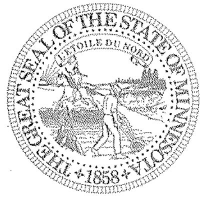
State of Minnesota \ LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT



TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Lawrence A. Martin, Executive Director

RE: Mandated Commission Study; Investment Based Post-Retirement Adjustment Mechanism Structure and Teacher Retirement Benefit Provision Comparison: First Consideration

DATE: August 23, 2006

Introduction

Laws 2006, Chapter 277, Article 2, Section 1, requires a study by the Legislative Commission on Pensions and Retirement of the topic of the structure and implication of the investment performance-based post-retirement adjustment procedures used by the retirement plans administered by the Minnesota State Retirement System (MSRS), the retirement plans administered by the Public Employees Retirement Association (PERA), the Teachers Retirement Association (TRA), the Minneapolis Employees Retirement Fund (MERF), the first class city teacher retirement fund associations, the Minneapolis Firefighters Relief Association, and the Minneapolis Police Relief Association and the topic of a comparison of Minnesota teacher retirement plans with other state teacher retirement plans with respect to normal retirement age, early retirement penalties, benefit taxation, Social Security coordination of pension benefits, pension benefit accrual rate formula multipliers, pension benefit final average salary periods, and pension benefit special early normal retirement provisions.

The mandate requires that the Commission produce a report containing its findings as a result of the study on or before December 1, 2006. The report is also required to include draft proposed legislation to implement any recommendations it formulates as a result of the study. The report must be filed with the State and Local Governmental Operations Committee and the Finance Committee of the Senate and the Governmental Operations and Veterans Affairs Committee, the State Government Finance Committee, and the Ways and Means Committee of the House of Representatives.

This Commission staff issue memorandum accompanies the Commission's first consideration of the study topic. The memorandum will present background information on investment-related post-retirement adjustment mechanisms applicable to the various statewide retirement plans (Minnesota Post Retirement Investment Fund), the Minneapolis Employees Retirement Fund (MERF), the first class city teacher retirement fund associations, the Minneapolis Firefighters Relief Association, the Minneapolis Police Relief Association and the Fairmont Police Relief Association. The memorandum will also present background information on various aspects of the benefit practices of the benefit plans of the Teachers Retirement Association (TRA), the Duluth Teachers Retirement Fund Association (DTRFA), and the St. Paul Teachers Retirement Fund Association (SPTRFA), including the normal retirement age, early retirement reductions, taxation of benefits, coordination with Social Security, pension benefit accrual rates, pension benefit final average salary periods, and special early normal retirement provisions.

The course of the study as anticipated by the Commission staff would involve two additional considerations by the Commission of the topic. The anticipated second Commission consideration would be accompanied by a Commission staff memorandum that would compare the past post-retirement adjustments with inflation, review the post-retirement adjustment mechanism costs and budgets, identify state aid implications of post-retirement adjustments, identify inconsistencies between the various post-retirement adjustments and identify related policy implications. The Commission staff issue memorandum accompanying the Commission's second consideration would also compare various benefit plan provisions for the statewide or largest teacher retirement plans in 50 states as identified by the Nations Conference on Teacher Retirement (NCTR), identify additional benefit plan provisions appropriate for comparison and compare those provisions for 50 state teacher retirement plans, discuss alternative measures of the relative generosity or related actuarial cost of the pension benefit plans, identify study and comparison limitations, and make preliminary potential findings based on study results. The anticipated third Commission consideration would review preliminary study findings and make final findings, identify available legislative alternatives in addressing post-retirement adjustment mechanism findings, identify available legislative alternatives in addressing teacher benefit plan provision comparison findings, take additional testimony from interested and relevant parties, and formulate legislative recommendations.

Background Information on Investment-Related Post-Retirement Adjustment Mechanisms in Minnesota Public Pension Plans

A. Minnesota Post Retirement Investment Fund (MPRIF)

1. In General. The Minnesota Post Retirement Investment Fund (MPRIF) is the post-retirement adjustment mechanism currently applicable to the various statewide public retirement plans in Minnesota. The Minnesota Post Retirement Investment Fund includes both an inflation-related post-retirement adjustment component and an investment-related post-retirement adjustment mechanism.

   Because the Minnesota Post Retirement Investment Fund is the subject of an additional contemporaneous interim study, this background information is abbreviated to avoid undue repetition.

2. Pre-Minnesota Adjustable Fixed Benefit Fund Post-Retirement Adjustments. According to information assembled by the Commission staff in 1976 and 1979, the major Minnesota statewide retirement plans provided some post-retirement adjustments during the period 1953-1969, but none of the adjustments were determined based on investment performance on retirement assets or were otherwise investment related.. Between 1953 and 1969, retirees of the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General) received three post-retirement adjustments, retirees of the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General) received three post-retirement adjustments, and retirees of the Teachers Retirement Association (TRA) received seven post-retirement adjustments. The post-retirement adjustments during the period 1953-1969 generally were granted to retirees at large (except for TRA, where four adjustments were related to the 1959 law (prior plan) retirees) and were funded out of the retirement fund rather than the State General Fund more frequently.

3. Minnesota Adjustable Fixed Benefit Fund. The initial automatic post-retirement adjustment mechanism (Laws 1969, Chapter 485, Section 32, and Laws 1969, Chapter 914, Section 10) was the Minnesota Adjustable Fixed Benefit Fund (MAFB), which was created to provide increases in the pensions of retired persons to help meet increased costs of living. The adjustments under the Minnesota Adjustable Fixed Benefit Fund were wholly funded from investment gains in excess of the post-retirement interest rate actuarial assumption on the fully funded reserves for the retirement annuities covered by the mechanism. Under the Minnesota Adjustable Fixed Benefit Fund, if the mechanism experiences investment losses, previous post-retirement increases, if any, can be reduced, but the retirement annuity amount originally payable at retirement is guaranteed. Thus, the Minnesota Adjustable Fixed Benefit Fund was functionally a variable annuity mechanism with an original benefit amount benefit floor.

   Each retirement fund taking part in the Minnesota Adjustable Fixed Benefit Fund transferred sufficient reserves to permit level annuities to be paid to retirees, providing the fund continued to earn at least the actuarial interest requirement. The Minnesota Adjustable Fixed Benefit Fund annuity amounts could be modified through an adjustment mechanism relying on a two-year average total rate of return measure. The use of the averaging feature was intended to add some stability. The total rate of return included dividends, interest, and realized and unrealized gains or losses. Annually, a "benefit adjustment factor" was computed. This was calculated by dividing the result of one plus a two-year average total rate of return by one plus the actuarial return. If the fund was not meeting the actuarial investment earnings requirement, the ratio was less than one. If the return equaled the actuarial return, the ratio was equal to one. If the returns exceeded the actuarial return, the ratio would be greater than one. The law provided that benefits could be increased if the benefit adjustment factor was greater than 1.02, providing that certain additional requirements were met. If the benefit adjustment factor was less than .98, a benefit decrease was required, but at no time could the retirement benefits drop below the benefit level received on the date of retirement.

   The benefit increases actually granted through the Minnesota Adjustable Fixed Benefit Fund were minimal, due in part to an initial failure to isolate out mortality gains and losses in the first version adjustment formula, to the poor investment climate during the early 1970s, and to the presence of the annuity stabilization reserve that was part of the Minnesota Adjustable Fixed Benefit Fund adjustment process. Benefit increases above four percent could not be paid unless the annuity stabilization reserve contained enough assets to cover 15 percent of the past year's benefit payments. If the reserve was insufficient, part of the new investment earnings were added to the reserve, rather than being paid out as benefits. Benefit increases above four percent required correspondingly higher annuity reserves under the Minnesota Adjustable Fixed Benefit Fund law.

The Minnesota Adjustable Fixed Benefit Fund was initially proposed by the Teachers Retirement Association (TRA), was developed by the TRA actuary (the late Edward Brown of the actuarial firm of Brown & Flott), and was not reviewed by the Legislative Retirement Study Commission during the 1967-1969 interim. The initial TRA proposal provided for separate adjustment mechanisms for each of the various statewide plans and was funded from investment income in excess of the interest rate actuarial assumption when that fortuitous funding occurred. During the 1969 Session, the TRA proposal was broadened to cover all statewide retirement plans and to cover the Minneapolis Employees Retirement Fund (MERF) in a single combined mechanism administered by the State Board of Investment. The mechanism benefited from the funding progress that the State experienced since 1957 when its pension funds amassed assets greater than the required reserves for retirees and attempted to balance the limited goal of providing periodic increases to help meet the increased costs of living without "raiding" the pension funds or the public treasury because increases were funded from the yield on investment assets in excess of the statutory assumptions. Commission policy before 1969 held that post-retirement adjustments were a version of public assistance rather than part of the pension program. The Commission staff in the 1960s appears to have been strongly committed to variably annuity programs.

With the enactment of the 1973 benefit improvements, principally the replacement of the career average salary base with the highest five years average salary base for benefit calculations, the increase of the interest rate actuarial assumption from 3.5 percent to 5.0 percent, the granting of a two-part 25 percent post-retirement increase to pre-1973 retirees, and the occurrence of high inflation and modest investment performance in the mid-1970s, the Minnesota Adjustable Fixed Benefit Fund did not fulfill the fanfare that accompanied its establishment. The Minnesota Adjustable Fixed Benefit Fund only paid one set of increases operating as designed, in 1972 (MSRS-General, 2.0 percent; MERF, 4.0 percent; PERA-General, 4.0 percent; and TRA, 2.5 percent; differing because mortality gains and losses were not isolated out of the formula until 1973), with the potential for increases 1973-1975 overridden by the 25 percent 1973 interest rate actuarial assumption modification-based adjustments, with the "initial benefit amount" reset to include the benefit amounts payable after the 1973 and 1974 increases, and with legislative intervention (Laws 1978, Chapter 665, Section 2) allowing for a 4.0 percent 1978 adjustment, even though the Minnesota Adjustable Fixed Benefit Fund formula did not permit the payment of an increase.

4. <u>Minnesota Post Retirement Investment Fund 1980-1992</u>. The Minnesota Adjustable Fixed Benefit Fund was substantially revised in 1980 (see Laws 1980, Chapter 607, Article XV, Section 16) and was renamed the Minnesota Post Retirement Investment Fund. The 1980 Minnesota Post Retirement Investment Fund retained the pooling of fully funded retirement annuity reserves of the Minnesota Adjustable Fixed Benefit Fund and increases were based on investment performance in excess of the post-retirement interest rate actuarial assumption akin to the Minnesota Adjustable Fixed Benefit Fund, but the investment performance was determined on a yield basis (i.e., dividends on equities, interest on debt equities, and realized gains on the sale of investments) rather than the total rate of return used by the Minnesota Adjustable Fixed Benefit Fund.

   Like the Minnesota Adjustable Fixed Benefit Fund, the 1980 version of the Minnesota Post Retirement Investment Fund included an automatic adjustment mechanism intended to provide benefit adjustments to help offset, to some degree, increases in living costs. One difference was that while the Minnesota Adjustable Fixed Benefit Fund based adjustments on total investment return, including unrealized gains, the 1980 version of the revised Minnesota Post Retirement Investment Fund provided adjustments based solely on realized income. Another difference was that the Minnesota Post Retirement Investment Fund contained no provisions for reducing benefit levels when investment returns were low. Third, the original revised Minnesota Post Retirement Investment Fund based adjustments on a single year's realized investment return, rather than using an average of a multi-year period. To determine adjustments, at the end of each fiscal year (June 30), the required reserves were calculated. The required reserves were the assets needed to meet the current stream of annuity payments to be paid to retirees over time, providing that the assets earned at least five percent, which was the Minnesota Post Retirement Investment Fund actuarial interest assumption at that time. The total reserves were multiplied by 1.05 to determine the amount of investment income needed to sustain the current benefit level. By subtracting this amount from total realized investment earnings, excess investment earnings were determined and were used to create a permanent increase in the annuities of retirees. The fiscal year information was used to determine the amount of increase, if any, payable on the next January 1, the effective date of any benefit increase. To determine benefit increases payable as of January 1, the excess investment income and the required reserves must be projected forward to that date by increasing the excess investment income by 2.5 percent, the return which those funds must earn for the six

month period in order to meet the actuarial assumption, and by estimating the total required reserves on January 1 for those eligible for a post-retirement adjustment.

