TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Lawrence A. Martin, Executive Director

RE: Commission Interim Project: Alternative Retirement Plan Design, First Consideration

DATE: October 29, 2013

Introduction

As a topic for consideration by the Legislative Commission on Pensions and Retirement, Commission Chair Senator Sandra Pappas, has designated the consideration of potential alternative retirement plan designs for Minnesota public employee pension coverage.

The Commission staff has estimated that the topic will require Commission consideration over three Commission meetings. For the initial consideration of the topic, this Commission staff issue memorandum attempts to set the stage for Commission consideration of the topic and will summarize:

1. The distinction between defined benefit retirement plans and defined contribution retirement plans;
2. The defined benefit retirement plans and defined contribution retirement plans in Minnesota;
3. Defined benefit retirement plans in general and the basic operation of defined benefit plans;
4. Defined contribution plans in general and the basic operation of defined contribution plans;
5. The trend of replacing defined benefit plans with defined contribution plans in the private sector;
6. The components of defined contribution pension plans and of defined benefit pension plans;
7. The identified advantages and deficiencies of distinctions between defined benefit plans and defined contribution plans;
8. The characteristics of the broad types of public sector employees and the relative advantage of a pension plan type for them;
9. The historic impetuses that have led to the creation of defined contribution retirement plans in the public sector;
10. Employer or plan sponsor considerations in choosing between defined benefit plans and defined contribution plans; and
11. Federal Internal Revenue Code treatment of defined benefit and defined contribution public pension plans.

Subsequent staff memoranda will develop the topic as Commission consideration proceeds and the need for additional research and information becomes clear.

Distinction Between Defined Benefit Retirement Plans and Defined Contribution Retirement Plans

The use of defined contribution retirement plans and the use of defined benefit retirement plans is not really new, although the practice of attempting to make these academic classifications appears to be relatively new.

The military pensions that developed out of the American Civil War as well as the early police and firefighter service pensions were defined benefit plan benefits, with the pension amount based on the length of service rather than any level of assets amassed or wealth developed over a career. While defined benefit retirement plans also occurred in early general employee retirement plans, a fair number of early general employee retirement plans followed a defined contribution retirement plan, or "money purchase" retirement plan, model. Hybrids of the two types of retirement plans also have been utilized, with the most common being a two part public employee retirement benefit comprised of a "defined contribution" annuity purchased from accumulated member contributions and the investment income derived on them and of a "defined benefit" retirement allowance based on the length of service and some benefit multiple amount which was supported by employer contributions. This hybrid was promoted by the actuary George B. Buck, Sr. Even in early defined contribution retirement plans, the retirement annuity was usually "purchased" internally and self-insured, thereby blurring the purity of the categorization and making the pension plan responsible for the investment risk during retired years.

The creation of the academic distinction between defined contribution retirement plans and defined benefit retirement plans appears to be a relatively recent one. For instance, in a 1918 Bulletin produced by the Carnegie Foundation For The Advancement of Teaching on the topic of pensions for public school teachers, the terms "defined contribution plan" and "defined benefit plan" do not appear in the text or in the index,

although the report does discuss pension plans with retirement benefits purchased from accumulated contributions separate from pension plans with retirement benefits determined by various formulas.

The distinction between defined benefit retirement plans and defined contribution retirement plans is of relatively recent vintage, as a characterization, although the retirement plans of each particular design date back more than a century. In regulating primarily private sector retirement plans, the Employee Retirement Income Security Act of 1974 (Public Law 93-406, 98 Stat. 2705) in Section 3, Paragraphs (34) and (35), used the distinction between individual account plans (defined contribution plans) and defined benefit plans to organize its regulation.

The federal law definitions of the terms are:

> (34) The term ''individual account plan'' or ''defined contribution plan'' means a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.
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> (35) The term ''defined benefit plan'' means a pension plan other than an individual account plan; except that a pension plan which is not an individual account plan and which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant—
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> (A) for the purposes of section 202, shall be treated as an individual account plan, and
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> (B) for the purposes of paragraph (23) of this section and section 204, shall be treated as an individual account plan to the extent benefits are based upon the separate account of a participant and as a defined benefit plan with respect to the remaining portion of benefits under the plan.

Pension plans, whether in the public sector or in the private sector, thus are classified as being of one of two types, either a defined benefit plan or a defined contribution plan. The question is whether the pension plan is focused on the certainty of inputs or outputs. There are two major factors or elements in designing retirement plans. These are the level of the benefits, the outputs, and the level of contributions, the inputs. When one factor is fixed or made pre-determinable, the other factor is automatically made variable. If the level of benefits or computation of benefits is fixed or established by formula in law, the plan is a defined benefit plan, and the contribution rate is variable, adjusted as necessary to ensure that the liabilities of the plan are covered. If the level of contribution is fixed, the plan is a defined contribution plan. With a defined contribution plan, the benefit level is unspecified. The benefit level will ultimately be determined through the investment markets, which will determine the growth of the assets prior to distribution.

Current Defined Benefit Plans and Defined Contribution Plans in Minnesota

The oldest public pension plans in Minnesota are public safety pension plans, principally paid firefighter relief associations. The following sets forth the oldest Minnesota public pension plans by the year of their establishment:

Establishment Year	Plan
1868	Minneapolis Fire
1885	St. Paul Fire
1887	Duluth Fire
1887	Winona Fire
1890	Minneapolis Police
1891	Rochester Fire
1892	Red Wing Fire
1895	Albert Lea Fire
1895	Mankato Fire
1897	Faribault Fire

The first general employee public pension plans in Minnesota were the three first class city teacher retirement fund associations (1909), the predecessor to the current statewide Teachers Retirement Association, the Teachers Insurance and Retirement Plan (1915), the Minneapolis Employees Retirement Fund (1919), the defunct St. Paul Bureau of Health Relief Association (1919), the General State Employees Retirement Plan (1929), and the Public Employees Retirement Association (1931).

Given the years that have elapsed since the creation of these earliest Minnesota public employee pension plans and the lack of regular legislative staff and records in the past, it is impossible to specifically document the reason why these plans were created and why these plans were structured as they were, but some rationale for their creation can be imputed. The earliest Minnesota public pension plans were established wholly or primarily by public employee action, not public employer action, and hence reflect

a public employee perspective. The earliest Minnesota public pension plans were nonprofit corporations, rather than purely governmental entities or mechanisms, and generally were organized by the affected employee groups under permissive legislation. The affected employing unit or units either provided no initial funding to the earliest Minnesota public pension plans or provided only nominal levels of funding for decades. The early Minnesota public pension plans were funded almost exclusively on a "pay-as-you-go" or current disbursements basis, even when the plan, like the statewide Teachers Retirement Association (TRA), was designed as a defined contribution plan. Rather than make sizable employer contributions to TRA in the early years, the State simply imputed an employer contribution by doubling the amount of the accumulated member contributions and interest when determining the amount of the retirement annuity purchasable, and then simply funding from a state property tax levy the amount of the annuities actually payable that are not covered by member contributions. Because it takes a period of years for a body of retirees to be accumulated in a new pension plan, the demand for employer funding on a current disbursements basis initially remains modest for a significant number of years. Hence, in TRA, it was not until the late 1960's that the cumulative amount of employer contributions to the plan first exceeded the cumulative amount of the member contributions.

In establishing the early Minnesota public pension plans, because the plans were established largely by public employee action, the goal was unlikely to be the recruitment of new qualified employees or the retention of existing qualified employees. Rather the early goal of Minnesota public pension plan coverage would have been to permit the out-transitioning of employees who have reached the end of their expected working career. Without the federal Social Security program (Old Age, Survivors and Disability Insurance (OASDI)), which was not extended to public employees until the early 1950's, and without a retirement plan associated with public employment, a large number of older public employees could be expected to have difficulties in terminating employment and having adequate retirement income solely derived from their personal resources and any savings that occurred during the period of employment. This concern for other employees who have reached or exceeded the normally expected end of their public sector working career is also probably the explanation of the frequent existence of "superannuation benefits" in many of these earliest Minnesota public pension plans. Superannuation is akin to a disability, except that it is based on a nonspecific decline in ability related to advancing age rather than a specific illness or injury. Thus, the out-transitioning function for Minnesota public pension plans is the likely primary motivation for their creation and initial organization by the affected public employee groups and is most consistent with a concern about the level of retirement benefit to be provided by the public pension plan rather than concerns about funding, portability or other issues.

