the definition portions of Minnesota Statutes, Chapters 352, 352C, 353, 354, 354A, 422A, and 490, the governing laws for the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), the Correctional Employees Retirement Plan of the Minnesota State Retirement System (MSRS-Correctional), the Elected State Officers Retirement Plan, the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General), Public Employees Police and Fire Plan (PERA-P&F), the Teachers Retirement Association (TRA), the first class city teacher retirement fund associations, the Minneapolis Employees Retirement Fund (MERF), and the Uniform Judges Retirement Plan, to transfer the various definitions of “average salary” from the retirement annuity calculation sections to the definition sections.

Section-By-Section Summary

A section-by-section summary of S.F. 436 (Betzold); H.F. 2115 (Smith) is attached.

Background Information on Defined Benefit Plan Retirement Annuity Calculations and the Determination of Average Salary

Principle II.C.7 of the Commission’s Principles of Pension Policy, last revised in 1995-1996, generally suggests that normal retirement benefits should respond to economic changes, should be adequate as of retirement, measured on the basis of the retiree’s final average salary, with 30 years of service as a reasonable public employment career, at the normal retirement age, and should reflect any Social Security benefit earned during public employment.

Specifically, the principle states:

7. Adequacy of Benefits at Retirement

- a. Benefit adequacy requires that retirement benefits respond to changes in the economy.
- b. The retirement benefit should be adequate at the time of retirement.
- c. Except for local police or firefighter relief associations, the retirement benefit should be related to an individual’s final average salary, determined on the basis of the highest five successive years’ average salary unless a different averaging period is designated by the Legislature.
- d. Except for local police or firefighter relief associations, the measure of retirement benefit adequacy should be at a minimum of thirty years service, which would be a reasonable public employment career, and at the generally applicable normal retirement age.
- e. Retirement benefit adequacy must be a function of the Minnesota public pension plan benefit and any Social Security benefit payable on account of Minnesota public employment.

Thus, the Principles indicate that the Minnesota public pension plans only have an obligation to provide an adequate retirement benefit for career public employees who retire at the normal retirement age and, consequently, do not have an obligation to provide a fully adequate pension benefit to public employees who retire at an earlier age or who retire with less than a full public service career. The Principles indicate that retirement benefit adequacy, which should be determined on the basis of the person’s highest five successive years’ average salary, should be measured at the generally applicable normal retirement age with 30 years of service credit. The Principles also indicate that retirement benefit adequacy must be

a function of the public pension plan retirement benefit and Social Security benefits earned during public employment.

In 1980-1981, the President's Commission on Pension Policy addressed the question of benefit adequacy, indicating that the replacement of pre-retirement disposable income from all sources is a desirable retirement income goal. That panel indicated that the precise replacement of pre-retirement disposable income was too difficult to quantify, but that a reliable rough sense of the rates for the replacement of gross income can be identified, as follows:

Gross Pre-Retirement Income	Single Person		Married Couple	
	Replacement of Gross Pre-Retirement Income		Replacement of Gross Pre-Retirement Income	
	as \$ amount	as %	as \$ amount	as %
\$ 6,500	\$ 5,167	79%	\$ 5,567	86%
10,000	7,272	73	7,786	78
15,000	9,941	66	10,684	71
20,000	12,282	61	13,185	66
30,000	17,391	58	18,062	60
50,000	25,675	51	27,384	55

Derived from Tables 19 and 20 of Coming of Age: Toward a National Retirement Income Policy, Report of the President's Commission on Pension Policy, prepared by Preston C. Bassett, Consulting Actuary (1980).

More recently, addressing the same question of the replacement percentage of pre-retirement earnings, the National Retirement Income Policy Committee of the American Society of Pension Actuaries, in a 1994 study, recommended that income during retirement from a combination of defined benefit plans, defined contribution plans, and Social Security should provide between 70 percent and 80 percent of pre-retirement earnings.

The President's Commission on Pension Policy also attempted to provide a sense of the relative role of the three sources of retirement income in providing that replacement of pre-retirement disposable income. The three sources of retirement income are Social Security, employee pension coverage, and personal savings and investments. That panel's 1981 report included a chart that attempted to provide a general sense of the relative contribution to an adequate retirement benefit that should be made from the three sources.