The 1980-1992 Minnesota Post Retirement Investment Fund paid increases in each of the 12 years that it was in effect. The average increase during the 12-year period was 6.5 percent.

5. Combined Cost-of-Living Component/Investment-Performance Component Minnesota Post Retirement Investment Fund. Significant changes in the Minnesota Post Retirement Investment Fund occurred in 1992 (Laws 1992, Chapter 530). The mechanism was revised to include two components rather than the prior single component. The combined components were:

   i) Inflation Match Component. An annual post-retirement increase matching inflation, but not to exceed 3.5 percent, was created; and

   ii) Additional Investment-Based Component. An additional investment performance-based increase was permitted based on investment performance in excess of 8.5 percent total returns over five-year periods, based on the total rate of return of the investment fund rather than investment yield.

   The addition of an inflation match component t the Minnesota Post Retirement Investment Fund, measured by the annual increase in the Consumer Price Index, changed the effective post-retirement interest rate actuarial assumption from the previous understated five percent assumption to the identical rate as the pre-retirement interest rate actuarial assumption, the official rate of five percent plus 3.5 percent to account for the inflation component, or 8.5 percent. The investment performance component was triggered by total rate of return investment performance in excess of 8.5 percent, with one-fifth of that performance credited to the current year and the remaining four one-fifths credited to the succeeding four years to smooth out performance results over several years. The net total amount of past and current investment performance credited to the current year become the required reserves for the investment performance component increase based on the percentage relationship between the new reserves and the total required reserves of retirees eligible for an investment component increase.

   The 1992 revisions in the Minnesota Post Retirement Investment Fund resulted in the payment of post-retirement adjustments in each of the five years that this version of the mechanism was in effect. The average increase during the five-year period was 5.80 percent.

6. Downsized Cost of Living Component of the Minnesota Post Retirement Investment Fund. In 1997 (Laws 1997, Chapter 233, Article 1, Section 5), the inflation match component was revised downward to 2.5 percent rather than 3.5 percent, and at the same time the Minnesota Post Retirement Investment Fund investment return assumption was revised from five percent to six percent, retaining the effective post-retirement interest rate actuarial assumption governing the mechanism at 8.5 percent. The revised Minnesota Post Retirement Investment Fund investment return assumption was part of a package of benefit changes intended to increase the benefit level payable at the time of retirement. The benefit improvement as it applied to the State Board of Investment-invested plans increased the benefit accrual rates for all of the defined benefit plans participating in the Minnesota Post Retirement Investment Fund. In part, the 1997 benefit accrual rate increase was financed by the revised Minnesota Post Retirement Investment Fund inflation-match component and investment component actuarial assumption. Fewer reserves are needed to support any given annuity if the assets are assumed to earn six percent prior to payout rather than five percent. The released reserves were used to cover higher benefits at the time of retirement. But the 1997 six percent return requirement, rather than the prior five percent, leaves less of a margin between the Minnesota Post Retirement Investment Fund investment return assumption and the true long-term expected annual rate of return, which is 8.5 percent. The inflation match component was reduced from 3.5 percent to 2.5 percent to compensate. In effect, in 1997 a higher benefit at the time of retirement was traded for approximately one percent per year lower Minnesota Post Retirement Investment Fund inflation-related adjustments.

   The 1997 revisions in the Minnesota Post Retirement Investment Fund resulted in the payment of a post-retirement adjustment in each of the past nine years since the most recent substantive modifications. The average increase during the nine-year period was 5.88 percent.

7. Post-Retirement Adjustment Maximum. In 2006 (Laws 2006, Chapter 277, Article 1, Section 1), a maximum annual adjustment from the Minnesota Post Retirement Investment Fund of five percent was adopted, effective July 1, 2010. The 2006 maximum was intended to moderate the high and

low adjustments year to year by eliminating very high rates of increase, automatically retaining the reserves related to the unpaid increase amount to fund higher future increases during low investment performance periods. The delay to 2010 was intended to permit the applicable retirement plans to seek approval from the federal Internal Revenue Service of the change.

B. Minneapolis Employees Retirement Fund (MERF) Retirement Benefit Fund

1. In General. The Minneapolis Employees Retirement Fund (MERF), once known as the Minneapolis Municipal Employees Retirement Plan (MMER), was initially included in the Minnesota Adjustable Fixed Benefit Fund (MAFB), 1969, and its successor, the Minnesota Post Retirement Investment Fund (MPRIF), 1980, but separated in 1981 from the MPRIF in favor of the separate MERF Retirement Benefit Fund, which includes both an inflation-related post-retirement adjustment component and an investment-related post-retirement adjustment component.

2. Inclusion in the Minnesota Adjustable Fixed Benefit Fund. In 1969 (Laws 1969, Chapter 485, Section 32), the Minnesota Adjustable Fixed Benefit Fund was created as a joint State Board of Investment-administered post-retirement adjustment mechanism for the various statewide Minnesota retirement plans and the Minneapolis Municipal Employees Retirement Plan (MMER) was included in the mechanism. Inclusion of MMER/MERF in the Minnesota Adjustable Fixed Benefit Fund required the transfer of MMER/MERF assets to the State Board of Investment in an amount equal to the retired reserves for the plan's retired members. In 1969, the Minnesota Adjustable Fixed Benefit Fund held 74 percent of the total MMER/MERF assets.

3. Conversion to the Minnesota Post Retirement Investment Fund (MPRIF). In 1980 (Laws 1980, Chapter 607, Article XV, Section 16), the Minnesota Adjustable Fixed Benefit Fund was revised and renamed as the Minnesota Post Retirement Investment Fund (MPRIF) and MMER/MERF continued as a participating retirement fund.

   While the Minnesota Adjustable Fixed Benefit Fund was basically a variable annuity program adapted to include an "original benefit amount" floor of prior benefit increase reductions and to moderate increases through a minimum threshold for increase payments and through the existence of an annuity stabilization reserve, the 1980 Minnesota Post Retirement Investment Fund was an investment-driven increase mechanism based on investment yield in excess of a five percent post-retirement interest rate actuarial assumption and providing an annual increase based on any investment yield in excess of that assumption, without any benefit reductions in the event of poor investment performance.

4. MPRIF Withdrawal/MERF Retirement Benefit Fund Creation. In 1979 (Laws 1979, Chapter 303, Article 6, Section 10, the MMER/MERF was closed to new members, with new Minneapolis city and Special School District No. 1 employees having retirement coverage by the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General). The MMER/MERF closure placed the retirement plan, with approximately 3,000 retired members and 6,000 active members in 1979, on a phase-out basis. At the time of the phase-out legislation, approximately 62 percent of MMER/MERF assets had been transferred to the Minnesota Adjustable Fixed Benefit Fund.

   In 1981 (Laws 1981, Chapter 298, Sections 5 through 10), the participation of MERF, officially renamed as such, in the Minnesota Post Retirement Investment Fund (MPRIF) officially ended, the MERF retiree reserves and liabilities were transferred from the State Board of Investment to the newly created MERF Retirement Benefit Fund, and the MERF Retirement Benefit Fund was required to replicate the MPRIF mechanism and to operate identically to the MPRIF. The transfer undoubtedly was prompted by a number of factors, but the transfer increased the investment-related activities of the MERF Board and MERF Executive Director, then former Senator John Chenoweth, and extended the need for a MERF administration potentially by several decades. At the withdrawal of MERF from the MPRIF, MERF's participation in the MPRIF equaled 59.4 percent of the total MERF assets.

5. Conformity with 1992 MPRIF Changes. In 1992 (Laws 1992, Chapter 530), an inflation component adjustment feature was added to the Minnesota Post Retirement Investment Fund (MPRIF), capped at 3.5 percent annually, and the MERF Retirement Benefit Fund was modified identically.

6. Exclusion from 1997 and 2006 MPRIF Changes. In 1997 (Laws 1997, Chapter 233, Article 1, Section 5), the Minnesota Post Retirement Investment Fund (MPRIF) inflation component

adjustment was scaled back from a 3.5 percent maximum Consumer Price Index (CPI) increase adjustment to a 2.5 percent maximum CPI increase adjustment as part of a benefit accrual rate increase for the MPRIF-covered statewide retirement plans affecting retirement annuities at retirement, but MERF was not included in the benefit accrual rate increase and the MERF Retirement Benefit Fund was excluded from implementing the 1997 MPRIF changes, leaving the MERF Retirement Benefit Fund operating under the 1992 MPRIF law. The MERF Retirement Benefit Fund was also excluded from the post-retirement adjustment maximum enacted for the MPRIF in 2006 (Laws 2006, Chapter 277, Article 1, Section 1).

C. Duluth Teachers Retirement Fund Association (DTRFA) Post-Retirement Adjustment Mechanism.

1. In General. The Duluth Teachers Retirement Fund Association (DTRFA) has had two versions of an investment performance post-retirement adjustment mechanism, which were the initial mechanism that provided a one-time, annual non-compounding, non-percentage, "thirteenth check" increase and the subsequent mechanism that provides a permanent, compounding percentage annuity increase.

2. DTRFA Thirteenth Check Post-Retirement Adjustment Mechanism. In 1985 (Laws 1985, Chapter 259, Section 2) the Duluth Teachers Retirement Fund Association (DTRFA) was authorized to amend its articles of incorporation to implement a post-retirement adjustment mechanism. The special law authorizing the mechanism permitted up to one percent of the asset value of the retirement fund as of the end of the prior fiscal year to be paid to eligible retirees if DTRFA investment performance exceeded six percent of asset value at the end of the fiscal year, required retirees to have been receiving an annuity for at least three years to be eligible for an adjustment, and allocated the increase based on a unit value determined by dividing the total amount available for the adjustment by the aggregate number of years of service and the number of years of annuity receipt, based on each retirees' years of service and annuity receipt. The special legislation required that the DTRFA Board have the power to eliminate or reduce the adjustment in any fiscal year and to specify a minimum annuity receipt period longer than three years.

   In implementing the adjustment in 1985, the DTRFA Board set the investment performance threshold amount at 6.36 percent, required a minimum of three years of retirement benefit receipt, and retained Board discretion on whether or not an adjustment would be paid at the end of each October.

   In 1990 (Laws 1990, Chapter 570, Article 7, Section 4), approval was granted for DTRFA to amend its articles of incorporation to allow for the lump sum adjustments to be annuitized based on the age of the annuitant or survivor, the plan's mortality table, and the interest rate assumption governing the Minnesota Post Retirement Investment Fund (MPRIF).

   Under the mechanism, adjustments were paid in 1985, 1986, 1987, 1989, 1990, 1991, 1992, 1993, and 1994. The initial unit value of $34 in 1985 increased to $55 in 1993.

3. Subsequent DTRFA Post-Retirement Adjustment Mechanism. In 1995 (Laws 1995, Chapter 262, Article 2, Sections 3, 4, 5, 11, and 14), a new post-retirement adjustment mechanism replaced the 1985 DTRFA thirteenth check. The replacement adjustment was an automatic percentage increase combined with an investment performance-related adjustment.

   The pool of eligible post-retirement adjustment recipients was set at all annuitants or retirement benefit recipients who had received an annuity or retirement benefit for at least 12 months as of the adjustment date. The automatic increase is two percent annually of the annuity or benefit amount payable on the prior December 1 and is payable on January 1. the investment performance-related adjustment is payable to annuitants and retirement benefit recipients who have received the annuity or benefit for at least one year if the five-year annualized time-weighted total rate of return investment performance was in excess of 8.5 percent and the percentage increase must be downwardly modified by any actuarial valuation contribution deficiency (i.e., (time-weighted total rate of return – 8.5 percent) x (1 – actuarial contribution deficiency rate)). The investment performance-related adjustment is also payable on January 1.