Over time, public pension plans in Minnesota have developed a more complex purpose than the out-transitioning function that seems to have characterized the initial motivation for their creation. The Principles of Pension Policy of the Legislative Commission on Pensions and Retirement, adopted in 1996, specifies the purposes for the creation and continued existence of Minnesota public pension plans, as follows:

A. Purpose of Minnesota Public Pension Plans

1. Minnesota public pension plans exist to augment the Minnesota public employer's personnel and compensation system by assisting in the recruitment of new qualified public employees, the retention of existing qualified public employees, and the systematic outtransitioning of existing public employees at the normally expected conclusion of their working careers by providing, in combination with federal Social Security coverage, personal savings and other relevant financial sources, retirement income that is adequate and affordable.
2. Minnesota public pension plans should play their appropriate role in providing financial security to public employees in retirement.
3. As Minnesota public employee workforce trends develop, Minnesota public pension plans should be sufficiently flexible to make necessary adaptations.

The broadening of the recognized purpose for a Minnesota public pension plan as represented in the Commission's current pension policy principles reflects the addition of an employer perspective to the existence of public pension plans. In addition to the presumed original out-transitioning purpose, the Commission's current policy principle statement indicates clearly that the public pension plan exists to augment the broader employer personnel and compensation system by assisting in new employee recruitment and in existing employee retention. It also provides that the public pension benefit is intended to produce total retirement income in connection with Social Security and personal savings, the traditional "three legged stool," of retirement income, that the pension coverage is intended to be both adequate and affordable, that the public pension plan should play an appropriate role in providing financial security in retirement, and that the public pension plan design should be sufficiently flexible to adapt to public employee workforce trends.

In Minnesota, by both number and membership, public employee pension plans are predominantly defined benefit pension plans.

The following is a list of Minnesota defined benefit public pension plans and a list of Minnesota defined contribution public pension plans:

Minnesota Defined Benefit Plans	Applicable Statute(s)	Year Established
1. General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General)	Sec. 352.01-352.76	1929
2. MSRS Correctional State Employees Retirement Plan (MSRS-Correctional)	Sec. 352.01; 352.90-352.955	1973
3. MSRS Military Affairs Retirement Plan	Sec. 352.01; 352.85	1980
4. MSRS Transportation Department Pilots Retirement	Sec. 352.01; 352.86	1982
5. MSRS State Fire Marshal Division Employees Retirement Plan	Sec. 352.01; 352.87	1999
6. MSRS State Patrol Retirement Plan	Ch. 352B	1943
7. MSRS Elective State Officers Retirement Plan	Ch. 352C; 352D	1967
8. MSRS Legislators Retirement Plan	Ch. 3A; 352D	1965
9. MSRS Judges Retirement Plan	Ch. 490	predecessor plans in 1931, 1943, and 1949; current plan 1973
10. General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General)	Sec. 353.01-353.505; 353.67-353.87	1931
11. Public Employees Police and Fire Retirement Plan (PERA-P&F)	Sec. 353.01; 353.61-353.6691	1959
12. PERA-MERF Division	Sec. 353.01; 353.50	original hybrid plan 1919; successor defined benefit plan 1955; administrative consolidation 2010
13. PERA Local Government Correctional Service Retirement Plan (PERA-Correctional)	Ch. 353E	1999
14. PERA Statewide Lump-Sum Volunteer Firefighter Retirement Plan (PERA-SVFP)	Ch. 353G	2009
15. Teachers Retirement Association (TRA)	Ch. 354	original predecessor defined contribution plan 1915; successor defined contrib. plan 1931; current defined benefit plan 1969
16. Duluth Teachers Retirement Fund Association (DTRFA)	Ch. 354A	1909
17. St. Paul Teachers Retirement Fund Association (SPTRFA)	Ch. 354A	1909
18. Volunteer firefighter relief associations (about 625)	Sec. 69.771-69.775; Ch. 424A	before 1905
19. University of Minnesota Faculty Supplemental Plan	No statutory provision; Board of Regents action	N/R[1]

Minnesota Defined Contribution Plans	Applicable Statute(s)	Year Established
1. Unclassified Employees Retirement Program of the Minnesota State Retirement System (MSRS-Unclassified)	Ch. 352D	1971
2. PERA Defined Contribution Retirement Plan (PEDC)	Ch. 353D	1987
3. Individual Retirement Account Plan (IRAP)	Ch. 354B	1988
4. College and University Supplemental Retirement Plan	Ch. 354C	1967
5. State Arts Board Individual Retirement Account Plan	Ch. 354D	1994
6. Minnesota Humanities Center Individual Retirement Account Plan	Ch. 354D	1994
7. Minnesota Historical Society Individual Retirement Account Plan	Ch. 354D	1996
8. Volunteer Firefighters Relief Associations (about 75)	Ch. 424A	N/R
9. Ambulance Personnel Longevity Plan	Sec. 144E-40-144E.48	1993
10. Hennepin County Supplemental Retirement Plan	Sec. 383B.46-383B.52	1969
11. University of Minnesota Faculty Plan	No statutory provision; Board of Regents action	N/R
12. Public Employee Supplemental Thrift Plan through State Deferred Compensation Plan or selected tax-sheltered annuity programs	356.24	1988
13. Housing and Redevelopment Agency Retirement Plans	No statutory provision	N/R
14. Pre-1971 School District Supplemental Retirement Plans (total of 8)	No statutory provision; grandparented by Sec. 356.24	N/R

[1] *N/R means no establishment date is reported.*

Defined Benefit Plans in General and the Basic Operation of Defined Benefit Plans

a. Defined Benefit Plans, In General. A defined benefit plan is a pension plan where the pension benefit amount that is ultimately payable is pre-determinable or fixed using a formula or comparable arrangement. The fixed element of the benefit amount leaves a variable element, which is the funding required to provide that benefit. As a defined benefit plan, the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General) and the employing units covered by the plan have the inflation and investment risks. If the investment return on plan assets is poor or if inflation produces ever-increasing final salaries and benefit payouts, that risk is borne by the plan and its associated employers. The member has the turnover risks. If a plan member terminates with modest service having been rendered or at an early age, the member will receive either no benefit or an inadequate benefit. A defined benefit plan favors long-term or long-service employees. It also favors employees who receive regular promotions and sizable salary increases throughout their careers or who achieve substantial salary increases in their compensation at the end of their career. It also favors employees who retire at or before the plan's normal retirement age. The General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General) is also an example of a defined benefit plan.

b. Basic Operation of Defined Benefit Plans. These plans are called defined benefit plans because the benefit is defined in the benefit plan, which in Minnesota is generally specified in law. Law for these plans states that the benefit payable from these plans is to be computed by multiplying three factors: the high-five average salary, the accrual rate, and years of covered service. The high-five average salary is the average salary over the five-year period which produces the highest average. For individuals who work full time up to retirement, the high-five years are generally the five years just prior to retirement or termination of service. This follows because salaries tend to increase over time due to inflation and due to merit raises and promotions. In some cases where individuals work overtime in mid-career but then cut back near retirement, the high-five may not be the last five years. The accrual rate or rates are stated in statute. It is the percentage of the high-five average salary which the person receives per year of service.

   To illustrate using an example, in the Public Employees Police and Fire Retirement Plan (PERA-P&F), the accrual rate is 3.0%. This means that individuals who retire from that plan receive 3.0% of the high-five average salary for each year of service they provide. If the high-five average salary is $50,000 and the individual provided 30 years of covered service, then the annual pension benefit for the individual (providing that the member is at least at the normal retirement age for this plan, age 55) is $45,000. This is computed by multiplying $50,000 x 30 years x 3.0%, which equals $45,000.