Relative Contribution to an Adequate Retirement Benefit From
Various Sources of Retirement Income

Gross Pre-Retirement Income	Social Securit y	Employee Pension Plan	Personal Savings and Investments
\$15,000	58%	42%	0%
20,000	54	46	0
25,000	54	46	0
30,000	52	44	4
35,000	49	44	7
40,000	46	46	8
45,000	43	47	10
50,000	42	46	12
55,000	40	45	15
60,000	39	41	20

Derived from Chart 7 of Coming of Age: Toward a National Retirement Income Policy, Report of the President's Commission on Pension Policy (1981)

The table reflects the weighting of benefit coverage in favor of the lower compensated employees that is present in the Social Security System and reflects a policy decision that personal savings should provide an ever greater proportion of total retirement income at higher compensation levels. The table also reflects the prior table, with an ever-reducing replacement percentage required as gross income increases.

Using the suggestions of the 1980-1981 President's Commission on Pension Policy as to the replacement of gross pre-retirement income that constitutes an adequate retirement benefit and the relative contribution towards an adequate retirement income from various sources, the following compares the situation of a general public employee in Minnesota retiring at age 65 with 30 years of covered service at various pre-retirement income levels:

Final Salary	\$15,000		\$20,000		\$30,000		\$50,000	
High-5 Ave. Salary ¹	\$13,576		\$18,102		\$27,153		\$45,255	
Presidential Pension Commission Target Retirement Benefit \$ / % Hi-Five ²	\$9,941	73.22%	\$12,282	67.85%	\$17,391	64.05%	\$25,675	56.73%
Retirement Income								
Social Security \$ / % Hi-5	\$8,856	65.23%	\$9,000	49.72%	\$11,999	44.19%	\$15,500	34.25%
MSRS-General \$ / % Hi-5	<u>\$6,923</u>	<u>51.00%</u>	<u>\$9,232</u>	<u>51.00%</u>	<u>\$13,848</u>	<u>51.00%</u>	<u>\$23,080</u>	<u>51.00%</u>
Total \$ / % Hi-5	\$15,779	116.23%	\$18,232	100.72%	\$25,847	95.19%	\$38,580	85.25%

¹ Assumes 5.25 percent salary increases, the MSRS-General salary increase assumption, for the five years prior to retirement.

² Calculated based on President's Commission on Pension Policy target for a single person.

The highest five successive years' average salary basis for calculating a Minnesota defined benefit public pension plan retirement annuity was the major benefit improvement enacted by the 1973 Legislature. Before the 1973 legislative session, the statewide Minnesota defined benefit public pension plans used a career average salary base for the retirement annuity calculation. The first class city retirement plans introduced the highest five years' average salary base for retirement annuity calculation several years before 1973, when it became the standard for the various statewide defined benefit pension plans.

A final salary basis for a retirement annuity calculation contributes to the adequacy of the retirement benefit calculation at the time of retirement, based on a replacement of immediate pre-retirement compensation perspective. It represents a view that retirement adequacy is the replacement of a certain pre-retirement standard of living, as demonstrated by the compensation achieved in the period immediately before retirement.

The use of an averaging period in conjunction with the final salary to determine the basis for calculating a retirement annuity is a mechanism intended to reduce the potential for manipulating the retirement annuity calculation base or for final year upward or downward aberrant career-end salary figures arising out of demotions, downsizing, or temporary disabilities from causing a distortion in the retirement annuity calculation base. Unless a person has lived for a period with a given salary level, that salary level cannot reliably be used as a representation of the person's standard of living. The use of a highest five successive years' average salary retirement annuity calculation base, however, has not been totally successful in eliminating manipulation potential or in negating aberrant salary distortions. Because the 1973 legislation that implemented the highest five successive years' average salary did not include a mechanism to reflect part-time service in a comparable manner that the prior career average salary did in most Minnesota public pension plans, it is possible for a person to be employed part-time in the public sector for most of the person's career, then become more fully employed during the final five-year period of the person's working career and receive a retirement annuity well out of proportion to the person's career accumulated contributions and the person's public career standard of living. Full time employees who elect to work overtime extensively during the immediate pre-retirement period or who can time-shift a portion of their compensation to the immediate pre-retirement period can also obtain a larger retirement annuity than their accumulated member contributions or career standard of living would merit. Conversely, a public employee who worked overtime for a significant portion of the person's early and middle career, but who elected or was compelled by the employer's economic situation or the person's health to discontinue doing so, or a person who suffers a late career demotion or a late career disrupting disability will receive a smaller retirement annuity than their accumulated member contributions or career standard of living would merit.