D. St. Paul Teachers Retirement Fund Association (SPTRFA) Post-Retirement Adjustment Mechanism.

1. In General. The St. Paul Teachers Retirement Fund Association (SPTRFA) has had two versions of an investment performance post-retirement adjustment mechanism, with the initial mechanism that provided a one-time, non-compounding, non-percentage, "thirteenth check" increase and the subsequent mechanism that provides a permanent, compounding, percentage annuity increase.

2. SPTRFA Thirteenth Check Post-Retirement Adjustment Mechanism. The St. Paul Teachers Retirement Fund Association (SPTRFA) was the initial first class city teacher retirement fund association establishing a thirteenth check post-retirement adjustment mechanism. In 1979 (Laws 1979, Chapter 109), SPTRFA was authorized to amend its bylaws to implement a post-retirement adjustment mechanism. The special law authorizing the mechanism permitted the use of one-half of one percent of the fund's asset value at the end of the prior fiscal year to be paid as an adjustment to eligible annuitants and benefit recipients if the SPTRFA investment income during the preceding fiscal year was in excess of 5.5 percent of the asset value of the plan as of the end of the current fiscal year, required annuitants and survivor benefit recipients be in receipt of the annuity or benefit for at least three years to be eligible for an adjustment, and allocated the increase in proportion to each eligible recipient's credited years of service relative to the total years of service credit of all eligible recipients. The adjustment was payable on April 1, annually. The SPTRFA board of trustees was not given any discretion to downwardly adjust the amount. The special authorization was subject to a December 31, 1982 sunset.

   In 1981 (Laws 1981, Chapter 157), the December 31, 1982, sunset date on the adjustment was eliminated and the mechanism became permanent.

   In 1985 (Laws 1985, Chapter 259, Section 3), the SPTRFA thirteenth check mechanism was significantly revised, with the payment date of the adjustment set as January 1, annually, the minimum investment performance required for the payment of the adjustment of fund income increased to an amount in excess of six percent of the asset value of the fund at the end of the current fiscal year, and with the allocation of the adjustment charged to be based on units that combined both years of service credit and years of annuity or survivor benefit receipt, with each recipient receiving a proportional amount related to the whole.

   In 1990 (Laws 1990, Chapter 570, Article 7, Section 4), approval was granted for SPTRFA to amend its bylaws to allow for the lump sum adjustment to be annuitized based on the age of the annuitant or survivor, the plan's mortality table, and the interest rate assumption governing the Minnesota Post Retirement Investment Fund.

3. Subsequent SPTRFA Post-Retirement Adjustment Mechanism. In 1997 (Laws 1997, Chapter 233, Article 3, Section 7), the prior St. Paul Teachers Retirement Fund Association (SPTRFA) thirteenth check post-retirement adjustment mechanism was eliminated and was replaced by a new post-retirement adjustment mechanism that combined an automatic annual percentage adjustment with an investment performance related adjustment.

   The recipients eligible to receive an automatic adjustment or an investment performance related adjustment are those retirement annuity or benefit recipients who had received a retirement annuity or benefit for at least 12 months as of the adjustment date. The automatic adjustment is two percent of the annuity or benefit amount without a specified payment date and the adjustment is payable annually. The investment performance related adjustment is payable if the five-year annualized total time-weighted rate of return of the plan assets exceeds the post-retirement interest actuarial assumption rate. The adjustment is the amount by which the five-year investment performance rate exceeds the post-retirement interest assumption after being downwardly modified by any contribution deficiency disclosed in the most recent actuarial valuation (i.e., (time-weighted total rate of return – 8.5 percent) x (1.00 – (the total actuarial funding requirement – the total required contribution rate))).

   When the shift from the thirteenth check to the current two-part adjustment mechanism occurred in 1997, a transitional benefit was payable to 1997 retirees based on the federal Consumer Price Index increase since retirement.

E. Minneapolis Firefighters Relief Association

1. In General. The Minneapolis Firefighters Relief Association (MFRA) has three post-retirement adjustment mechanisms, with one based on the periodic salary increases applicable to a first grade firefighter, one based on investment performance, and one based on the funded ratio of the retirement plan.

2. MFRA Escalator Adjustment. Until 1955, the Minneapolis Firefighters Relief Association (MFRA) provided a specific dollar amount service pension and that service pension was not subject to any automatic post-retirement adjustment. In 1955 (Laws 1955, Chapter 188, Section 7), the MFRA

converted to a service pension based on the monthly salary of a first grade firefighter each January 1, based on "units." The unit value was initially set at and remains defined as one-80th of the base salary, which is the monthly salary of a first grade firefighter. The escalator authority was permissive, requiring the relief association to implement the escalator through a relief association bylaw amendment.

3. Investment Performance-Based Thirteenth Check. In 1989 (Laws 1989, Chapter 319, Article 19, Section 7), an investment-related post-retirement adjustment was added to the Minneapolis Firefighters Relief Association (MFRA) benefit plan in addition to the post-retirement escalator. The adjustment was a single automatic lump sum payment that in total equaled one-half of one percent of the assets of the relief association. The adjustment was payable if the total time-weighted rate of return investment performance for the fiscal year exceeds by two percent the actual fiscal year annual increase in the salary of a top grade firefighter and if the annual average time-weighted rate of return investment performance for the previous five years exceeds by two percent the annual actual average increase in the salary of a top grade firefighter. Each adjustment recipient's share is determined based on the relationship between the number of units of the person's base benefit and the total number of units for all recipients. If the "thirteenth check" is payable, an amount equal to an additional one-half of the assets of the relief association is applied to reduce that year's state amortization aid or state supplemental amortization aid.

   In 1996 (Laws 1996, Chapter 438, Article 4, Sections 12 and 13), the MFRA investment-related post-retirement adjustment mechanism was modified by reducing the investment performance triggers for the mechanism to one to solely match the five-year average annual salary increase rate plus two percent.

   In 1997 (Laws 1997, Chapter 233, Article 4, Sections 13 to 16), the amount of relief association assets available for distributions through the "thirteenth check" was increased to 1.5 percent of the assets if the relief association has a funding ratio in the most recent actuarial valuation of at least 103 percent, and retaining the one-half of one percent maximum on the amount of assets available for distribution if the funding ratio of the relief association in the most recent actuarial valuation is under 102 percent.

4. Additional Funded Ratio Related Post-Retirement Adjustment. In 2000 (Laws 2000, Chapter 461, Article 17, Sections 7 to 12), an "excess asset amount component" post-retirement adjustment was added to the Minneapolis Firefighters Relief Association (MFRA) benefit plan. The additional adjustment is payable to all pensioners and benefit recipients if the funding ratio of the relief association exceeded 110 percent, with the amount in excess of a 110 percent funding requirement, reduced by an active member adjustment (assets in excess of 110 percent fund x (1 – (total number of active member units ÷ sum of active member units and retirement member units))), with 20 percent of the excess asset amount allocated to pensioners and benefit recipients in proportion to the relationship that their respective units amount bears to the total number of units of all pensioners and benefit recipients, but prorated if the person has not received a pension or benefit for at least 12 months. The adjustment is payable each May 1.

F. Minneapolis Police Relief Association.

1. In General. The Minneapolis Police Relief Association (MPRA) has three post retirement adjustment mechanisms, with one based on the periodic salary increases applicable to a first grade patrol officer, one based on investment performance, and one based on the funded ratio of the retirement plan.

2. MPRA Escalator Adjustment. Until 1953, the Minneapolis Police Relief Association (MPRA) provided a specific dollar amount service pension and that service pension was not subject to any automatic post-retirement adjustment. In 1953 (Laws 1953, Chapter 127, Sections 1 and 5), the MPRA shifted to a service pension based on the monthly salary of a first grade patrol officer each December 1, based on "units." The unit value was initially set at and remains defined as one-80th of the base salary, which is the monthly salary of a first grade patrol officer. The escalator provision was not conditioned on amendments to the relief association articles of incorporation or bylaw.

3. Investment Performance-Based Thirteenth Check. In 1989 (Laws 1989, Chapter 319, Article 19, Section 7), an investment-related post-retirement adjustment was added to the Minneapolis Police Relief Association (MPRA) benefit plan in addition to the post-retirement escalator. The adjustment was a single automatic lump sum payment that in total equaled one-half of one percent of the assets of the relief association. The adjustment was payable if the total time-weighted rate of return

investment performance for the fiscal year exceeds by two percent the actual fiscal year annual increase in the salary of a top grade patrol officer and if the annual average time-weighted rate of return investment performance for the previous five years exceeds by two percent the annual actual average increase in the salary of a top grade patrol officer. Each adjustment recipient's share is determined based on the relationship between the number of units of the person's base benefit and the total number of units for all recipients. If the "thirteenth check" is payable, an amount equal to an additional one-half of the assets of the relief association is applied to reduce that year's state amortization aid or state supplemental amortization aid.

In 1996 (Laws 1996, Chapter 438, Article 4, Sections 10 and 11), the MPRA investment-related post-retirement adjustment mechanism was modified by reducing the investment performance triggers for the mechanism to one to solely match the five-year average annual salary increase rate plus two percent.

In 1997 (Laws 1997, Chapter 233, Article 4, Sections 8 to 11), the amount of relief association assets available for distributions through the "thirteenth check" was increased to 1.5 percent of the assets if the relief association has a funding ratio in the most recent actuarial valuation of at least 103 percent, and retaining the one-half of one percent maximum on the amount of assets available for distribution if the funding ratio of the relief association in the most recent actuarial valuation is under 102 percent.

4. Additional Funded Ratio Related Post-Retirement Adjustment. In 2000 (Laws 2000, Chapter 461, Article 17, Section 2), an "excess asset amount component" post-retirement adjustment was added to the Minneapolis Police Relief Association (MPRA) benefit plan. The additional adjustment is payable to all pensioners and benefit recipients if the funding ratio of the relief association exceeded 110 percent, with the amount in excess of a 110 percent funding requirement, reduced by an active member adjustment (assets in excess of 110 percent fund x (1 – (total number of active member units ÷ sum of active member units and retirement member units))), with 20 percent of the excess asset amount allocated to pensioners and benefit recipients in proportion to the relationship that their respective units amount bears to the total number of units of all pensioners and benefit recipients, but prorated if the person has not received a pension or benefit for at least 12 months. The adjustment is payable each May 1.

G. Fairmont Police Relief Association

1. In General. The Fairmont Police Relief Association has two post-retirement adjustment mechanisms, with one based on the periodic salary increases applicable to a patrol officer and with the other based on investment performance.

2. Fairmont Police Relief Association Escalator Adjustment. Before 1963, the service pension and retirement benefits from the Fairmont Police Relief Association were a specific fraction of the patrol officer's salary at retirement or a specific dollar amount. In 1963 (Laws 1963, Chapter 423, Section 1), the Fairmont Police Relief Association service pension and survivor benefits were revised and were set at a specific fraction of a Fairmont patrol officer's maximum monthly pay periodically. The shift to the escalator was entrusted to the Fairmont Police Relief Association board of directors consistent with the statutory and special law limitations.

3. Investment Performance-Based Thirteenth Check. In 1999 (Laws 1999, Chapter 222, Article 3, Sections 3 and 5), an investment performance-related post-retirement adjustment mechanism was added to the Fairmont Police Relief Association benefit plan in addition to the post-retirement escalator. The adjustment was payable if the actuarial value of the assets of the relief association were equal to at least 102 percent of the actuarial accrued liability of the relief association as of the prior December 31 and if the average time-weighted rate of return for the total relief association portfolio for the most recent five-year period exceeds by at least two percent the actual average percentage increase in the current monthly salary of a first class patrol officer for the most recent prior five fiscal years. The adjustment is based on one percent of the actuarial value of relief association assets and is determined based on the relationship that each pensioner or benefit recipient's benefit amount bears to the total pensions and benefit paid to all pensioners and benefit recipients. The adjustment is paid monthly as one-12ths of the total calculated adjustment, does not compound, and is not added to the pension or benefit for any subsequent post-retirement adjustment calculation. The mechanism was not conditioned on the passage of a bylaw or articles of incorporation amendment, but was subject to Fairmont city approval as local legislation.