   PERA-P&F is a public safety plan and is not coordinated with Social Security; the employee and employer do not pay into the Social Security system, and the individual does not accrue a Social Security benefit due to the public safety employment. The accrual rate in PERA-P&F, and also in the similar MSRS State Patrol Plan, is high, set at 3.0% per year of allowable service credit. The rate is high in recognition that the person will not be receiving any Social Security benefit in retirement due to the public safety employment. General employee plans, such as TRA and the first class city teacher plans, or MSRS-General and PERA-General, are coordinated with Social Security, and the Minnesota public plan provides a lesser benefit in recognition that part of the person's retirement income will be coming from Social Security. The accrual rate assuming the person retires at normal retirement age in these general employee plans (age 65 if the person started covered employment before July 1, 1989, or age 66 if the employment began after June 30, 1989) is 1.7%, although TRA is somewhat higher at 1.9%, for recent employment.

   Since defined benefit plans pay benefits that are determined by high-five average salary, the accrual rate or rates, and years of service, the value of the specific benefit paid to any individual is not a direct function of the employee and employer contributions made specifically for the individual. Rather, the plan actuary needs to predict the required contributions for the entire covered group, given the liabilities expected due to the demographics of the group, the likelihood that individuals entering the plan will eventually draw plan benefits, the mortality of plan participants, and other factors. Thus, the benefits are defined, but the contributions are not. Those contributions are adjusted in law over time as necessary to meet the liabilities created by the plan.

   For individuals who tend to not change jobs, at least not between different employers, and who provide long service, defined benefit plans is the coverage preferred. The benefit is predictable, and the long service leads to a sizable benefit. Defined benefit plans tend to penalize short-service employees. When individuals terminate after several years of employment, often the best financial option available to the individual is to take refund from the pension plan. By taking a refund, the individual gives up any right to a pension from the plan. The refund consists of the employee contribution plus 6% interest. This does not make the terminating employee whole; the plan keeps the employer contributions made on behalf of the individual and all investment earnings above the interest paid on the refund. The retained moneys are used to offset some of the liabilities of the remaining plan membership. These retained amounts are referred to as turnover gain. Without turnover gain, the contribution requirements to our defined benefit plans would be much higher.

Defined Contribution Plans in General and the Basic Operation of Defined Contribution Plans

a. Defined Contribution Plans, in General. A defined contribution plan is a pension plan where the funding for the pension plan is fixed as a dollar amount or as a percentage of payroll and the fixed element of funding leaves a variable element, which is the benefit amount that is ultimately payable. Under a defined contribution plan, the plan member bears the inflation and investment risks. If there is poor investment performance, the plan member's pension assets will be depressed. If inflation impacts the immediate pre-retirement standard of living, the plan member's benefit will be less adequate in meeting the person's pre-retirement standard of living. The employer loses any turnover gain potential, where past plan funding becomes more concentrated on a subgroup of total plan membership. A defined contribution plan favors employees who are very employment-mobile, where employment changes beyond a single employer or a multiple-employer group. It also favors short-term employees in comparison to defined benefit plans. It also favors employees with very stable and modestly increasing salary histories and employees who work considerably beyond the plan's normal retirement age. An Individual Retirement Account (IRA) or an Internal Revenue Code Section 403(b) tax-sheltered annuity is an example of a defined contribution plan.

b. Basic Operation of Defined Contribution Plans. There are several state-level defined contribution plans. These are the Unclassified State Employees Retirement Program of the Minnesota State Retirement System (MSRS-Unclassified), the Public Employees Defined Contribution Plan, and the individual retirement account plans (IRAPs). MSRS-Unclassified provides coverage to post-1997 legislators, pre-1997 legislators who elect this coverage, judges who have exceeded the maximum years of service permitted under the Judges Retirement Plan, and various unclassified employees. The Public Employees Defined Contribution Plan provides coverage largely to local elected officials. The IRAPs provide coverage to higher education faculty within the Minnesota State Colleges and Universities System (MnSCU) who choose this coverage, Minnesota Historical Society employees, and supervisory and professional employees of the State Arts Board and Minnesota Humanities Center.

   In a defined contribution plan, the contribution is determined, but the benefit is not. The plan specifies in law the employee and employer contribution rates that will be paid to an account for the individual. This account is invested in stocks, bonds, and other investments offered through mutual fund-like options that the plan makes available to its membership. In Minnesota plans, the individual selects these investment options.

   The value of the account when the individual terminates or retires is unknown; that will depend upon how long the individual works and upon the returns provided by the investment markets on the contributed amounts. Thus, the benefit is undetermined. At retirement, the individual can take the value of the account and purchase an annuity, or, under MSRS-Unclassified, create an annuity payout by rolling the account's value into the MSRS-General fund, which pays the benefit that can be supported by that account value and which provides post-retirement increases during retirement.

   Employment-mobile employees often prefer defined contribution plan coverage. When they change jobs, they retain the full value of their account and it can move with them. The pension portability of defined contribution plans is an attractive feature to these employees.

   The MSRS Unclassified Program is the oldest defined contribution retirement plan of those remaining in effect (TRA converted from a defined contribution retirement plan to a defined benefit retirement plan, in the late-1960s). The plan principally covers individuals who are employed in potentially politically sensitive positions where employment longevity was not insured and the state employee may not meet the vesting period then in effect, ten years of allowable service. The plan was created at the request of the state agency and department heads. It includes the option for members who do achieve ten or more years of state employment to receive a MSRS-General deferred benefit plan retirement annuity.

   The Public Employees Defined Contribution Plan now largely functions to provide pension coverage for local public officials who were not eligible for PERA-General coverage or who elected not to become a PERA-General member, growing out of a predecessor deferred contribution plan for local ambulance service personnel. The Public Employees Defined Contribution Plan does not include an option to convert to PERA-General.

Trend of Replacing Defined Benefit Plans with Defined Contribution Plans in the Private Sector

Defined contribution pension plans predominate in the private sector, while defined benefit pension plans predominate in the public sector. The U.S. Department of Labor, in a study by the Bureau of Labor Statistics entitled *National Compensation Survey: Employee Benefits in Private Industry in the United States, 2002*, indicates that 36% of all private sector employees are covered by a defined contribution plan and that only 18% of private sector employees are covered by a defined benefit plan. A 2007 study by the Center for Retirement Research at Boston College, *Why Have Defined Benefit Plans Survived in the Public Sector*, found that 88% of private sector workers who were covered by a retirement plan at their workplace had defined benefit retirement plan coverage in 1975, but that percentage dropped to 33% 30 years later. The Employee Benefits Research Institute, in a 2007 report, *Facts From EBRI: Basics of the Pension Benefit Guaranty Corporation*, found that the number of single-employer defined benefit plans in the United States exceeded 112,000 retirement plans in 1985, while the number was 27,650 in 2009. In a study entitled *Employee Benefits in State and Local Governments, 1998*, the Bureau of Labor Statistics reported that 90% of public employees were covered by a defined benefit plan and only 14% of public employees are covered by a defined contribution plan. In both Bureau of Labor Statistics studies, the total of the percentages for the two types of plans exceeds the total number of employees covered by pension plans because some employees are covered by more than one plan.

In the private sector as a whole, currently, defined contribution plans are prevalent, while in the public sector as a whole, defined benefit plans predominate. However, many of those private-sector defined contribution plans have been established and are maintained by sole proprietor businesses or similar small employers. Among industrial employers in the private sector and other large employers, defined benefit plans are more prevalent. Public sector pension plans, which are typically very large single employer or multiple employer pension plans, tend to follow the private sector industrial model in establishing defined benefit pension plans. In the private sector, defined contribution plans, in the form of Internal Revenue Code Section 401(k) plans, are relatively common and generally function as supplemental thrift or savings plans. In the public sector, supplemental defined contribution pension plans also occur frequently.

Looking at the history of public pension plans, a checkered picture emerges. Among public pension plans that were established in the 19th century, generally public safety employee pension plans, a defined benefit plan along the lines of the federal military pension plan predominated. In the early portion of the 20th century, with the growth principally of teacher pension plans, defined contribution plans predominated, following the private insurance company annuity model. With the growth of general or non-uniformed public employees in the early middle portion of the 20th century, combinations of defined contribution and defined benefit plans were instituted, frequently with an annuity derived from accumulated member contributions and investment income and an additional benefit funded by employer contributions. In the immediate period after World War II, following the private sector large industrial corporation model, most new public pension plans were defined benefit plans. In recent years, there has been a mixed trend, with the creation of new pension plans of both types and some conversions from defined benefit plans to defined contribution plans or vice versa.