Discussion and Analysis

S.F. 436 (Betzold); H.F. 2115 (Smith) moves the existing definitions of “average salary” from the retirement benefit calculation provisions to the definition sections for the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), the Correctional Employees Retirement Plan of the Minnesota State Retirement System (MSRS-Correctional), the Elected State Officers Retirement Plan, the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General), Public Employees Police and Fire Plan (PERA-P&F), the Teachers Retirement Association (TRA), the first class city teacher retirement fund associations, and the Minneapolis Employees Retirement Fund (MERF), and updates the “average salary” definition for the Uniform Judges Retirement Plan.

While the proposed legislation does not make a substantive change in the various “average salary” definitions but simply repositions the definitions into the general definition sections of the applicable statute chapters, there are pension and related public policy issues connected with the issue of the final salary figure averaging period that the Commission may wish to consider and discuss, which are as follows:

1. Appropriate Reflection of a Retiree’s Pre-retirement Standard of Living in a High-Five Years Average Salary. The policy issue is the appropriateness of a highest five successive years’ average salary figure as a surrogate for a retiree’s pre-retirement period standard of living. In 1973, the Legislature decided to set public defined benefit annuity levels based on a mechanism that more closely reflects the retiree’s pre-retirement standard of living, shifting from the prior career average salary base to the highest five successive years’ average salary base. While the high-five average salary is a better reflection of standard of living changes than a career average salary, the high-five average salary has not been significantly reappraised by the Commission since 1973. The high-five average salary does retain some protection against end-of-career salary (and benefit) manipulation. Based on experience studies and other demographic information, statutory salary increase assumptions exist for the various statewide and major local retirement plans. The following sets forth the normal career-end salary increase assumptions for the plans (age 61-65 for general employee plans and age 51-55 for public safety plans):

Age	General Employee Plans						Public Safety Plans		
	MSRS- General	PERA- General	TRA	DTRFA	MTRFA	SPTRF A	Age	PERA- P&F	State Patrol, MSRS- Corr., Local Corr.
61	5.25	5.00	5.40	5.00	5.00	5.00	51	5.25	5.4384
62	5.25	5.00	5.50	5.00	5.00	5.00	52	5.25	5.3776
63	5.25	5.00	5.60	5.00	5.00	5.00	53	5.25	5.3167
64	5.25	5.00	5.70	5.00	5.00	5.00	54	5.25	5.2826
65	5.25	5.00	5.70	5.00	5.00	5.00	55	5.25	5.2500
High 5 as % of Final Salary	90.51%	90.92%	89.94%	90.92%	90.92%	90.92%		90.51%	90.45%

The current high five successive years’ average salary base will represent 90-91 percent of a retiring member’s final year’s salary. While other jurisdictions also use a high-five average salary, a large number of jurisdictions use a highest three successive years’ average salary. A high three years’ average salary will represent about 95 percent of a retiring member’s final year’s salary under the same normal career-end salary increase assumptions. Changing the average salary base to a high three years’ average would represent a significant benefit increase and would increase the potential for salary manipulation.

2. Potential Need to Accommodate In-Kind Compensation in Final Average Salary. The policy issue is the potential need for changes in the definitions of covered salary and the computations of final average salary to better accommodate public employees who are partially compensated in kind. The in-kind compensation for public employees can range from supplied housing for state park managers to supplied transportation for state troopers, police officers, school superintendents, and other employees. While the in-kind compensation contributes to a public employee’s standard of living to some degree, these amounts are not covered for retirement contributions during the person’s career and are not included in the final average salary determinations. In a recent Commission staff project reviewing covered salary public pension laws in other jurisdictions, in-kind compensation was covered by the applicable public pension plan in several instances.