Background Information on Selected Benefit Plan Provisions

A. Normal Retirement Age.

1. Definition. The "normal retirement age" is the earliest age under a retirement plan at which a retirement annuity is payable without any reduction for an early retirement.

2. Commission Principles of Pension Policy Provision. Principle II.C.4. of the Principles of Pension Policy of the Legislative Commission on Pensions and Retirement indicates that the normal (unreduced for early retirement) retirement ages should be set based on the employability limits of average public employees and will be different for public safety employees when compared with general employees.

   Specifically, the applicable principle states:

   > II.C.4. Appropriate Normal Retirement Ages
   >
   > The normal retirement age should be set in a reasonable relationship to the employability limits of the average public employee and should differentiate between regular public employees and protective and public safety employees.

   The current set of principles, last revisited by the Commission in 1996-1996, in this particular principle, largely continued the earliest statement of the principle in 1980, emphasizing normal retirement ages at usual employability limits, but without any of the 1980 age specificity.

3. Policy Consideration Respecting Normal Retirement Ages. Age 65 has come to be the traditional age at which many employees are expected to retire. It is, however, unclear why this age has become the regularly expected retirement age for Social Security and for many public retirement plans. Age 65 does not appear to represent an empirically determined conclusion about when most employees retire that was drawn from the experience of employees before the creation of Social Security and the significant expansion of employment-based pension coverage in the 1930s. Before the 1930s, retirement for most people appears to have been a function of a physical inability to continue in employment, at whatever age that occurred. Early employee retirement plans were frequently referred to as superannuation plans and some plans substitute the term "superannuitation age" for what is referred to as the "normal retirement age" in other plans. Until recent decades, the most impoverished sector of the population was older folks and the improvement of their situation was one of the goals of President Franklin Roosevelt in proposing the Social Security System in 1934. The age 65 normal retirement age is frequently ascribed to Chancellor Otto Von Bismark of Germany, who is reported to have set age 65 as the normal retirement age for the retirement coverage provided to the Prussian army.

   Since the 1960s, in both larger corporate defined benefit pension plans and public employee pension plans, the trend clearly appears to have been to institute normal retirement ages earlier than age 65. In the opposite direction, based on considerations of lengthening expected life spans and of the related cost of providing benefits for ever lengthening retirement periods, as part of 1986 Congressional amendments, Social Security has instituted a later full benefit retirement age, as follows:

Social Security

Year of Birth	Normal Retirement Age
Before 1938	Age 65
1938	Age 65, 2 months
1939	Age 65, 4 months
1940	Age 65, 6 months
1941	Age 65, 8 months
1942	Age 65, 10 months
1943-1954	Age 66
1955	Age 66, 2 months
1956	Age 66, 4 months
1957	Age 66, 6 months
1958	Age 66, 8 months
1959	Age 66, 10 months
1960 and later	Age 67

   Minnesota public pension plans currently reflect some uniformity in normal retirement ages. The following compares the normal retirement ages applicable to the various Minnesota public pension plans:

Minnesota Retirement Plan Normal Retirement Age Provisions

a. General Employee Plans

1. General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General)
   - Hired before July 1, 1989: Age 65; or age 62 with 30 years of service; or "Rule of 90"
   - Hired after June 30, 1989: Social Security full benefit age, but not to exceed age 66

2. Public Employees Retirement Association (PERA)
   - Hired before July 1, 1989: Age 65; or age 62 with 30 years of service; or "Rule of 90"
   - Hired after June 30, 1989: Social Security full benefit age, but not to exceed age 66

3. Teachers Retirement Association (TRA)
   - Hired before July 1, 1989: Age 65; or age 62 with 30 years of service; or "Rule of 90"
   - Hired after June 30, 1989: Social Security full benefit age, but not to exceed age 66

4. Duluth Teachers Retirement Fund Association (DTRFA)
   a. Old Law Plan
      - Age 60
   b. New Law Plan
      - Hired before July 1, 1989: Age 65; or age 62 with 30 years of service; or "Rule of 90"
      - Hired after June 30, 1989: Social Security full benefit age, but not to exceed age 66

5. St. Paul Teachers Retirement Fund Association (SPTRFA)
   a. Basic Program
      - Age 65; or age 60 with 25 years of service; or "Rule of 90"
   b. Coordinated Program
      - Hired before July 1, 1989: Age 65; or age 62 with 30 years of service; or "Rule of 90"
      - Hired after June 30, 1989: Social Security full benefit age, but not to exceed age 66

6. Minneapolis Employees Retirement Fund (MERF)
   - Age 65; or age 60 with 10 years of service; or any age with 30 years of service

7. Legislators Retirement Plan
   - Age 62

8. Elective State Officers Retirement Plan
   - Age 62

9. MSRS Military Affairs Department Retirement Plan
   - Mandatory federal military retirement age or age 65.

10. Transportation Department Pilots Retirement Plan
    - Age 62

11. MSRS State Fire Marshal Division Employees Retirement Plan
    - Age 55

12. Judges Retirement Plan
    - Age 65

b. Public Safety Plans

1. State Patrol Retirement Plan
   - Age 55

2. MSRS Correctional Employees Retirement Plan (MSRS-Correctional)
   - Age 55

3. Public Employees Police and Fire Fund (PERA-P&F)
   - Age 55

4. PERA Local Government Correctional Retirement Plan
   - Age 55

5. Minneapolis Police Relief Association
   - Age 50

6. Local Paid Firefighters Relief Associations (Minneapolis and Bloomington)
   - Age 50

7. Volunteer Firefighters Relief Association
   - Generally Age 50

The 1986 resetting of the Social Security full retirement benefit receipt age appears to have been motivated largely by financial concerns and by a need to reduce future benefit outlays in order to delay the date of a benefit default than by any clearly delineated empirical evidence that American workers were actually continuing working to later ages. Indeed, the literature on the topic suggests that the last 20 years have seen continuing reductions in the retirement age of many workers compared to prior generations of workers. The life expectancy of American workers, however, has been increasing throughout the 20th century, meaning that workers could delay the start of their retirement period compared to prior generations without causing any actual reduction in the duration of benefit receipt compared to earlier generations. Although the potential employability limits of general employees appear to be lengthening, it is not clear that the same phenomenon is true to some extent for public safety employees.

B. Early Retirement Reductions.

1. Definition. An "early retirement reduction" is the factor or calculation procedure that governs the determination of the amount of a retirement annuity that commences at an age younger than the normal retirement age.

2. Commission Principles of Pension Policy Provision. Principle II.C.5. of the Principles of Pension Policy of the Legislative Commission on Pensions and Retirement indicates that Minnesota public pension plans should not subsidize early retirement benefits and that, unless it is a part of an appropriately designed early retirement incentive, the early retirement reduction should be calculated on an actuarial equivalent basis.

   Specifically, the applicable principle states:

   > II.C.5. Appropriate Early Retirement Reductions
   >
   > Public employee pension plans should not subsidize early retirement benefits and, except for appropriately designed early retirement incentive programs, retirement benefits should be actuarially reduced for retirement before any applicable normal retirement age.

   The current set of principles, last revisited by the Commission in 1996-1996, in this particular principle, indicates that early retirement should not be subsidized by the public pension plan other than as part of an appropriately designed early retirement incentive and that early retirement benefits should be actuarially reduced. The 1995-1996 principle was a slight modification of the 1980 principles, which indicated that retirement benefits should be reduced on an actuarially equivalent basis for retirement at an age earlier than the normal retirement age, except for retirement by long service employees at age 62 with 30 years of service credit. That long service early retirement eligibility was first authorized by the Legislature in 1973.

   Legislative changes since 1996 have been potentially at variance with the principle to some degree with respect to the State Patrol Retirement Plan, the Correctional State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-Correctional), and the Public Employees Police and Fire Retirement Plan (PERA-P&F). In 1997, the actuarial equivalent early (pre-age 55) retirement reduction for the State Patrol Retirement Plan was replaced by a subsidized reduction factor (Laws 1997, Chapter 233, Article 1, Section 32). In 1999, for the State Patrol Retirement Plan, the MSRS State Correctional Employees Retirement Plan (MSRS-Correctional), and the PERA Police and Fire Retirement Plan (PERA-P&F), the early (pre-age 55) retirement reduction was subsidized, with the MSRS-Correctional reduction factor changed from an actuarial equivalency reduction and with the State Patrol Retirement Plan and PERA-P&F reduction factor both further subsidized (Laws 1999, Chapter 222, Articles 13, Section 5, and 14, Sections 1 and 3). The State Patrol Retirement Plan and PERA-P&F reduction factors are very slight after the 1997 and 1999 changes, making the early retirement annuity amount almost identical to the normal retirement annuity amount.

3. Policy Considerations Respecting Early Retirement Reductions. A defined benefit retirement plan is intended to provide the greatest benefit value to its members (and to incur its greatest actuarial accrued liability) at the normal retirement age. The use of actuarial equivalent early retirement reduction factors is intended to provide access to a benefit at an earlier age and, presumably, for a corresponding longer period of time of receipt without increasing that pension value for the retiree and the corresponding actuarial accrued liability for the retirement plan.

   Minnesota public pension plans currently do not uniformly and rigorously require actuarial equivalent early retirement reduction factors, thereby generally subsidizing early retirement by actually providing

the governmental employee retiring before the normal retirement age with a somewhat greater pension value (and imposing on the pension plan a greater actuarial accrued liability) than would occur at the normal retirement age. The 1997 and 1999 public safety employee retirement plan early retirement reduction factor legislation furthers that subsidization for those plans. The following identifies the various Minnesota public retirement plan early retirement reduction rates currently imposed:

1. Reduction Method: Actuarial equivalent value of annuity deferred to the normal retirement age and augmented at three percent per year of imputed deferral.

   Plans Involved:
   - General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General) "level benefit" tier
   - General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General) "level benefit" tier
   - Teachers Retirement Association (TRA) "level benefit" tier
   - Duluth Teachers Retirement Fund Association (DTRFA) Old Law or New Law Plan "level benefit" tier
   - St. Paul Teachers Retirement Fund Association (SPTRFA) Basic or Coordinated Program "level benefit" tier
   - Legislators Retirement Plan

2. Reduction Method: One-half of one percent per month (six percent per year) that the retiree is under the normal retirement age.

   Plans Involved:
   - Elective State Officers Retirement Plan
   - Judges Retirement Plan

3. Reduction Method: One-quarter of one percent per month (three percent per year) that the retiree is under the normal retirement age.

   Plans Involved:
   - MSRS-General "Rule of 90" tier
   - PERA-General "Rule of 90" tier
   - TRA "Rule of 90" tier
   - DTRFA Old Law or New Law Plan "Rule of 90" tier
   - MTRFA Basic or Coordinated Program "Rule of 90" tier
   - SPTRFA Basic or Coordinated Program "Rule of 90" tier

4. Reduction Method: Two-tenths of one percent per month (2.4 percent per year) that the retiree is under age 55.

   Plan Involved:
   - State Correctional Employees Retirement Plan (MSRS-Correctional)

5. Reduction Method: One-tenth of one percent per month (1.2 percent per year) that the retiree is under age 55.

   Plans Involved:
   - State Patrol Retirement Plan
   - Public Employee Police and Fire Retirement Plan (PERA-P&F)

6. Reduction Method: Defined contribution plan (two dollar bill and annuity) benefit for early retirement.

   Plan Involved:
   - Minneapolis Employees Retirement Fund (MERF)

The wide variety of the reductions imposed by the various retirement plans and the extent of the subsidizations provided calls adherence to the current Commission policy principle into question.

C. Benefit Taxation.

1. Definition. "Benefit taxation" is the practice of imposing income taxation or estate/inheritance taxation on retirement annuities and other benefits payable from a public retirement plan.