Components of Defined Contribution Pension Plans and of Defined Benefit Pension Plans

a. In General. To assist in the analysis of defined contribution pension plans and defined benefit pension plans, the components of each type of pension plan can be grouped into benefit considerations, funding considerations, investment considerations, administrative considerations, legal considerations, oversight considerations, and other considerations.

b. Defined Contribution Pension Plan Attributes.

   1. Benefit Considerations.

      a) Participation Requirements. Defined contribution plans are flexible with respect to participation requirements, which are the potential limitations on immediate universal pension plan membership and coverage. Liberal participation requirements in a defined contribution plan will have an immediate funding increase impact, because of the direct tie between funding and benefits in a defined contribution plan, while stringent participation requirements in a defined contribution plan will have an immediate funding decrease impact.

      b) Benefit Eligibility and Vesting Requirements. Defined contribution plans are flexible with respect to the requirements of the plan for eligibility for benefits and vesting. Since a true defined contribution plan provides a lump sum benefit rather than a self-insured direct annuity and since that lump sum benefit is directly related to the funding of the plan, the plan retirement benefit can be made available at any time to a plan member, even before retirement or before employment termination. Access to a lump sum retirement benefit before reaching

an expected retirement age (age 59-1/2 under current federal Internal Revenue Code provisions) can bring adverse federal income tax considerations (currently a 10% surcharge).

c) Retirement Benefit Amount. Defined contribution plans provide retirement benefits that are very dependent on the duration of contributions, the relative magnitude of contributions during the early years of membership, and the extent of investment performance. A defined contribution plan retirement benefit is an uncertain mechanism for insuring benefit adequacy, however adequacy is defined. Under the three part traditional view of the provision of retirement income, under a defined contribution plan arrangement, Social Security provides some version of a subsistence benefit and the defined contribution plan and any personal savings provide a margin above that subsistence, without any direct augmentation of the subsistence benefit to produce total retirement income that is adequate, however defined. Because of the impact of compound interest, under a defined contribution plan, early moderate levels of contributions are more valuable that late high levels of contributions. For example, if $100,000 in contributions are amassed for a 20 years of service retiring employee in equal annual increments of $5,000, plus 8% compound annual interest, the total lump sum benefit would be $247,114. If the same $100,000 in contributions is amassed for the same retiring employee in an ever increasing pattern at the compound increase rate of 10%, plus 8% compound annual interest the total lump sum benefit would be $194,841. The $52,273 increase under the equal annual increments pattern demonstrates the value of the compound interest earned on the greater contributions for years 1 through 12, when the contribution amount was greater under the first example.

d) Casualty Benefits. Defined contribution plans provide the same benefit amount in the event of a casualty occurrence (death or disablement) as the retirement benefit earned to that date, which is the individual member account balance. This makes long service casualty benefit coverage significantly larger than short service casualty benefit coverage, which may fit some employment patterns while not fitting others. Unless augmented by additional term insurance death and disablement coverage, the size of the defined contribution plan casualty coverage cannot be readily changed.

e) Post Retirement Adjustments. Under a true defined contribution plan, which provides only a lump sum benefit at retirement, no post retirement adjustment coverage is provided unless the retiree purchases an insurance company annuity with that feature. An insurance annuity with automatic annual percentage increases will produce a smaller initial annuity amount than would a straight life annuity.

2. Funding Considerations.

a) Magnitude of Member Contributions. Defined contribution plans provide long term certainty in the amount of any member contributions, without any need for any periodic assessment of increases and reductions. Defined contribution plans also can easily adapt to the desire by a plan member to make additional member contributions.

b) Magnitude of Employer Contributions. Defined contribution plans also provide long term certainty in the magnitude of employer contributions. Flexibility of employer contributions can also be easily incorporated into a defined contribution plan, where the employer contribution could be set based on the amount of a given state aid, or as a percentage of tax revenue actually collected, or based on the extent of entity performance.

c) Long Term Liability Issues. Since a defined contribution plan benefit is solely a function of the funding and investment performance amassed in a member account, defined contribution plans are always fully funded and there is no potential for an unfunded accrued actuarial liability. Defined contribution plans, providing only lump sum benefits, have no long term liability issues since any mortality risk or other actuarial experience issues are borne by the member rather than the pension plan and the employer.

d) Other Funding. If a defined contribution plan implements a vesting requirement or a normal retirement age requirement, future forfeitures under those requirements would be available either for reallocation to remaining member accounts or for cancellation to the financial benefit of the employing unit. There is generally an only limited amount of turnover gain in defined contribution plans, making turnover forfeiture reallocations modest.

3. Investment Considerations.

a) Investment Performance and Long Term Risk. Defined contribution plans place the plan member at risk for the investment performance of the plan assets. Defined contribution plans typically attempt to accommodate that risk placement by utilizing individual accounts reflecting individual investment preferences. Performance for the total plan portfolio will be, in whole or in part, a function of the aggregation of individual investment approaches, rather

than a single investment policy. This investment performance risk borne by plan members will shape later career investment needs and decisions. Late career potential retirees will be ill equipped, generally, to bear any late career downward investment volatility, which will require the plan to establish structures for significant late career asset mix changes (presumably, from more volatile investment security types to less volatile investment security types) or will require the public employer to bear highly varied late career out-transitioning and retirement patterns that may result from volatile market conditions.

b) Investment Program Flexibility. Because defined contribution plans typically permit the particularized investment of individual accounts, a defined contribution plan requires a flexible investment program. Generally, this flexibility is obtained by the establishment within the retirement fund of the equivalent of a family of mutual funds, with each portion of the investment program emphasizing a different long or short term investment strategy. Procedures need to be fashioned to handle the ability of plan members to shift prior accumulations to new investment options as well to change the investment options for new contributions. A policy issue arises whether or not there will be maximums set on certain volatile investment options in order to limit the losses of potentially imprudent plan members.

4. Administrative Considerations.

a) Ease of Administration. Defined contribution plans can be expected to have modest plan documents and those plan documents can be expected to be less complex, thereby adding to the ease of administration.

b) Administrative Expense. Defined contribution plans frequently are expected to be somewhat less expensive to administer, with the elimination of some or all service credit recordkeeping, the elimination of actuarial valuation work, and the elimination of the payment of retirement annuities. Administrative expense, however, may be increased by virtue of the complexity of the defined contribution plan investment structure and the increased volume of investment-related changes, member contacts, and member communication.

c) Member Contacts and Member Communication. Defined contribution plans typically have member contacts related to investment performance and investment changes, which tend to be spread over the entirety of the member's career. Because the members are typically involved in the investment of individual account balances, a defined contribution plan will need to communicate substantial investment information to members in order to meet its fiduciary responsibilities.

5. Legal Considerations.

a) Benefit Certainty. Defined contribution plans provide a benefit based on past funding and investment performance, rather than more abstract and contingent legal rights to accumulated pension assets. There is little question about the certainty of benefits, although the benefit amount is subject to investment risk, and there is little need to establish or consider elaborate legal theories of the nature of public pension coverage.

6. Oversight Considerations.

a) Financial and Compliance Auditing. Auditors appear to be well equipped to undertake financial and compliance auditing of defined contribution plans, since those plans are virtually entirely limited to financial transactions.

b) Legislative or Executive Branch Oversight. The conceptual simplicity of defined contribution plans make them accessible to legislative or executive branch oversight.

c) Susceptibility to Manipulation. Since defined contribution plans depend on entire career funding levels and generally have decentralized member-directed investment operations, defined contribution plans have minimal susceptibility to manipulation.

7. Other Considerations.

a) Portability. Defined contribution plans provide significant retirement benefit portability for employment-mobile plan members, both public sector and private sector.

b) Early Retirement Incentive Potential. Defined contribution plans lack any direct role to play in fashioning or implementing early retirement incentive programs.

c) Overall Plan and System Structure. Defined contribution plans have a straightforward function to perform, thereby reducing the need for the creation of administrative or governing boards and thereby allowing for more public pension plan centralization.

c. Defined Benefit Pension Plan Attributes.