3. Potential Need for a Better Accommodation of Part-Time Employment and the Proration of Service Credit. The policy issue is the need to resolve the ongoing problem of handling retirement coverage for part-time public employment. The problem has existed since 1973, when the high-five average salary replaced the career average salary, and has only been partially accommodated in the case of combined service annuities. Career average salary plans accurately accommodate part-time public sector employment through the salary amount credited. With a final average salary plan, as implemented in 1973, the other factor in calculating retirement annuities, service credit, must be adjusted in order to accurately accommodate part-time employment. The General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General) prorates service credit for part-time employees in some cases, but not all. The Teachers Retirement Association (TRA) prorates service credit for part-time teaching service if the teaching service is less than five hours per day. Service credit proration for part-time employees is not provided for in the benefit plans in the other retirement plans. Without proration, long-time part-time public employees who become full-time employees near the end of their career or who increase the extent of their part-time employment at the end of their career receive disproportionate retirement benefits in terms of the relationship between total contributions and monthly annuity compared to full-time employees or unchanging part-time employees.
4. Potential Need to Curb Late Career Salary Manipulation. The policy issue is the question of a persistent need to take steps to curb the manipulation of late career salary levels to enhance subsequent retirement benefits. The Commission's policy is to provide adequate retirement benefits by basing them on a measure of the retiree's pre-retirement standard of living. The policy only works in practice if the measure of the pre-retirement standard of living is accurate and the measure in the form of the highest five successive years' average salary has not been accurate in all cases. There is evidence in the past that some public employees begin working overtime in the pre-retirement period in order to boost their high-five average salary. Recent information strongly suggests that some school administrators are enhancing or "packing" their final five years' average salary by redirecting compensation items by changing the timing of compensation items. Laws 2004, Chapter 267, Article 7, Sections 6 and 9, attempted to address this potential late career salary manipulation by school administrators by requiring the Teachers Retirement Association (TRA) to specially audit the final salaries of any retiree with a salary in excess of 95 percent of the Governor's salary level. The manner in which final salary manipulation is curbed can vary from improved governmental employer management through increased retirement plan salary audits, to legislation that limits the increases in annual covered salary.
5. Appropriateness of Covered Salary Maximum. The policy issue is the appropriateness of the continued utilization of the covered salary maximum in Minnesota Statutes, Section 356.611. Minnesota Statutes, Section 356.611, enacted in 1994 (Laws 1994, Chapter 528, Article 4, Section 11), and last amended in 2004 (Laws 2004, Chapter 267, Article 2, Section 5), sets a maximum of 95 percent of the salary of the Governor on the salary covered for public retirement plan contributions or benefit purposes for all statewide and major local defined benefit public retirement plans and for the Unclassified State Employees Retirement Program of the Minnesota State Retirement System (MSRS-Unclassified), with several exceptions to the maximum, which are the Governor; some political subdivision employees excluded under Minnesota Statutes, Sections 43A.17, Subdivision 9 (i.e. school district employees and public hospital employees); some public employees with a salary rate approved by the Commissioner of Employee Relations; judges; all state employees as defined in Minnesota Statutes, Section 43A.02, Subdivision 21; Gillette Hospital employees covered by the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General); employees of the Minnesota Crop Improvement Council; and employees of the Minnesota Historical Society. Although the covered salary maximum applies to a very small number of public employees, for the those individuals, the regulation will not produce an adequate benefit for the public employee upon retirement as the concept is defined in the Commission's Principles of Pension Policy, although the applicable plan member has access to other retirement savings programs (principally, the Minnesota Deferred Compensation Program) and resources to devote to that savings program in the form of the member contribution amount on the limited salary amount. The covered salary maximum was intended, in 1994, to reduce the potential of final salary manipulation by very well-compensated public pension plan members, but salary manipulation can occur at any salary level, whether the level approaches that of the Governor's salary or is substantially less. As the elements of public employee compensation have become more complex in recent years, with shift differentials, uniform allowances, cafeteria compensation plans, court appearance pay, pay for work on non-duty days, deferred compensation, single and family health insurance rate differential payments, and payments in lieu of employer-paid fringe benefits, the potential for future intentional or unintentional salary manipulation grows.