2. Commission Principles of Pension Policy. The Principles of Pension Policy of the Legislative Commission on Pensions and Retirement do not address the issue of the taxation of retirement annuities or other public retirement plan benefits.

3. Policy Considerations Respecting the Taxation of Public Pension Plan Retirement Benefits. In Minnesota, public pension plans were initially developed for public safety employee groups in order to assist the survivors of public safety employees who died or to assist public safety officers who become disabled or who are enfeebled by age. As retirement benefit coverage became a regularly recurring part of the employment compensation and benefit package in the nation at large, first for teachers, then for state employees, and then for local government employees, Minnesota established retirement plans for those groups. Virtually all Minnesota public employees have retirement plan coverage as part of their employment benefit package

   Two Minnesota public pension plan laws initially addressed the issue of the taxation. The law governing the State Employees Retirement Association, the predecessor to the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), exempted all moneys, annuities, or other benefits from the retirement fund from any state income tax (see Minnesota Statutes 1953, Section 352.15). The General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General) similarly had all moneys, annuities, and other benefits exempt from any state income tax (see Minnesota Statutes 1953, Section 353.15).

   Over time, other Minnesota public pension plan laws addressed the issue of state taxation exemption. The Legislators Retirement Plan was exempted from all state taxation (see Minnesota Statutes 1965, Section 3A.08), but that exemption was modified to not include an inheritance tax exemption unless the benefit was payable to a surviving spouse or surviving minor or dependent child (see Minnesota Statutes 1974, Section 3A.08), and the tax exemption provision was repealed in the 1979 tax bill (see Laws 1979, Chapter 303, Article 3, Section 41). The MSRS-General exemption provision was subsequently extended to the Legislators Retirement Plan (see Minnesota Statutes 1994, Section 3A.13). The State Employees Retirement Association exemption from state income tax was expanded to include a state inheritance tax exemption (see Minnesota Statutes 1965, Section 352.15), but the state inheritance tax exemption was subsequently modified for the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General) to be applicable only to surviving spouse of surviving minor of dependent child benefits (see Minnesota Statutes 1974, Section 352.15). The State Police Officers Retirement Fund, eventually merged into the State Patrol Retirement Plan, was included in the State Employees Retirement Association income and inheritance tax exemption (see Minnesota Statutes 1965, Section 352A.081). The Correctional State Employees Retirement Plan (MSRS-Correctional) was included in the MSRS-General exemption (see Minnesota Statutes 1974, Section 352.90). The Unclassified State Employees Retirement Program of the Minnesota State Retirement System (MSRS-Unclassified) was covered by the MSRS-General tax exemption (see Minnesota Statutes 1974, Section 352D.09, Subdivision 1). The MSRS-General, MSRS-Correctional, and MSRS-Unclassified tax exemption provision was modified by the 1979 tax bill to eliminate the state income tax exemption and state inheritance exemption, but a state estate tax exemption was added (see Laws 1979, Chapter 303, Article 3, Section 28). The state estate tax exemption was eliminated in 2003 for estates of decedents who died after December 31, 2002 (see Laws 2003, Chapter 127, Article 3, Section 18). The Elective State Officers Retirement Plan was exempted from state income taxation for a retired member or the retired member's surviving spouse (see Minnesota Statutes 1974, Section 352C.07), but the exemption provision was repealed by the 1983 tax bill (see Laws 1983, Chapter 342, Article 1, Section 44).

   The General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General) state income tax exemption was expanded to include a state inheritance tax exemption (see Minnesota Statutes 1965, Section 353.15), and those exemptions were extended to the Public Employees Police and Fire Retirement Plan (PERA-P&F) (see Minnesota Statutes 1965, Section 353.68, Subdivision 1). The PERA-General and PERA-P&F state tax exemption was modified with respect to the state inheritance tax by limiting the exemption to surviving spouse or surviving minor or dependent child benefits (see Minnesota Statutes 1974, Section 353.15). The PERA-General and PERA-P&F state tax exemption was modified by the 1979 tax bill to eliminate the state income tax exemption and the state inheritance tax exemption, but a state estate tax exemption was added (see Laws 1979, Chapter 303, Article 3, Section 29). The Local Government Correctional Employees Retirement Plan of the Public Employees Retirement Association (PERA-Correctional) was included in the PERA-General exemption provision (see Laws 1999, Chapter 222, Article 2, Section 14). The state estate tax exemption for PERA plans was eliminated in 2003 for estates of decedents who died after December 31, 2002 (see Laws 2003, Chapter 127, Article 3, Section 19).

   The Teachers Retirement Association (TRA) was exempted from all state taxation (see Minnesota Statutes 1965, Section 354.10), but the state inheritance tax exemption was subsequently modified to limit it to surviving spouse and surviving minor or dependent child benefits (see Minnesota

Statutes 1974, Section 354.10). The 1979 tax bill modified the TRA tax exemption provision to exempt TRA benefits form state estate taxation (see Laws 1979, Chapter 303, Article 3, Section 30). The state estate tax exemption was eliminated in 2003 for estates of decedents who died after December 31, 2002 (see Laws 2003, Chapter 127, Article 3, Section 20).

The first class city teacher retirement fund association law was exempted from state inheritance taxes for surviving spouse or surviving minor or dependent child benefits (see Minnesota Statutes 1974, Section 354A.11), and the 1979 tax bill modified that exemption by eliminating any reference to an inheritance tax exemption and by specifying an exemption to the state estate tax (see Laws 1979, Chapter 303, Article 2, Section 31).

The Minnesota State Colleges and Universities System (MnSCU) Individual Retirement Account Plan (IRAP) was exempted from state estate tax in 1995 (see Laws 1995, Chapter 141, Article 4, Section 15) and the state estate tax exemption was eliminated in 2003 for estates of decedents who died after December 31, 2002 (see Laws 2003, Chapter 127, Article 3, Section 21). The same addition and elimination of a state estate tax exemption occurred for the Higher Education Supplemental Retirement Plan (see Laws 1995, Chapter 141, Article 4, Section 23 and Laws 2003, Chapter 127, Article 3, Section 22).

The Minneapolis Municipal Employees Retirement Plan (MMER), subsequently renamed the Minneapolis Employees Retirement Fund (MERF), was exempted from state inheritance tax provisions (see Minnesota Statutes 1965, Section 422.20), but that exemption was subsequently limited to surviving spouse and surviving minor or dependent child benefits (see Minnesota Statutes 1974, Section 422A.24).

No state income, inheritance, or estate tax exemptions appear to apply to the various local police or paid firefighter relief associations, the State Patrol Retirement Plan, the various volunteer firefighter relief associations, or the various judges' retirement plans. Two tax exemptions still remain in retirement plan statutes, a state estate tax exemption for the first class city teacher retirement fund associations (see Minnesota Statutes 2004, Section 354A.11) and a state inheritance tax exemption for MERF (see Minnesota Statutes 2004, Section 422A.24).

If the state subjects retirement annuities and retirement benefits to an income tax, an inheritance tax, or an estate tax, that practice reduces the economic value of the annuity or benefit to some degree and if the state does not tax retirement annuities or benefits while other states do tax retirement annuities or benefits, the annuitants and benefit recipients in that state have an economic advantage.

The variability of state tax practices in Minnesota over time and between retirement plans indicates that any retirement policy in this area has been driven by idiosyncratic constituent or interest group demand or other factors rather than any overriding pension policy principle and that policymakers in the tax field have had to struggle to capture tax provisions codified outside of the tax code.

D. Social Security Coverage.

1. Definition. "Social Security coverage" is the applicability of a set of federal governmental benefit programs, the Old Age, Survivors, Disability, and Health Insurance programs, that provide various retirement and casualty benefits. While virtually all private sector employees are covered by Social Security on a mandatory basis, Social Security coverage for public sector general employees in Minnesota historically (before 1986) was elective by the Legislature and by the employee groups and Social Security coverage is not available for public sector public safety employees in Minnesota by virtue of their public employment.

2. Commission Principles of Pension Policy Provision. Principle II.C.2. of the Principles of Pension Policy of the Legislative Commission on Pensions and Retirement indicates that for Minnesota public employees, other than police officers or firefighters, Social Security coverage should be part of the total retirement benefit coverage package.

   Specifically, the applicable principle states:

   II.C.2. Social Security Coverage

   Except for public employees who are police officers or firefighters, coverage by the federal Old Age, Survivors, Disability and Health Insurance (Social Security) Program should be part of the retirement coverage for Minnesota public employees.

3. General Summary of the Provision of Social Security Coverage for Minnesota Public Employees. Social Security is a product of the Great Depression of the 1930s, when being old generally meant being poor, and represents the response of the federal government to this phenomenon of poverty among the elderly. Since President Franklin D. Roosevelt announced his initiative to provide a Social Security program on June 8, 1934, Social Security has become a key element in the retirement planning of most U.S. citizens. The first Social Security Act was signed into law on August 14, 1935. The original act provided only lump sum retirement benefits.

In 1939, dependent (spouse and minor children) benefits were added to the old age assistance benefits in the event of the premature death of a worker were also added. In 1940, monthly Social Security benefits replaced lump sum benefits. Social Security coverage was extended to public sector workers, under an agreement between the federal government and the applicable governmental unit, in the early 1950s. Ad hoc cost-of-living adjustments to Social Security benefits began in 1950, with automatic Social Security cost-of-living adjustments beginning in 1972. In 1956, a disability benefit program was added to Social Security and was expanded in 1958. In 1956, the minimum retirement age for Social Security benefit eligibility was reduced to age 62 for women, and in 1961, for men. In 1965, Medicare (the Health Insurance Program) was added to Social Security.

Currently, 17 percent (45 million) of all Americans receive a Social Security benefit, of which about 30 million are retirees. Approximately 98 percent of all American workers are covered by Social Security. Most workers who are not covered by Social Security are public employees.

Old Age, Survivors, Disability and Health Insurance program (Social Security) coverage for public employees, under 42 U.S. Code Section 418, is generally provided through coverage agreements between the applicable state and the federal Department of Health and Human Services. When Social Security was established in 1935, it did not permit coverage for public employees since it is funded by employee and employer payroll taxes (the Federal Insurance Contribution Act or FICA tax) and taxation of state governments by the federal government is unconstitutional. In 1954, Social Security coverage was extended to public employees by virtue of intergovernmental (state-federal) agreements. The applicable law in Minnesota is coded as Minnesota Statutes, Chapter 355. In 1986, Medicare coverage was extended on a mandatory basis by federal law to all public employees and in 1991, Social Security coverage was extended on a mandatory basis to any public employee who is not covered by a public employee pension plan.

Under both state and federal law, Minnesota police officers and firefighters with Minnesota public pension plan coverage are not eligible for coverage by Social Security. Under Minnesota Statutes, Section 355.07, police officers and firefighters are not permitted to be included in any agreement between the State of Minnesota and the federal Department of Health and Human Services extending Social Security to public employees. The last sentence of that statute, first enacted in 1955, indicates that:

> Nothing in any provision of this chapter shall authorize the extension of the insurance system established by this chapter, as amended, to service in any police officer's or firefighter's position or in any position covered by a retirement system applicable exclusively to positions in one or more law enforcement or fire fighting units, agencies or departments.

Under federal law, 42 U.S. Code, Section 418(d)(8)(D), police officers and firefighters are not eligible for inclusion in a Social Security coverage agreement, although 42 U.S. Code, Section 418(l) has been recently amended to permit police officers and firefighters to be included in a Social Security coverage agreement. Previously, 42 U.S. Code, Section 418(l) allowed police officer and firefighter inclusion in Social Security coverage agreements in only 22 states (including North Dakota and South Dakota, but not Minnesota) and Puerto Rico unless the Governor of the remaining 28 states determined that Social Security coverage would improve the firefighters benefit coverage. Minnesota's Social Security coverage agreement does not include Minnesota police officers or firefighters in Social Security coverage.