1. Benefit Considerations.

a) Participation Requirements. Defined benefit plans are flexible with respect to participation requirements, with liberal participation requirements having a long-term funding increase impact because of a delayed and conjectural tie between funding and benefits in a defined benefit plan. Stringent participation requirements also having a long-term funding reduction impact.

b) Benefit Eligibility and Vesting Requirements. Defined benefit plans establish the overall financial liability of the plan in large measure by the relative level of its requirements for eligibility for benefits and vesting. The maximum liability for a plan member in a defined benefit plan is established as of the earliest normal retirement age of the plan, since that is the earliest age at which a benefit unreduced for early commencement is payable and that age defines the length of the period over which a retirement annuity will be payable. Because defined benefit plans typically are not fully funded at any given time, defined benefit plans typically do not provide an equivalent lump sum retirement benefit instead of an annuity at the time of retirement. The vesting requirement in a defined benefit plan will govern the extent of the turnover actuarial gain that a defined benefit plan will obtain from plan members who terminate prior to the normal retirement age and who elect to take a refund of member contributions in lieu of a deferred retirement annuity entitlement.

c) Retirement Benefit Amount. A defined benefit plan can be made very inflation sensitive and very responsive to the replication of all or a portion of the pre-retirement standard of living of a retiring plan member by the selection of the final salary averaging period and the specification of the per-year-of-credited-service benefit accrual rate.

d) Casualty Benefits. Defined benefit plans provide a policymaker with great flexibility in determining the adequacy and extent of casualty benefit coverage for both long career and short career plan members.

e) Post Retirement Adjustments. Defined benefit plans typically provide an annuity for life, thus requiring some consideration of the issues of post retirement adequacy and the need for post retirement adjustments. Any post retirement adjustment mechanism will increase the actuarial liability of the defined benefit plan, either by adding directly to the actual recognized actuarial cost of the plan in a discernible manner or by foregoing an actuarial experience gain that will otherwise affect some actuarial liability and actuarial cost.

2. Funding Considerations.

a) Magnitude of Member Contributions. Because the financing requirements of defined benefit plans change over time solely due to demographic and economic forces, even without benefit changes, the size of required member contributions are not certain over the long term. Defined benefit plans cannot easily accommodate the desire of plan members to make additional member contributions.

b) Magnitude of Employer Contributions. Identical to the circumstance with member contributions, employer contributions are not certain over the long term. With unfunded actuarial accrued liabilities under a defined benefit plan, an additional issue of the allocation of the amortization contribution requirement arises.

c) Long Term Liability Issues. Defined benefit plans are not usually fully funded at any given time, so a long term liability concern frequently exists. If a defined benefit plan is fully funded, or even if the defined benefit plan is being amortized at a faster pace than the minimum under the established funding policy, that favorable circumstance will frequently become an argument for a benefit increase.

d) Other Funding Issues. Defined benefit plans tend to produce a regular retirement annuity for a relatively small subset of the total plan membership, with the balance gaining only a refund of their member contributions and interest because of relatively high membership turnover. The benefits for that subset are funded in significant portion based on the foregone employer contributions and investment income for the portion of the membership that is largely unbenefitted.

3. Investment Considerations.

a) Investment Performance and Long Term Risk. Defined benefit plans place the risk for investment performance of the pension plan on the employer plan sponsor. Investment income will pay a sizable portion of total pension cost and stellar performance in a defined benefit plan will work to reduce future contribution amounts, either member, employer or both.

Conversely, poor investment performance adds to the long term liability risk of the plan. The investment responsibility in a defined benefit plan is generally entrusted to the governing board of the plan, which may not be well representative of the governmental entities at greatest financial risk for the consequences of poor investment performance.

b) Investment Program Flexibility. Defined benefit plans generally will be invested as a single unit and, consequently, are structured very simply. This simplicity provides the investment authority with considerable latitude in conducting the investment activity.

4. Administrative Considerations.

a) Ease of Administration. Defined benefit plans provide a complex set of retirement benefits, typically through the use of extensive plan documents. Defined benefit plans incur more or less actuarial liability based on various status determinations (retirement age, requiring birth certificates; service, requiring extensive recordkeeping; or disablement, requiring considerable medical information) and those status determinations typically require considerable administrative capabilities and effort.

b) Administrative Expense. Defined benefit plans have a certain level of administrative duties and will produce a certain level of expense. The complexity of participation requirements, the number of alternative retirement benefit tiers, the complexity of covered salary and covered service definitions, and the complexity of casualty coverage will increase administrative expenses. To the extent that the pension administration becomes a lobbying force in the process of benefit setting, the administration expenses of the plan also can be expected to increase.

c) Member Contacts and Member Communication. Direct member contacts prior to the period immediately before retirement can be expected to be modest in defined benefit plans, but the communication of benefit plan provisions is very important because of the extent of intangible benefit rights accruing to a plan member under a defined benefit plan. During the period immediately before retirement, member contacts in the form of benefit estimates and benefit counseling will be considerable.

5. Legal Considerations.

a) Benefit Certainty. Under defined benefit plans, the benefit during a public employees working lifetime is a promise of an eventual payment which will be certain only to the extent of current and future funding. The intangible nature of defined benefit plan pension coverage also raises the question of the applicable legal theory to be used to analyze defined benefit plan coverage.

6. Oversight Considerations.

a) Financial and Compliance Auditing. Because of the additional recordkeeping in defined benefit plans, the intangibility of that coverage, its impact on long term liability, and its inaccessibility to normal audit processes, financial and compliance auditing of defined benefit plans is a significant challenge.

b) Legislative or Executive Branch Oversight. The complexity of a defined benefit plan makes it less accessible to legislative or executive branch oversight.

c) Susceptibility to Manipulation. Under defined benefit plans, the component parts of the defined benefit plan document, its interpretation, and its application produce pension plan liability and these aspects of defined benefit plan coverage are relatively susceptible to manipulation for policy ends other than those of the appropriate policymakers.

7. Other Considerations.

a) Portability. Defined benefit plans can provide portability for employees of the same employer or of a group of similar or related employers, but are not readily open to portability beyond that level for employment-mobile employees.

b) Early Retirement Incentive Potential. Defined benefit plans have a direct potential role to play in fashioning early retirement incentive programs.

c) Overall Plan and System Structure. The complexity of defined benefit plans tends to support more complex administrative and governing board structures.

Identified Advantages and Deficiencies of Distinctions Between Defined Benefit Plans and Defined Contribution Plans

Several distinctions can be drawn in comparing between defined benefit pension plans and defined contribution pension plans. The distinctions will be advantages or deficiencies based largely on the circumstances of the plan member and the member's past employment history and future employment potential.

These distinctions are as follows:

Item	Defined Benefit Plan Characteristic	Defined Contribution Plan Characteristic
a. Basic Differentiating Factor		
1. Fixed Item	Method for determining retirement annuity or benefit amount, usually by virtue of a formula	Contribution rate
2. Variable Item	Annual contribution requirement	Eventual retirement annuity or benefit amount
b. Retirement Benefit Coverage Factors		
1. Retirement Age	Specified, but affects retirement benefit amount only upon retirement before normal retirement age	Generally not specified, but always affects retirement benefit amount
2. Vesting requirement	Generally a specified period of service	Generally immediate vesting
3. Benefit amount at retirement	Generally determined by use of a formula emphasizing length of service and final average salary; for the same contributions, produces a higher retirement benefit for older long service employees	Generally the accumulation in the person's individual retirement account is payable in a lump sum or may be converted to a monthly benefit through the purchase of an annuity contract, with the monthly benefit dependent on the person's age and the applicable mortality and post-retirement interest rate assumption for the same contributions, higher for younger short service employees.
4. Post-retirement adjustments	Generally provided on either an ad hoc or automatic basis	Difficult to provide except on an ad hoc basis
5. Benefit design flexibility	Plan is easy to modify or augment	Plan design options restricted
6. Benefit predictability	Benefit amount generally predictable	Benefit amount generally unpredictable
7. Benefit adequacy	Generally nonexistent or nominal for short service employees; generally available and measurable for long service employees	Generally more available for short service employees; generally uncertain for long service employees
8. Portability	Generally not portable	Virtually always portable
9. Out-transitioning function; availability of early retirement incentives	Available option	Generally unavailable
10. Burden of inflation risk	Largely borne by plan and plan sponsor	Largely borne by employee
c. Ancillary Benefit Coverage	Flexible coverage available	Coverage generally limited and inflexible