Section-By-Section Summary of S.F. 436 (Betzold); H.F. 2115 (Smith)

Sec.	Page & Line	Plan	Provision	Summary
1	Page 1, Lines 18-36 Page 2, Lines 1-8	MSRS-General and MSRS-Correctional	352.01, New Subd. 14a	Moves the “average salary” definition from Minnesota Statutes, Sections 352.115, Subdivision 2, and 352.93, Subdivision 1, to the definitions section.
2	Page 2, Lines 9-29	MSRS-General	352.115, Subd. 2	Eliminates the transferred definition of “average salary.”
3	Page 2, Lines 30-36 Page 3, Lines 1-22	MSRS-General	352.115, Subd. 3	Revises crossreferences to the transferred “average salary” definition.
4	Page 3, Lines 23-34	MSRS-Fire Marshal Plan	352.87, Subd. 3	Revises crossreferences to the transferred “average salary” definition.
5	Page 3, Lines 35-36 Page 4, Lines 1-16	MSRS-Correctional	352.93, Subd. 1	Eliminates the transferred definition of “average salary” and clarifies the language relating to combinations of MSRS-General and MSRS-Correctional service.
6	Page 4, Lines 17-23	Elected State Officers	352C.021, New Subd. 1a	Moves the “average salary” definition from Minnesota Statutes, Section 352C.031, Subdivision 3, to the definition section.
7	Page 4, Lines 24-36 Page 5, Lines 1-3	PERA-General and PERA-P&F	353.01, New Subd. 17a	Moves the “average salary” definition from Minnesota Statutes, Section 353.29, Subdivision 2.
8	Page 5, Lines 4-36 Page 6, Lines 1-2	PERA-General	353.29, Subd. 3	Revises crossreferences to the transferred “average salary” definition.
9	Page 6, Lines 3-17	PERA-General	353.33, Subd. 3	Revises crossreferences to the transferred “average salary” definition.
10	Page 6, Lines 18-27	PERA-P&F	353.651, Subd. 3	Revises crossreferences to the transferred “average salary” definition.
11	Page 6, Lines 28-36 Page 7, Lines 1-14	PERA-P&F	353.656, Subd. 1	Revises crossreferences to the transferred “average salary” definition.
12	Page 7, Lines 15-25	TRA	354.05, New Subd. 13a	Moves the “average salary” definition from Minnesota Statutes, Section 354.44, Subdivision 6.
13	Page 7, Lines 26-36 Page 8, Lines 1-36 Page 9, Lines 1-36 Page 10, Lines 1-10	TRA	354.44, Subd. 6	Revises crossreferences to the transferred “average salary” definition.
14	Page 10, Lines 11-21	First Class City Teacher Plans	354A.011, New Subd. 7a	Moves the “average salary” definition from Minnesota Statutes, Section 354A.31, Subdivision 4
15	Page 10, Lines 22-36 Page 11, Lines 1-24	MTRFA and SPTRFA Coordinated Programs	354A.31, Subd. 4	Revises crossreferences to the transferred “average salary” definition.
16	Page 11, Lines 25-36 Page 12, Lines 1-24	DTRFA New Law Coordinated Program	354A.31, Subd. 4a	Revises crossreferences to the transferred “average salary” definition.
17	Page 12, Lines 25-36 Page 13, Line 1	MERF	422A.01, New Subd. 4a	Moves the “average salary” definition from Minnesota Statutes, Section 422A.15, Subdivision 1.
18	Page 13, Lines 2-35	MERF	422A.15, Subd. 1	Revises crossreferences to the transferred “average salary” definition.
19	Page 13, Line 36 Page 14, Lines 1-36 Page 15, Lines 1-3	MERF	422A.16, Subd. 9	Revises crossreferences to the transferred “average salary” definition.
20	Page 15, Lines 4-15	Uniform Judges Retirement Plan	490.121, Subd. 21	Revises the language, style, and structure of the provision.
21	Page 15, Lines 16-18		Repealer	Repeals the Elected State Officers Retirement Plan, PERA-General, and PERA-P&F “average salary” definitions.
22	Page 15, Lines 19-20		Effective Date	Effective on July 1, 2005.