In 1990 legislation, effective July 1, 1991, amending 42 U.S. Code, Section 410(a)(7)(F), Social Security coverage was extended to those public employees who are not covered by a public pension plan. Public pension plan coverage for purposes of 42 U.S. Code Section 410(a)(7)(F) means coverage by any pension plan established for public employees unless provided differently by federal Department of Treasury regulation. Treasury regulation 26 Code of Federal Regulation, Section 31.3121(b)(7)-2 specifies which public employees are considered to have sufficient public pension coverage to be exempt from Federal Insurance Contribution Act (FICA) taxes if not included in a federal-state social security coverage agreement under U.S. Code, Section 418.

In Minnesota, virtually all public employees are included in Social Security coverage based on a 42 U.S. Code, Section 418 state federal coverage agreement. The groups currently excluded from Minnesota's agreement with the federal government extending Social Security coverage are as follows:

1. Constitutional Officers first taking office before July 1, 1997;
2. Legislators first taking office before July 1, 1997;
3. Judges first taking office before July 1, 1973;
4. Members of the State Patrol Retirement Plan;
5. Members of the Public Employees Police and Fire Plan (PERA-P&F);
6. Members of the various local police or salaried fire relief associations or consolidation accounts administered by Public Employees Retirement Association (PERA);
7. Members of the PERA Basic Program (pre-1967 hires);
8. Members of the Teachers Retirement Association (TRA) Basic Program (pre-1959 hires);
9. Members of the Minneapolis Teachers Retirement Fund Association (MTRFA) Basic Program (pre-1978 hires);
10. Members of the St. Paul Teachers Retirement Fund Association (SPTRFA) Basic Program (pre-1978 hires);
11. Members of the Minneapolis Employees Retirement Fund (MERF, pre-1979 hires);
12. State or local government employees excluded from the coverage by the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), PERA, TRA, MERF, or the first class city teacher retirement plans; and
13. Members of the various volunteer firefighter relief associations for their volunteer firefighter service.

Originally, in 1954, Social Security coverage was extended by a coverage agreement that required an "all or none" referendum of current public pension plan members. The State Employees Retirement Association (SERA), renamed the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), and the Duluth Teachers Retirement Fund Association (DTRFA) both coordinated with social Security on an "all or none" referendum basis, which is why those plans lack a Basic program. Later in the 1950s, the Social Security Act was amended to permit coverage extensions on a split basis referendum basis, where existing public pension plan members who did not desire Social Security coverage could retain their prior coverage. The Legislators Retirement Plan, the Judges Retirement Plan, the Elected State Officers Retirement Plan, the Public Employees Retirement Association (PERA), the Teachers Retirement Association (TRA), the Minneapolis Teachers Retirement Fund Association (MTRFA), the St. Paul Teachers Retirement Fund Association (SPTRFA), and the Minneapolis Employees Retirement Fund (MERF) all coordinated with Social Security on a split basis referendum basis.

4. General Summary of Social Security Benefits. A fully insured covered worker at the Social Security normal retirement age will be entitled to a Social Security old age benefit equal to 100 percent of the primary insurance amount. A reduced Social Security benefit is available as early as age 62 and an increased benefit is payable if benefit receipt is postponed beyond age 65.

A covered worker typically must have 40 calendar year quarters of Social Security coverage to be considered to be fully insured (if born before January 2, 1929, adjusted downward on a sliding scale to 28 quarters for a 1917 year of birth). Social Security coverage is a function of employment covered by Social Security and the magnitude of employment earnings. A covered worker receives a quarter of Social Security coverage if the worker had at least $970 (2006 figure; which is indexed) in covered employment earnings, up to four quarters per calendar year. Self-employed individuals also are covered by Social Security for self-employed income, which does not generally include real estate rental in-come, stock dividends, bond interest, net capital gains, limited partner income from a partnership, and incidental, casual work, or de minimis self-employment wages or income.

The compensation covered by the Social Security Old Age benefit is limited ($94,200 in 2006, indexed annually).

The Social Security normal retirement age varies, depending on the year of birth of the covered worker, as follows:

Year of Birth	Normal Retirement Age
1937 and before	65 years
1938	65 years 2 months
1939	65 years 4 months
1940	65 years 6 months
1941	65 years 8 months
1942	65 years 10 months
1943-54	66 years

Year of Birth	Normal Retirement Age
1955	66 years 2 months
1956	66 years 4 months
1957	66 years 6 months
1958	66 years 8 months
1959	66 years 10 months
1960 and later	67 years

The Social Security primary insurance amount is the basic Social Security benefit calculation. While the Social Security old age benefit is a defined benefit plan benefit, the computation of the benefit amount is more complicated than a typical public sector defined benefit plan benefit. Social Security uses a modified career average salary base, known as the average indexed monthly earnings amount, and replaces a preset amount of the base without reference to the length of employment. Short periods of employment or part-time employment will be reflected in a reduced career average salary amount, with the inclusion of several low earnings years or no earnings years. The average indexed monthly earnings amount is the covered wages of a covered worker in covered employment since 1950 or after age 21, if later, through age 62, after dropping out the lowest five years from the averaging period, and indexed based on the national average wage through the year in which the worker reached age 60. The primary insurance amount is determined by multiplying the three component parts of the average indexed monthly earnings by the applicable replacement percentage. For 2006, the three component parts were average indexed monthly earnings up to $656, average indexed monthly earnings over $656 and under $3,955, and average indexed monthly earnings over $3,995 up to the maximum covered average indexed monthly earnings amount, or $94,200. The average indexed monthly earnings component part dollar amounts are referred to as the bend points and the bend points are adjusted annually on January 1 based on the comparison between the national average wage for the second preceding year with the comparable figure for the year 1977, with the ratio applied to the 1979 bend points. The replacement ratio formula is as follows:

average indexed monthly earnings $0 - $656	90 percent
average indexed monthly earnings $656 - $3,995	32 percent
average indexed monthly earnings $3,955 and over	15 percent

The calculated Social Security old age benefit is payable at the normal retirement age. Social Security old age benefits are payable early at age 62, with a reduction of five-ninths of one percent per month that the person is under the normal retirement age. Social Security old age benefits paid after the Social Security normal retirement age are increased based on an age-related schedule.

Social Security old age benefits are subject to an annual earnings test and limits. A covered worker begins receipt of a Social Security old age benefit based on attaining a requisite age, rather than by terminating employment with a particular employer or all employers. If an old age benefit recipient is employed after commencing receipt, the Social Security old age benefit is reduced by one dollar for each three dollars of earnings above a designated limit until the recipient reaches age 70. The 2006 limits were $12,480 for the period age 62-age 64 and $33,240 for the period age 65-age 69.

If a covered worker has pension coverage from employment not covered by Social Security at the time of benefit calculation, such as a pre-1998 legislator, there is a potential "windfall offset" reduction in the primary insurance amount replacement percentage for the initial component portion of the average indexed monthly earnings, which is normally 90 percent and could be reduced to 40 percent. No reduction in the replacement rate applies to persons who were age 62 before 1986, or who had at least 30 years of covered employment with substantial earnings, which is at least one-quarter of the prior (old law) maximum taxable earnings base. If the years of substantial covered employment earnings are less than 30 years, the reduction will vary (from 90 to 85 percent with 29 years of substantial earnings ranging down on a sliding scale to 40 percent with less than 21 years of substantial earnings). The maximum windfall offset is one-half of the pension attributable to post-1956 employment earnings not covered by Social Security.

A fully insured covered worker who becomes disabled will be entitled to a Social Security disability benefit equal to 100 percent of the primary insurance amount without reduction for payment earlier than the Social Security normal retirement age.

A covered worker who is older than age 30 and becomes disabled after 1990 must have 40 calendar year quarters of Social Security coverage and must have 20 calendar year quarters of Social Security coverage in the 40 quarter period ending with the quarter in which the disability

began, which must not include any quarter used for a prior disability benefit. A covered worker who is older than age 23 and younger than age 31 and becomes disabled for a reason other than blindness must have 20 calendar year quarters of Social Security coverage after the quarter in which the covered worker attains age 21 and ending with the quarter in which the disability begins. A covered worker who is under age 24 and becomes disabled for a reason other than blindness must have six calendar year quarters of Social Security coverage in the 12 calendar year quarters ending with the quarter in which the disability begins. A covered worker who becomes disabled by blindness must have 40 calendar year quarters of Social Security coverage.

A covered worker is disabled if the person is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that is expected to result in death or either has continued or is expected to continue without interruption for a period of at least 12 months unless alcoholism or drug addition is a contributing material factor. For blindness that occurs after age 54, the inability must be to engage in the person's usual occupation.

The Social Security primary insurance amount calculation for the Social Security old age benefit also applies to the Social Security disability benefit coverage.

Social Security disability benefits are not subject to the earnings test and limits applicable to Social Security old age benefits, but workers compensation benefits may be offset if the benefit combined with workers compensation and certain governmental disability programs exceed 80 percent of average current earnings, which is typically the average monthly earnings for the highest year in the six years of covered employment ending with the year in which the disability occurred. Social Security disability benefits are also subject to the windfall offset reduction that is applicable to Social Security old age benefits.

The spouse, the divorced spouse, the child, or the grandchild of a Social Security old age benefit recipient or a Social Security disability benefit recipient will be entitled to a Social Security dependent benefit. The dependent benefit is 50 percent of the primary insurance amount subject to early receipt reductions after age 61 and before age 65 for dependent spouses and former spouses and subject to a family maximum benefit.

The dependent spouse benefit automatically applies to the spouse of an old age benefit recipient or a disability benefit recipient who is at least age 62. The dependent spouse benefit applies to the former spouse of an old age benefit recipient or a disability benefit recipient if the person is un-married or is remarried after age 60 (age 50 if disabled), was married for at least ten years before the divorce and the divorce occurred after the benefit recipient began receipt or occurred two years before benefit receipt. The dependent spouse benefit also applies to the spouse who cares for a child under age 16 or is disabled, is unmarried, and is under age 22. The dependent child benefit applies to an unmarried child of a recipient who is either under age 18, is under 19 if a full-time elementary or secondary school student, or becomes disabled before age 22, when eligibility is continuing. The dependent grandchild benefit is identical in its requirements to the dependent child benefit, but additionally requires that the grandchild's parents must be deceased or must be disabled.

The family maximum benefit limits the total amount of benefits payable with respect to the record of each covered worker or benefit recipient.

A government pension offset also applies to dependent spouse benefits. The Social Security dependent spouse benefit will be reduced by 66.67 percent of the amount of any public pension benefit payable to the spouse based on the spouse's own work in employment not covered by Social Security. Thus, a retiring State Patrol trooper who is the dependent spouse of a Social Security old age benefit recipient will have an amount equal to 85 percent of the State Patrol Retirement Plan single life age and service retirement annuity offset against the 50 percent of the primary insurance amount dependent spouse benefit otherwise payable on account of the spouse of the trooper retiring with a Social Security old age benefit.

The surviving spouse, the surviving former spouse, the surviving child, the surviving grandchild, or the surviving parent of a deceased covered worker or benefit recipient will be entitled to a Social Security survivor benefit. The surviving spouse or surviving former spouse benefit is either 100 percent or 75 percent of the covered worker's primary insurance amount, the surviving child or grandchild benefit is 75 percent of the covered worker's primary insurance amount, and the surviving parent benefit is 82.5 percent of the covered worker's primary insurance amount.

A surviving spouse or surviving former spouse of a covered worker or benefit recipient with at least 40 calendar quarters of coverage, if the spouse is either at least age 60 or is disabled and is at least age 50, is eligible for the 100 percent of the primary insurance amount. A surviving spouse or surviving former spouse of a covered worker or benefit recipient with at least six calendar quarters during the 13 quarter period ending with death, disablement, or the termination of active ser-vice, if the spouse is caring for a child who is under age 16 or who became disabled before reaching age 22 and is unmarried, is eligible for 75 percent of the primary insurance amount. A surviving child of a covered worker with at least six calendar quarters during the 13 quarter period ending with death, disablement, or the termination of active service, if the child; is unmarried and is under age 18, under age 19 and is a full time elementary or secondary school student, or is disabled before age 22 is eligible for 75 percent of the primary insurance amount. The same benefit applies to a surviving grandchild who meets the same requirements as a surviving child and whose parents are either dead or disabled. A surviving parent of a covered worker or benefit recipient with at least 40 calendar quarters of coverage, if the parent is dependent on the worker or recipient and the parent is at least age 62, is eligible for 82.5 percent of the primary insurance amount.