Item	Defined Benefit Plan Characteristic	Defined Contribution Plan Characteristic
d. Funding/Investment Factors		
1. Existence of unfunded actuarial accrued liability	Possible, generally occurring, and open for future increases	Not possible
2. Asset allocation	Pension fund assets not allocated among plan participants	Pension fund assets allocated to individual plan participant accounts
3. Investment risk	Borne solely by plan sponsor	Borne solely by employee
4. Employer cost amount	Generally variable over time	Fixed over time
5. Employer cost flexibility	Available through choice of actuarial funding method and amortization procedure	Essentially nonexistent
6. Employer cost predictability	Future cost unpredictability	Future cost predictability
e. Administration		
1. Ease of benefit administration	Generally complex	Generally complex
2. Ease of investment administration	Investments generally managed as single pool under a single investment policy	Investments generally managed as numerous individual accounts with a multitude of potential investment policies and policy changes
f. Member Communication	Relatively complex before and at retirement; frequent member understandability problems	Relatively simple before retirement and relatively complex at retirement; frequent member understandability problems
g. Manipulation Potential	Generally open to changes that disproportionately benefit selected groups, especially long service participants at or approaching retirement age	Generally less open to manipulation
h. Potential for Transition to Other Type	Transition to a defined contribution plan is difficult unless the pension fund is fully funded or plan sponsor is willing to accelerate future funding	Transition to a defined benefit plan is generally easy
i. Employee Perception and Appreciation	High appreciation by older employees; low appreciation by younger employees	High appreciation by younger and middle-aged employees; perceived as threat by older employees

Characteristics of the Broad Types of Public Sector Employees and the Relative Advantage of Pension Plan Type for Them

a. Types of Public Employees. Public employees with Minnesota public pension coverage reflect a wide range of types, with a number of differences in their prior employment situation, demographic factors, and future employment prospects that are pertinent for pension purposes.

These differences in type and the public pension plan coverage impact are as follows:

Difference	Pension Plan Coverage Impact
Entry age	An older entry age reduces the potential for pre-retirement turnover; an earlier entry age has a greater pre-retirement turnover potential.
Service duration	Longer past service reduces the potential for pre-retirement turnover and produces a greater potential future pension benefit; shorter past service increases the turnover potential.
Compensation level	Higher paid public service produces a higher potential pension benefit; lower paid public service is indicative of entry level employment, part-time employment, or limited duration employment.
Pre-retirement disability or death risk	The existence of a greater risk of a pre-retirement casualty eliminates the employee's latitude for risk about the amount of the potential future pension benefit, the timing of the benefit payment, and the beneficiaries for the pension benefit; reduced risk of a pre-retirement casualty provides greater employee latitude for risk about the size, timing, or beneficiaries of the public pension benefit coverage.
Expected normal retirement age	A later expected normal retirement age, by increasing the pre-retirement funding period and reducing the post-retirement payout period, provides the employee with increased tolerance of risk concerning the amount of potential future retirement benefits; an earlier expected normal retirement age reduces the employee's tolerance of risk concerning the amount of potential future retirement benefits.
Promotional or advancement opportunities	The presence of opportunities for promotion or advancement to a higher paid or more secure position is indicative of a higher potential future pension benefit; the absence of promotional or advancement opportunities is indicative of a modest potential future pension benefit.
Political sensitivity or comparable employment volatility	Substantial political sensitivity or similar volatility of future public employment increases the potential for pre-retirement turnover and a reduced potential future pension benefit amount; the absence of political sensitivity or other future public employment volatility reduces the potential for pre-retirement turnover and a greater potential future pension benefit amount.
Spousal pension coverage	The existence of a spouse with significant pension coverage provides the employee with more latitude for risk about the amount of the potential future pension benefit; the absence of a spouse or the absence of significant spousal pension coverage reduces or eliminates the employee's latitude for risk about the potential future pension benefit amount.
Previous employment pension coverage	The presence of pension coverage for prior employment by the same or an associated pension plan produces a greater potential future pension benefit; the absence of prior associated pension plan coverage means that there is no preference for continuation in that coverage.
Other contemporaneous employment	The presence of other contemporaneous full-time or part-time employment with pension coverage increase the employee's latitude for risk about the amount of the potential future pension benefit in public employment; the absence of other contemporaneous employment decreases the employee's tolerance for risk about the size of the future potential pension plan benefit amount.

b. Relative Advantage of Defined Benefit or Defined Contribution Plan Coverage for Various Types of Public Employees. Based on the various types of public employees outlined above, the type of public employee most clearly benefited by a defined benefit plan or by a defined contribution plan can be identified, as follows:

Public Employee Group Most Advantaged by a Defined Benefit Plan	Public Employee Group Most Advantaged by a Defined Contribution Plan
Public employees entering service in middle age, but before the normal retirement age.	Public employees entering service at a young age.
	Public employees entering service shortly before or after the normal retirement age.
Public employees with long public service.	Public employees with short public service.
Highly compensated public employees.	Low or moderately compensated public employees.
Public employees with a pattern of late career rapidly increasing compensation.	Public employees with a pattern of relatively static compensation.
Public employees with moderate or high pre-retirement casualty risk.	Public employees with nominal or low pre-retirement casualty risk.
Public employees with an early expected normal retirement age.	Public employees with a later expected normal retirement age.
Public employees planning to retire at an early age.	Public employees without plans to retire at an early age.
Public employees with substantial late-career promotional or advancement opportunities.	Public employees with limited opportunities for late-career promotion or advancement.
Public employees with low political sensitivity or low volatility in their employment.	Public employees with high political sensitivity or high volatility in their employment.
Public employees without spouses.	Public employees with significant spousal pension coverage.
Public employees with spouses who do not have significant pension coverage.	
Public employees with prior defined benefit plan pension coverage by the same pension plan or by a plan with full portability.	Public employees with prior defined contribution pension plan coverage.
	Public employees with prior defined benefit plan pension coverage without full portability.
Public employees without other contemporaneous employment and pension coverage.	Public employees with other contemporaneous employment and pension coverage.

Employer or Plan Sponsor Considerations in Choosing Between Defined Benefit and Defined Contribution Plans

In addition to attempting to identify the types of public employees who are most advantaged by defined benefit plans or defined contribution plans, it is appropriate also to analyze the potential for a choice between defined benefit plans and defined contribution plans from the perspective of the public employer or the plan sponsor.

From this perspective, several issues and points of analysis arise. These issues and analysis points are as follows:

a. Consistency with Public Pension Plan Purpose. If public pension plan coverage has a stated or discernible purpose, the choice of which type of public pension plan, defined benefit or defined contribution, should be guided by that purpose. All too frequently, public pension plans were created so long ago that there is no stated purpose for the pension coverage and the reasons that gave rise to its creation may no longer be pertinent or provide adequate guidance. For Minnesota public pension plans, typically created between 1868 and 1935, there was not a clear statement of purpose by the Legislative Commission on Pensions and Retirement until the approval of a reformulation of its principles of pension policy on November 14, 1996. Under the Commission's policy principles, Minnesota public pension plans are to exist to augment the public personnel system by encouraging new public employee recruitment, by encouraging existing public employee retention, and by encouraging long service or older public employee out-transitioning by providing a pension benefit that makes its appropriate contributions to adequate post retirement income with the other available sources of retirement income to provide financial security to public retirees, while retaining sufficient flexibility to adapt to public employee workforce trends.

   The Commission's principles of pension policy also express a general preference for defined benefit pension plans over defined contribution plans.

   If adequacy of retirement income, as measured against the pre-retirement standard of living, is of primary importance, then the use of a defined benefit plan will most directly gain the intended result. If affordability of public pension plan coverage, as measured by total governmental budgetary outlays, is of primary importance, then the use of a defined contribution plan will most directly gain that intended result. If the recommended provision of public employee financial security is a preeminent goal, defined benefit pension plan coverage is the optimal means to do so. If the recommended flexibility and adaptability in public pension plan coverage is a preeminent goal, defined contribution pension plan coverage is the optimal means to accomplish this.

b. Exclusive Pension Plan Coverage Type. In the past, for most Minnesota public employees, their type of pension plan coverage has been preselected and has been uniform for all similar employees. The practice of utilizing an exclusive pension plan coverage type produces a less complicated pension plan administrative and investment structure, reduces the complexity of communications with prospective and existing employees, and, if a defined benefit plan is involved, maximizes the actuarial risk pooling on which future pension costs will be based.

c. Alternative Types of Pension Plan Coverage. Individual public employees could be provided with the opportunity to elect between the pension plan coverage types. This will potentially make the pension plan administrative and investment structure more complicated, will increase the complexity of communications with prospective and existing employees, and will permit potential cost-increasing adverse elections (elections against the fund).

d. Hybrid Pension Plan Coverage. The public employer or public pension plan sponsor could fashion hybrid pension plan coverage, where both types of pension plans are utilized in tandem or as a supplement to the other. Administrative and investment structures will be more complicated under this hybrid strategy, as will employee communication. The cost impact will be very sensitive to the actual plan provisions specified.

e. Transition Period for Any Changes in Plan Type. If any change from the existing Minnesota public pension plan type is contemplated, the transition period for that plan type change must be considered. The easiest manner for implementing a pension plan type change is to make it effective for new hires only. The most complex implementation method would be to make the pension plan type change for the entire group of existing active employees.

Historic Impetuses That Have Led to the Creation of Defined Contribution Retirement Plans in the Public Sector

a. Public Sector Defined Contribution Plans. In attempting to identify the circumstances that have prompted the public sector to establish defined contribution retirement plans, the Commission staff has discerned that defined contribution plans can function as supplemental retirement coverage, can be the outcome of compliance with a federal government model plan design, can represent a public sector replication of the nonprofit and private sector higher education models, occur where local retirement plans are broadly permitted when small governmental units are involved, represent a response to state aid incentives or accommodations to regulatory practices, or as a means to downsize significantly underfunded defined benefit public sector retirement plans.

b. Defined Contribution Plans as Supplemental Retirement Coverage. The most prevalent use of defined contribution plans nationwide, as in Minnesota, appears to be as retirement coverage that supplements primary defined benefit plan coverage. This use of defined contribution plans as vehicles for supplemental retirement coverage appears to have its basis in a determination by relevant policymakers that the existing defined benefit plan coverage provides an inadequate benefit for a given participant group, or in a determination by relevant policymakers that the further development of defined benefit plan coverage is inappropriate, or in response to a persuasive sales or marketing effort by an insurance, an investment, or a third-party plan administration vendor.

   Supplemental defined contribution plans can be a strategy for correcting perceived inadequacies in the primary defined benefit plan coverage for a participant group. In the late 1960s and early 1970s, in Minnesota, before the conversion of the major Minnesota defined benefit public pension plans from a career average formula to a final average formula, a number of supplementary defined contribution pension plans were established to correct for the modest benefit coverage provided by the statewide plan, such as the Hennepin County Supplemental Plan, the State College and University Faculty Supplemental Plan and supplemental pension plans established by eight local school districts. While defined contribution plans can be used in this manner and many supplemental defined contribution plans nationally are likely to have this as their policy rationale, the practice is not an optimal solution to a policy problem, which is the reason for the enactment of the general prohibition on supplemental public pension plans contained in Minnesota Statutes, Section 356.24. Supplemental pension plans tend to be created by or for a particular employer or for a particular employee group within a multiple-employer defined benefit pension plan arrangement. By virtue of its lack of comprehensiveness, the typical supplemental defined contribution plan practice leads to differing pension benefit levels for various groups within a broader comparable type of public employees, with inevitable upward spiraling competitive pressures, and differing pension funding levels for similar taxpayer groups.

   A channeling of future benefit improvement pressures into a supplemental defined contribution plan rather than improving the existing defined benefit plan is a viable strategy for policymakers to attempt to incorporate some greater fiscal discipline into future pension improvements. The New Hampshire Legislature is reported to have implemented the change for the various New Hampshire public pension plans in the mid 1980s. The result is that the defined benefit plan will guarantee some amount of benefit adequacy, which is the chief advantage of a defined benefit plan, while the defined contribution plan will provide some of the portability and equalization of the advantages of pension coverage over all plan participants that typifies defined contribution plans, while limiting to a greater extent the financial exposure of the public sector from benefit improvements to a known budgetable amount.

   It is also clear that supplemental defined contribution plans in the form of deferred compensation programs can represent the impact of strong marketing efforts by outside vendors on associations of governmental units. In Pennsylvania in the mid 1980s, deferred compensation program marketers made strong sales efforts within various governmental associations to attract an expanded client base, with some success. In Minnesota, the existence of deferred compensation programs in 80 of 87 counties, many with the same investment managers and options, is likely to be indicative of similar sales efforts within the Association of Minnesota Counties. While counties may be able to make some policy argument for the need creation of these deferred compensation programs, their existence in rural counties with modest public employee compensation such as Beltrami, Cass, Chippewa, Clearwater, Cook, Grant, Kittson, Koochiching, Lac Qui Parle, Lake of the Woods, Lincoln, Mahnomen, Murray, Norman, Otter Tail, Polk, Red Lake, Rock, Roseau, Todd, Traverse, Watonwan, and Yellow Medicine raises the strong suspicion of the results of an orchestrated sales effort rather than the independent analysis of and decision about the adequacy of existing Public Employees Retirement Association (PERA) retirement coverage for its employees by each county.

c. Compliance with Federal Model. A sizable number of public sector defined contribution plans exist among local housing or redevelopment agencies, where the plan follows a federal model promoted by

the federal Department of Housing and Urban Development (HUD). Because of the extent of federal funding of local housing and redevelopment associations (HRAs) in the past, HRA employee pension plans tend to follow the federal model. Since the late 1960s, HUD has favored defined contribution pension plans. A fair proportion of academic inquiry into public pension practices and issues has been done under contract with the Urban Institute, associated with HUD. It is likely, then, that HUD-induced defined contribution pension coverage is a result of an analysis of pension policy alternatives by the federal agency. In Minnesota, new hires of the St. Paul Housing and Redevelopment Association were shifted by state law from the separate St. Paul HRA defined contribution plan to the Public Employees Retirement Association (PERA) in 1977, but the St. Paul HRA lobbied for a return of new entrants to its defined contribution plan and the required legislation was enacted in 1981.

d. Duplication of Higher Education Model. Public pension coverage for public university and public college faculty and upper-level administrators frequently follow the private and nonprofit sector practice of utilizing defined contribution plan coverage, frequently through the use of the Teachers Insurance and Annuity Association-College Retirement Equity Fund (TIAA-CREF). The coverage generally either is exclusive defined contribution plan coverage or is the inclusion of defined contribution plan coverage as an alternative to the defined benefit plan coverage otherwise applicable to governmental employees at that level.

   The use of defined contribution plans for public sector higher education faculty and upper-level administrators is a reflection of the prevalence of that type of coverage in the remainder of the higher education universe and the need to achieve parallel coverage, apparently largely for portability concerns. In the private and nonprofit higher education sector, the policy underlying faculty retirement coverage dates back to the turn of the century and the work of the Carnegie Foundation in pursuing retirement coverage for teachers at all levels, which resulted in the creation of TIAA and the subsequent creation of CREF when it was determined appropriate for retirement savings to be invested in equity (stock) securities as well as debt (bond) securities. Following the insurance company model prevalent at the time, TIAA was created as a defined contribution plan. The use of a defined contribution plan also accommodated the situation of the use of a single fund for multiple employing units with varying levels of employer contributions. Since employment mobility among higher education types tends to be among other higher education institutions, rather than other governmental employers within a given state, portability considerations suggest the use of defined contribution plans within the public sector higher education field.