The family maximum benefit limits also apply to these survivor benefits as they do to dependent benefits. The government pension offset also applies to these survivor benefits.

E. Benefit Accrual Rates.

1. Definition. "Benefit accrual rate" is the percentage of final salary or final average salary amount per year of covered (allowable) service, unit value per year of covered service, or the dollar multiple amount per year of covered service used in the retirement annuity or retirement benefit calculation in a defined benefit retirement plan. The benefit accrual rate is sometimes known as the "formula multiplier." The term does not apply to defined contribution retirement plans.

2. Commission Principles of Pension Policy Provision. The Principles of Pension Policy of the Legislative Commission on Pensions and Retirement does not address the subject specifically, but does address the topic based on the role that the benefit accrual rates play in the provision of ultimate retirement annuities or benefits. The Commission's principles provide that there should be equal treatment within pension plans (Principle II.C.3.), that there should be equal uniformity and equal treatment among pension plans (Principle II.C.6.), and that there should be adequate benefits at the time of retirement (Principle II.C.7.).

   Specifically, the applicable policy principles provide:

   II.C.3. Equal Treatment Within Pension Plans

   There should be equal pension treatment of public employees in terms of the relationship between benefits and contributions.

   II.C.6. Uniformity and Equal Benefit Treatment Among Plans

   There should be equal pension treatment in terms of the relationship between benefits and contributions among the various plans and, as nearly as practicable, within the confines of plan demographics, retirement benefits and member contributions should be uniform.

   II.C.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 ser-vice, 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.

The equal treatment within pension plans and the uniformity/equal benefit treatment among pension plans principles have been part of the Commission's principles since the Commission first adopted and articulated the Principles of Pension Policy in 1961. The equal treatment and

uniformity principles appear to have their foundation in funding concerns, the principal orientation of the Commission since its creation as an interim commission in 1955, and appear to be an attempt to avoid "extra" publicly financed retirement benefits, to avoid discontent between groups of public employees, and to avoid demands for similar extra treatment because some members receive a better return on their contribution dollar than others and because differentials disrupt pension financing. In their purest sense, the principles would argue for identical benefit accrual rates for identical or similarly situated public employee groups.

The adequacy of benefits at retirement principle 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 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 in providing total retirement income.

3. Policy Considerations Respecting Benefit Accrual Rates. The 1995-1996 Principles of Pension Policy essentially continue the 1980 Principles that provide that the retirement benefit provided by a Minnesota public pension plan should be adequate during the period of retirement and that benefit adequacy at the time of retirement should be measured for an employee at age 65 with 30 years of service credit. A principal factor, but not the sole factor, in determining an adequate retirement benefit is the benefit accrual rate or rates that apply.

The Commission 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 should be determined on the basis of the person's highest five successive years' average salary and 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.

If pre-retirement income replacement rates are a well-designed measure of benefit adequacy, a replacement ratio target for a 30-years-of-service public employee at the normal retirement age provides a mechanism for determining the appropriate benefit accrual rate or rates.

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 immediate pre-retirement income can be identified, as follows:

Gross Pre-Retirement	Single Person Replacement of Gross Pre-Retirement Income		Married Couple Replacement of Gross Pre-Retirement Income	
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.

As part of research published in 1993 for the American Society of Pension Actuaries, a target pre-retirement income replacement ratio was suggested of combining two parts, one part 85 percent of the final year's rate of pay up to an amount equal to 300 percent of the poverty rate and the other

part 70 percent of the final year's rate of pay in excess of an amount equal to 300 percent of the poverty rate. Translating the 1993 American Society of Pension Actuaries suggested replacement ratio into a comparable table to that of the 1980-1981 President's Commission on Pension Policy provides the following table:

Gross Pre-Retirement	Single Person Replacement of Gross Pre-Retirement Income		Married Couple Replacement of Gross Pre-Retirement Income	
Income	As $ amount	As %	As $ amount	As %
$ 30,000	$25,000.00	84.0%	$ 25,500.00	85.0%
50,000	39,189.50	78.4	40,620.50	81.2
70,000	53,189.50	76.0	54,620.50	78.0
90,000	67,189.50	74.7	68,620.50	76.2
150,000	109,189.50	72.8	110,620.50	73.7
200,000	144,189.50	72.1	145,620.50	72.8
250,000	179,189.50	71.7	180,620.50	72.2

In 1997, Flora L. Williams and Helen Zhou of Purdue University and Deloitte & Touche LLP, respectively, in "Income and Expenditures in Two Phases of Retirement," surveyed the basis for generalization in the literature about replacement ratio goals and compared three other research reports, as follows:

	Replacement Rate Percentages		
Pre-Retirement Income	*Employee Benefit Plan Review* Report (1990)	Alexander & Alexander Consulting Group Report (1993)	Bruce A. Palmer, Ph.D. Georgia State University Report (1989)
$15,000	78%	82%	82%
20,000	71	76	
25,000	65		71
35,000	55		
40,000		71	68
45,000	50		
55,000	46		
60,000		72	66
80,000		76	68

Note: While not specifically disclosed in the paper, the results appear to relate to a single individual rather than to a couple.

In 1998, Glenn Cooper and Peter Scherer, in the Organization for Economic Cooperation and Development article "Can We Afford to Grow Old," compare replacement ratios in total and replacement ratios for Social Security-akin programs across various countries, concluding that the replacement target for couples in the United States ranges between 70 percent and 90 percent of the pre-retirement income level.

In 1999, the National Endowment for Financial Education, adapting the work of Kenn Tacchino and Cynthia Saltzman, professors at Widener College, suggesting that retiree expenses decrease as retirees get older and that a blended income replacement rate is appropriate, and where an 80 percent replacement rate at retirement translates to a 69.3 percent replacement rate if the retiree lives for 30 years after retirement.

In 2003, Karen Ellers Lahey, Doseong Kim, and Melinda L. Newman, in "Household Income, Asset Allocation, and the Retirement Decision" in the Financial Services Review conclude that the applicable literature on the retirement income replacement target indicates a result between 70 percent and 90 percent.

In 2004, the California State Teachers Retirement System (CalSTRS) conducted a study of the necessary replacement ratio for its retirees, concluding that a range of between 81 percent and 88 percent of pre-retirement income is necessary if the former employer provides the same health care insurance funding to retirees as provided to current employees and a higher percentage replacement if the former employer does not provide the same level of health care insurance funding for retirees.

Also in 2004, Aon Consulting and Georgia State University released its sixth update of a study of retirement income needs for a retired couple, with an age 65 wage earner and an age 62 spouse.

The following compares the 2004 results with the Aon Consulting/Georgia State University 2001 results:

Pre-Retirement Income Level	2001 Replacement Ratio	2004 Replacement Ratio
$20,000	83%	89%
30,000	78	84
40,000	76	80
50,000	74	77
60,000	75	75
70,000	75	76
80,000	75	77
90,000	76	78
150,000	85	85
200,000	86	88
250,000	87	88

Source: Replacement Ratio Study: A Measurement Tool for Retirement Planning.

In 2005, John E. Bartel of Bartel Associates LLC, conducted a replacement ratio study presentation for the League of California Cities that summarized the results of a 2001 California Public Employee Retirement System (CalPERS) target replacement ratio study, summarized the 2004 Aon/Georgia State University replacement ratio study and compared the two for both general California employees and public safety California employees. The CalPERS replacement ratio study indicated a range of ratios (with and without Social Security and public safety), as follows:

Pre-Retirement Income Level	Target Replacement Ratio Range	With Social Security Actual Replacement Ratio Range	Without Social Security Actual Replacement Ratio Range
$ 30,000	73-81%	95-107%	70-81%
40,000	67-75	90-100	68-75
50,000	64-71	86-95	66-71
60,000	61-73	80-89	65-70
70,000	57-65	75-83	64-68
80,000	56-63	70-80	63-67
90,000	55-62	66-78	62-66

The Bartel analysis concludes that for CalPERS plans without Social Security coverage, the actual replacement ratio is a close match to the CalPERS target, but falls below the 2004 Aon/Georgia State University study replacement result for general employees and is a close match for public safety employees, and that for CalPERS plans with Social Security coverage, the actual replacement ratio significantly exceeds the CalPERS target, but is a close match to the 2004 Aon/Georgia State University study replacement result for general employees and greatly exceeds the Aon/Georgia State University study replacement result for public safety employees. The CalPERS study and the Bartel analysis looked only at the Social Security benefit derived from public employment, if any, and the public pension plan coverage, without any benefit derived from personal savings and investments.

Although the replacement ratio approach is simple and is relatively easy to translate into a benefit accrual rate or rates, it is not the only way to measure adequacy at the time of retirement and does not necessarily address the relationship between retirement age benefit adequacy and retirement benefit adequacy needs after retirement.

All of the replacement ratio results summarized above suggest that the target or appropriate ratio differs over the range of compensation, generally with the highest replacement ratio being at the lowest compensation portion of the range, differs based on age, and differs based on marital status. These differences are largely based on features of the Social Security program, which is part of virtually all private sector retirement benefit coverage and which is generally applicable to public sector retirement benefit coverage. Social Security, created in the depths of the Great Depression of the early 1930s, attempted to eliminate old people as the greatest segment of the population in poverty by providing older workers and their spouses with a subsistence income.

While Social Security attempts to provide a subsistence income safety net, the purest rendition of a pre-retirement income replacement ratio represents an attempt to maintain the pre-retirement standard of living. While the Minnesota Legislative Commission on Pensions and Retirement has not specifically articulated its retirement benefit adequacy goal, in practice, the Commission's goal

has been to provide a reasonable margin above subsistence that, combined with personal savings or other investments, would allow the retired individual or couple to retain a reasonable standard of living in retirement after completing a normal working career.

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 an adequate benefit in the form of the 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, as follows:

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

Gross Pre-Retirement Income	Social Security	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 present in Social Security 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 an ever-reducing replacement percentage required as gross income increases.

The pre-retirement replacement ratio model of retirement benefit adequacy also has been challenged by commentators based on a more differentiated or nuanced view of income needs during retirement. The replacement ratio model assumes that the need for retirement income is unchanged during retirement, requiring only that the cost of living be replaced or substantially replaced. Some commentators have applied the life cycle hypothesis of consumption levels In 1997, in "Income and Expenditures in Two Phases of Retirement," Flora L. Williams and Helen Zhou reviewed the empirical bases for the "common guideline" of a 70 percent pre-retirement income replacement ratio, finding that there was little empirical evidence to support that guideline, and reviewed consumption pattern surveys for periods ages 45-75 and over, identifying two retirement phases (phase 1: ages 65-74 and phase 2: ages 75 and over) with decidedly different expenditure levels. In 2005, in "Age Bonding: A Model for Planning Retirement Needs," Somnath Basu suggests that expenditure patterns need to be analyzed for the 30-year period that a retiree is likely to receive benefits, looking at each of the three decades, and finds that leisure expenses are initially high and decline over the retirement period, that health care expenses initially rival leisure expenditures and grow significantly over the retirement period, that basic living expenses are initially the greatest portion of expenditures and halve over the retirement period, and that taxes are initially the second greatest expenditure item and remain relatively constant over the retirement period. In 2006, in "Change in Retirement Adequacy, 1995-2001: Accounting for Stages of Retirement," Chen-Chung Chen and Sherman D. Hanna criticize prior retirement adequacy studies has having ignored the complexities of retirement stages and suggest multiple stages, which is any period during retirement when real income is constant. In Spring 2006, the Society of Actuaries issued a call for papers on the topic of retirement spending and changing needs during the retirement period, indicating that the prior uniform pre-retirement income replacement model fails to recognize early retirement, post-retirement employment during the initial retirement period, the payment of lump sum retirement benefits, and the general elimination of early retirement subsidies, especially health care insurance coverage. The Society of Actuaries will review submitted papers, present the papers at a conference in May 2007, and then publish the papers later in 2007.