   The University of Minnesota has utilized a defined contribution plan for its faculty members and upper administrators for decades, with a defined benefit supplemental pension plan established during the 1960s and revised in the 1970s to augment the defined contribution benefits of older faculty members who were not advantaged to the same degree as younger faculty members by improvements made in the defined contribution plan in the early 1960s and to augment the defined contribution plan benefits of female faculty members who were victims of adverse salary practices that occurred before the late 1970s. The Minnesota State University System and the Minnesota State Community College System shifted to defined contribution plan coverage in the form of the Individual Retirement Account Plan (IRAP) in the late 1980s. Technical College faculty members were added to IRAP in the mid 1990s, when IRAP was also shifted from being the exclusive type of pension benefit coverage for new hires to an option as an alternative to defined benefit plan coverage by the statewide Teachers Retirement Association (TRA) or by one of the first class city teacher retirement fund associations. The creation of IRAP was as a result of active lobbying by the union representatives of State University and State Community College faculty.

e. Phenomenon of Small Government General Employee Defined Contribution Plans. In some states with a large number of local pension plans, like Arkansas, California, Florida, Michigan, and Pennsylvania, there is a general trend for a fair proportion of the general (non-public-safety, non-uniformed) employee pension plans to be defined contribution plans. It is very rare for local public safety employee pension plans, except as noted in the following subsection, to utilize defined contribution plans.

   While it is difficult to impute reasons for this trend for local government general employee defined contribution plans, from my four years of experience with Pennsylvania, public pension plans where this phenomenon has occurred, there are likely to be several reasons. For the local general employee defined contribution plans that were created long ago, the plans likely follow local or regional trends (analogy to a local higher education pension plan or a local business pension plan) or the plans likely follow the preferences of local insurance agents (who tend to favor money purchase or defined contribution plans) or other vendors. For more recently created local general employee defined contribution plans, the plans tend to follow the Individual Retirement Account (IRA) or Simplified Employee Pension Plan (SEP) models arising out of federal income tax regulation following the enactment of the Employee Retirement Income Security Act of 1974 (ERISA) that have been in vogue since the mid 1970s. In

states with statewide local employee public pension plans, the public pension plan practice tends to follow the defined benefit model more customary for public pension plans generally.

f. Response to State Aid or Other Regulatory Practices. Defined contribution public pension plans sometimes are established based on advantages derived from particular pension state aid or other regulatory program practices. This phenomenon has occurred among Minnesota volunteer firefighter relief associations in the late 1980s and early 1990s and may occur in other jurisdictions.

   In the late 1980s, the Legislative Commission on Pensions and Retirement was discussing the placement of a maximum or cap on fire state aid allocation based on pension cost, which prompted several volunteer firefighter relief associations to shift to defined contribution plans because there is not externally generated pension cost figures for defined contribution pension plans. No pension cost-related caps on fire state aid were ever enacted, however. Also, the uppermost maximum lump sum or monthly benefit service pension amounts specified in Minnesota Statutes, Section 424A.02, have been interpreted as not applying to defined contribution plans, thereby providing an incentive for volunteer firefighter relief associations that receive a large relative amount of fire state aid per firefighter to convert from defined benefit plans to defined contribution plans in order to realize larger individual benefit levels.

   Similar applications of the federal Internal Revenue Code Section 415 limits on benefits (defined benefit plans) or contributions (defined contribution plans) to public pension plans could also induce a shift from defined benefit plans to defined contribution plans for some perceived regulatory advantage.

g. Downsizing of Significantly Underfunded Defined Benefit Public Plans. Several newly created or newly converted defined contribution public pension plans have been cited favorably in the media or by other commentators for their attempt to impose fiscal discipline through that type of pension plan, frequently as a change from defined benefit public plans that have been viewed as being overgenerous in their benefit level and that have been historically underfunded. The plans are the Montgomery (Maryland) County Employees Retirement Plan, cited by a 1995 Forbes magazine article, and the Nebraska State Employees Retirement System, the Nebraska County Employees Retirement System, and the West Virginia Teachers Defined Contribution Retirement Plan, cited by the National Conference of State Legislators in a recent legislator's guide to public pensions. None of these plans apply to public safety employees or other specialty (legislators or judges) employees. The creation of defined contribution pension plans for general employees to replace significantly underfunded defined benefit plans is also currently being considered by a special task force for the District of Columbia government.

   The West Virginia Teachers Defined Contribution Retirement Plan was fashioned for newly hired teachers to replace a prior defined benefit pension plan that had never been properly funded in the past, and was implemented in 1991. Unless the turnover of teachers in West Virginia is very great currently, the experience with the revised defined contribution retirement plan has not been sufficiently long to determine the impact of the new defined contribution pension plan on the funding status of the prior defined benefit plan or the contribution of the new defined contribution pension plan to the total retirement coverage adequacy of post-1991 West Virginia teachers.

   Various commentators over time have suggested an exploration of replacing defined benefit plans by defined contribution plans to gain fiscal discipline and financial control over pension obligations. In the past, this suggestion has been forwarded by the Citizen's League, the League of Minnesota Cities, and the Minnesota Chamber of Commerce, and the Minnesota Free Enterprise Foundation. The recommendation of replacement defined contribution plan coverage usually comes from employer representatives or from outside business, taxpayer, or general good government groups, and not from public employee groups. During the process of reviewing the Pension Policy Principles of the Legislative Commission on Pensions and Retirement in 1995, representatives of the various employee groups were essentially unanimous in opposing defined contribution plans except as supplemental pension coverage and were unanimous in supporting defined benefit plans.

Federal Internal Revenue Code Treatment of Defined Benefit and Defined Contribution Public Pension Plans

a. In General. Since pension benefits represent or relate to compensation from employers to employees, all pension plans are subject to aspects of federal Internal Revenue Code regulation. Some federal tax regulation relates to the amount and timing of the tax obligation owed on a pension benefit distribution and are generally equally applicable to public and private pension plan beneficiaries. Other federal tax regulation relates to deferrals from taxation that can be accorded to pension plans if the plans meet certain minimum standards set forth in the federal Internal Revenue Code and related regulations, with the minimum standards generally referred to as “qualification requirements” and with the affected pension plans generally referred to as “qualified pension plans.”

b. Internal Revenue Code Provisions Applicable to Public Pension Plans. Public pension plans are not subject to all of the same regulation that applies to private sector pension plans, with most of the qualified pension plan regulation set forth in sections 401 through 418E of the federal Internal Revenue Code. Before September 2, 1974, the enactment date for the Employee Retirement Income Security Act of 1974 (ERISA), the federal Internal Revenue Code did not differentiate between public sector pension plans and private sector pension plans and the overall regulation of qualified pension plans by the federal tax laws was modest. In practice, before September 2, 1974, the federal Internal Revenue Service assumed that public pension plans were qualified and most public pension plans did not even bother to obtain qualification determination letters from the federal Internal Revenue Service. Since most public pension plans nationally (but not most public pension plans in Minnesota) are clearly governmental entities and are tax-exempt as such under federal Internal Revenue Code section 115, there was little need to formally establish their status as tax exempt organizations under federal Internal Revenue Code sections 401(a) and 501(a). In Minnesota, where most public pension plans are nonprofit corporations rather than a more formal governmental entity, beyond the application of federal Internal Revenue Code sections 401(a) and 501(a), local teacher retirement fund associations are tax exempt organizations by virtue of federal Internal Revenue Code Section 501(c)(11), and other local police and firefighter relief associations have been determined by the federal Internal Revenue Service to be tax exempt organizations by performing a governmental function and reducing the demands on government under an Internal Revenue Service interpretation of federal Internal Revenue Code section 501(c)(4).

   For pension plans, qualification for tax-exempt status provides tax benefits first for the employer sponsoring the plan, second for the fund or trust holding the pension plan assets, and third for the participants in the pension plan. The employer sponsoring the pension plan will have its contributions to the plan deductible from the employer’s gross income when made. The pension fund or trust will have any taxation of the investment earnings on the fund or trust assets deferred to the plan participants. The pension plan participants will have any tax on their accrued pension benefits deferred until the benefits are actually paid, typically after retirement, when the participant’s tax rate bracket will generally be lower. For public pension plans that gain tax exempt status outside of federal Internal Revenue Code sections 401(a) and 501(a), the only tax advantage of becoming a qualified pension plan is the plan participant benefit of tax exemption. Without this tax benefit plan, participants will have employer contributions to the plan on their behalf includable in their taxable gross income when the employer contributions are made or when the participant becomes vested for a retirement benefit under terms of the pension plan, whichever is later.