F. Pension Benefit Final Average Salary Periods.

1. Definition. "Pension benefit final average salary period" is the allowable service credit period over which covered salary is averaged and which functions as a base to which a percentage amount, resulting from multiplying a benefit accrual rate by the number of years of allowable service credit, is applied. The term only has application to a defined benefit plan that is salary related.

2. Commission Principles of Pension Policy. Principle II.C.7.c. of the Principles of Pension Policy of the Legislative Commission on Pensions and Retirement indicates, for all Minnesota public pension plans other than local police or firefighter relief associations, that retirement benefits should be calculated using a final average salary figure determined from the highest five successive years unless the Legislature designates a different period.

   Specifically, the applicable policy principles provide:

   > II.C.7.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.

   The highest five successive years' average salary preference in the principles was added after 1973, when the salary base for retirement benefit determinations for the major general employee retirement plans and some other plans was shifted from a career average salary to the current highest five successive years average salary. Prior to the 1973 Legislative Session, the principles provided for a career average salary retirement benefit basis, citing the need to emphasize sound pension plan funding and the need for a greater understanding of the retirement benefit computation method.

3. Policy Considerations Respecting Final Average Salary Periods. A defined benefit retirement plan typically utilizes some sort of a mathematical formula to determine the retirement benefit amount and, if the retirement plan is a salary related plan, the manner of determining the salary base for calculations must be specified. The salary period can range from the final day's covered salary and annualized to a career average covered salary, where all covered salary is totaled and divided by the total number of allowable years of service.

   The General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General), the Teachers Retirement Association (TRA), the first class city teacher retirement fund associations, the Minneapolis Employees Retirement Fund (MERF), and the various statewide plans covering correctional officers and police and paid firefighters are all defined benefit plans, and all currently use the high-five average salary in pension annuity calculations.

   Minnesota's statewide retirement plans were not originally salary-related pension plans, with the predecessor to TRA established in 1915 as a money purchase (defined contribution) plan, with MSRS-General established in 1929 as a set dollar amount ($200 per month) plan, and with PERA-General established in 1931 also as a set dollar amount ($200 per month) plan. Conversion to salary-related pension plans occurred for MSRS-General and PERA-General in 1957, which was a recommendation of the initial interim predecessor to the Legislative Commission on Pensions and Retirement, and for TRA in 1969, which was a recommendation of the initial permanent predecessor to the Pension Commission. The first class city teacher retirement fund associations and Minneapolis Employees Retirement Fund (MERF) generally shifted to salary-related pension plans in the 1950s (except for the Duluth Teachers Retirement Fund Association (DTRFA), which shifted in 1971).

   During the 1960s and early 1970s, the defined benefit plans commonly were designed as career-average-salary plans. Under a career-average salary plan, the member at the time of retirement received an annual benefit which was some percentage of the career average salary. The career average salary utilized the salary portion of the retirement formula to account for plan members who worked in disparate compensation arrangements, either as seasonal or part-time employees or as employees with considerable overtime or extracurricular compensation, thereby not requiring sensitivity in the crediting of allowable service. Covered salary for retirement purposes was limited for most or all public employees covered by a statewide retirement plan before 1967. In 1957, the maximum covered salary was $4,800. In 1965, the maximum covered salary was increased to $7,200. In 1967, covered salary was increased to a plan member's total salary. Using a long-term employee with 30 years of assumed service as an example, the salary used in the computation would

be a 30-year average of the wages received. The effect was to base the benefit on a salary that approximated the mid-career salary of the individual. For a 30-year employee with modest, consistent salary increases throughout his career, the average salary was approximately equal to the salary that the individual received 15 years prior to retirement. The accrual rate or rates, at least for the early years of credited service, were also modest by current standards. The result was a modest benefit, reflecting the cost of living many years prior to retirement, rather than a benefit reflecting the individual's salary close to retirement, and the income needs of that individual during retirement. A career average salary approach may produce acceptable results if there is no inflation or if inflation is modest over prolonged periods, but that has not been recent economic history.

In 1973, the Legislature addressed the benefit plan inadequacy of the major pension systems by moving from the career average salary to the high-five average salary. With a high-five average salary, the average tends to be approximately equal to the salary received three years prior to retirement, rather than at mid-career. This makes it easier to design a pension system which provides benefits at the time of retirement to long-term employees which is adequate to support the lifestyle of the employee at the time of retirement. The benefit provisions in place at the current time reflect the move to the high-five average salary in 1973 (or earlier for a few plans), various increases in the accrual rates enacted in subsequent years, and various recent law changes which included reduced reduction factors for early retirement.

For Minnesota defined benefit pension plans, the definition of covered salary is the surrogate for the measure of a plan member's standard of living to be used in determining the appropriate replacement amount. Several decades ago, when employees received only one form of compensation as remuneration for their services, there were fewer questions about the adequacy of using "salary" to measure a person's standard of living. Now, with the advent of numerous employment-related compensation items, this may no longer be the case. For instance, for police officers, their recurring compensation package can include a base salary, shift differential, uniform allowances, education incentive payments, court appearance amounts, dog handler compensation, tactical or special squad compensation, and overtime. There also may be additional compensation items like lump sum annual bonus or merit payments, tuition payments, and employer-paid flexible benefit account balances that apply to many public employees. Any definition or redefinition of covered salary should attempt to reasonably capture those items on which a public employee's regular standard of living is based. Among the teacher retirement plans, there have been recent complaints concerning the adequacy of the covered salary figure. Over a number of legislative sessions, proposed legislation has been introduced to attempt to reflect early or mid-career extracurricular teaching compensation in the highest five successive years' average salary figure. Also, in past legislative sessions, proposed legislation has been introduced to add an alternative highest five successive years' average salary figure in TRA based on the average salary of all comparable TRA members, to adjust for lower salaries for some rural teachers. Similarly, the definition of covered salary should accurately reflect real compensation, so not to overstate a person's standard of living. PERA, historically, has covered city attorneys and other professionals retained by local government units who bear a close resemblance to independent contractors and may be credited with covered salary amounts based on a gross retainer fee that does not closely relate to the individual's actual personal compensation.

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 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 correctly reflect part-time service the way 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 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 career disrupting disability will receive a smaller retirement annuity than their accumulated member contributions or career standard of living would merit.

With the Combined Service Annuity provision, Minnesota Statutes, Section 356.30, there is portability of pension credit between the various Minnesota public pension plans. Portability includes the use of a common highest five successive years' average salary for the benefit computation of all participating plans. This portability argues for consistency among the various pension plans in their definition of covered salary and the highest five successive years' average salary. While the retirement plan administrators have argued in the past that there is substantial consistency in the salary definitions among the various pension plans, that consistency is not as clear in reviewing the comparison of various statutory definitions.

G. Special Early Normal Retirement Provisions.

1. Definition. "Special early normal retirement provisions" refers to features of a defined benefit retirement plan that permit a plan member to retire in advance of the normal retirement age with some additional encouragement benefit or with a diminishment or elimination of any early retirement reduction factor.

2. Commission Principles of Pension Policy. In addition to the principle governing early retirement reduction factors, Principle II.C.19. of the Principles of Pension Policy of the Legislative Commission on Pensions and Retirement addresses the issue of the design of early retirement incentive programs. The principle indicates that early retirement incentives are valid public sector personnel system tools to be used when workforce reductions greater than normal attrition are needed by the public employer and when financed by the public employer receiving the benefit of the workforce reduction and without any pension plan subsidy.

   Specifically, the applicable policy principle provides:

   II.C.19. Design of Early Retirement Incentive Programs

   a. Early retirement incentive programs can have a valid role to play in the public sector personnel system.
   b. Early retirement incentive programs should be targeted to situations when a public employer needs to reduce staffing levels beyond normal attrition.
   c. Early retirement incentive programs should be financed appropriately, with the cost of the benefits provided under the early retirement incentive program borne wholly by the same public employer that gains any compensation savings from a staffing level reduction, without any subsidy from the affected public pension plan.

   The issue of early retirement incentive programs was first addressed in the Commission's principles in the 1995-1996 revision. The development of the policy principle arose out of the enactment of several retirement plan-wide and specific employer early retirement incentives, including the 1985 "Rule of 85" window, followed by a Department of Finance report that indicated that there was not a net savings from the early retirement window, but that for a majority of early retirees, there was a net cost and that the program was a windfall since they would have terminated employment anyway, and the 1993 early retirement window, followed by a report from the Program Evaluation Division of the Office of the Legislative Auditor that indicated that the program did not produce a net savings and did produce windfalls.

3. Policy Considerations Respecting Early Retirement Incentives. In the past several years, the Legislative Commission on Pensions and Retirement has recommended and the Legislature has enacted a number of early retirement incentives, ranging from a temporary "Rule of 85," to employer-paid health insurance coverage, to an additional benefit accrual amount. The stated reason for these early retirement incentives, which have most frequently applied to the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General,) was to produce budgetary savings from consequent reductions in the public employee workforce. Notwithstanding

these early retirement incentives, every statewide and major local Minnesota public pension plan other than the Minneapolis Employees Retirement Fund (MERF) has had an increasing plan membership over the 12 year period 1984-1995 and frequently during each year of the period.

In the 1995 early retirement incentive legislation, applicable to the Minnesota Historical Society and the Metropolitan Council, the Legislative Commission on Pensions and Retirement and the Legislature followed recommendations made by the Legislative Audit Commission and attempted to better match the actuarial cost of the early retirement incentive with the potential resulting salary savings on an employing unit basis and to better target the incentive. That legislation shaped the 1995-1996 policy principle.

Early retirement incentive programs attempt to accelerate the out-transitioning function of a retirement plan, inducing employees to retire somewhat before the conclusion of their normal working lifetime. If the actuarial cost of the early retirement incentive is borne wholly by the retirement plan, as was the case on occasion with the pre-1995 early retirement incentives, the retirement plan will assist the employer's personnel system in producing potential savings, but a lack of targeting and a disconnection of actuarial cost from potential salary savings in a multiple employer pension plan will allow for cost shifting from one employer to the joint entity of the pension plan.

Early retirement incentives set off a number of repercussions in both the retirement plan involved and in the personnel system. Early retirees need to replace some or all of the benefit package lost by terminating employment prematurely, the most important of which is health insurance coverage. Early retirees have not reached the end of their normal working lifetime, and consequently seek frequently to return to their prior employment later as either employees or independent contractors. Early retirees will generally include a substantial number of individuals who would have terminated employment without the program, so that a substantial portion of the salary savings potentially attributable to an early retirement incentive could be duplicated simply by implementing a hiring freeze. Early retirement incentives, especially if they are recurring, also permit public sector personnel managers to avoid making tough management decisions about the future employment of long term employees who have not kept pace in their job qualifications or who have become less than adequately productive.

Early retirement incentives also can include early normal retirement provisions, such as the "Rule of 90" normal retirement age provisions applicable to members of the various statewide general employees retirement plans and the first class city teacher retirement fund associations if they first became plan members before May 1989. Although the "Rule of 90" benefit tier utilizes a smaller benefit accrual rate for the initial decade of allowable service credit than the other ("Level Benefit") benefit tier, the smaller benefit accrual rate does not equal the actuarial present value difference between the early and later retirement annuities, thereby providing a potentially substantial subsidy. As the initial wave of post-1989 Minnesota public pension plan members gets closer to their normal retirement age in the future, without a significant shift in sentiment away from early retirement in society at large, the Commission and the Legislature will likely face increased demands to extend the "Rule of 90" to that post-1989 cohort, at a potentially significant actuarial cost.

Conclusion

This memorandum, accompanying the Commission's first of three likely considerations of the mandated study topic, is intended to provide sufficient background information on the topic to permit the subsequent Commission comparisons and analyses. Those comparisons and analyses will permit the Commission, with the assistance of interested parties, to formulate recommendations to accompany the mandated report to the Legislature.