TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director

RE: Review of Minnesota Defined Benefit Public Employee Retirement Plan Post-Retirement Adjustment Mechanisms: Concept of Benefit Adequacy

DATE: September 30, 2013

Introduction

At the September 12, 2013, meeting of the Legislative Commission on Pensions and Retirement, when post-retirement adjustments procedures from the various states were being discussed, Representative O'Driscoll asked staff questions about the concept of benefit adequacy, including the appropriate level of income replace. This memo attempts to provide some background on the benefit adequacy concept, the appropriate level of replacement of pre-retirement income deemed appropriate, and what guidance the Commission's Principles of Pensions Policy provide on this matter.

Commission's Principles of Pension Policy Related to Benefit Adequacy

According to the Commission's Principles of Pension Policy, retirement benefits for long-term employees who retire at normal retirement age ought to be set at a level which, when combined with Social Security and income from personal savings, is "adequate." However, the Principles do not attempt to define what specific level of income replacement is deemed to be adequate. Thus, the concept is general, leaving the term "benefit adequacy" to be interpreted as deemed appropriate by the current Commission and Legislature. More specifically, Principle II.A.1. states:

> II.A.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 out-transitioning of existing public employees at the normally expected conclusion of their working careers or the systematic phasing-out of existing employees who are nearing the normally expected conclusion of their full-time 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.

Basically, what is described in the principle is the notion of the "three-legged stool" that income in retirement comes from three sources: 1) the pension plan or plans, 2) personal savings, and 3) Social Security. If the plans are well designed and the individual had sufficient ability and initiative during his or her working life to accumulate adequate savings, the combined income from these three sources ought to be adequate to support the individual during retirement at a reasonable standard of living.

The Principles also include an item specifically addressing adequacy of benefits at retirement, which provides at least some additional specification:

> 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 service, which would be a reasonable public employment career, and at the generally applicable normal retirement age.
> e. Retirement benefit adequacy must be a function of the Minnesota public pension plan benefit and any Social Security benefit payable on account of Minnesota public employment.

In relevant part, the principle states that the retirement benefits ought to be set at a level which is adequate at retirement, when combined with Social Security benefits and presumably amounts from personal savings, for individuals who have provided a minimum of 30 years of public service and who are retiring at normal retirement age for the given plan. The statement is specific to the case of individuals who provided a long public career and who retire at normal retirement age, typically age 65 or 66 for general employee plans or at age 55 for public safety plans. There is no expectation that individuals should be kept whole in retirement if they retire early, at ages before normal retirement, or if they provide less than a full career in public service. This suggests that those who retire early after reasonable long public employment careers, if they are to not have a noticeable drop in standard of living in retirement, will need to rely more heavily on past personal savings. Regarding other short service individuals, they will need to rely to a larger extent on savings and on retirement plans or assets derived from other employment.

Economic and Non-Economic Benefit Adequacy Approaches

If the Commission were to adopt a specific policy objective regarding benefits at the time of retirement, the Commission can use either an economic or a non-economic approach. Selecting a particular income replacement target for long-term employees at or near normal retirement age is essentially a non-economic approach, because it is not directly based on labor market conditions. Rather, it is based primarily on a perception of fairness or justice. The income replacement standard or standards could be set at a level to create a living standard at retirement that is somewhat below, at, or above pre-retirement living standards. Alternatively, the Commission could reject this approach entirely and adopt an approach which is based directly on economic factors, adjusting the income replacement standard not based on notions of fairness, but rather in response on labor market conditions. Workers, in choosing employment and in deciding whether to remain in current employment, are influenced by many different factors, including a comparison of salary and benefits offered by various potential employers. If Minnesota public employers were unable to attract and retain a capable work force, that would indicate a need to improve salaries and benefits, which could include pensions. If public employers are not having trouble retaining capable workers, it could indicate that the package of current salary, benefits, and pensions is adequate.

Standards or Reference Points Used in Retirement Policy Studies

As previously noted, prior Commissions have never tried to specify an income replacement standard, beyond the statement that for long-term employees the income replacement from the combination of the Minnesota public pension plan, Social Security, and private savings ought to be "adequate." In 1988, the Wyatt Company, the actuarial firm retained at that time by the Commission, presented the 1988 Benefit Adequacy Study to the Commission. This study extensively examined the adequacy of retirement benefits provided by Minnesota public pension plans. Two measures were used; the first examining relative living standards pre-retirement compared to post-retirement, while the second examined the value of a retirement benefit throughout retirement. Basically, the second measure examined whether the post-retirement procedures would maintain the value of the benefit at retirement or whether deterioration during retirement would occur. The Wyatt Company also performed an extensive follow-up study a few years later for the Commission, to examine in detail the implications of extensive benefits improvements enacted in 1989. The Wyatt studies depicted several income replacement lines, including 100% after-tax income replacement with certain additional adjustments. The Wyatt Company used this as a reference point, not as an indication of Commission policy.

The President's Commission on Pension Policy appointed by President Carter published a report in 1981 entitled Coming of Age: Toward a National Retirement Income Policy. That Commission adopted a policy target or national goal of retirement income sufficient to maintain the pre-retirement standard of living. That presidential commission, however, did not attempt to specify the level of after tax income replacement needed to achieve that aim, because it recognized that the necessary result would differ by income level and many other circumstances. While the general objective may be clear, the relationship between pre-retirement income and post-retirement income needed to achieve the target is not unique or consistent. Many other studies of retirement income needs exist, and the objective of maintaining the same standard of living pre-retirement and post-retirement is well accepted, although not necessarily universally accepted. But all the studies do recognize the difficulty of specifying the relationship between the level of preretirement and post retirement income needed to achieve the objective, because of the complexity of circumstances, including the recognition that Social Security benefits replace a decline percentage of income in retirement the higher the person's pre-retirement income.

Difficulty in Identifying a Specific Income Replacement Standard

Even if there were agreement among Commission members regarding an income replacement standard in concept, an array of specific income replacement standards from the various Minnesota plans would be needed to express the results, with different results varying by plan, marital status and age of spouse, and income level. This also assumes that the Commission focused solely on long-service employees (30 years) at normal retirement age. The following serves to illustrate some of the complexity in determining whether the income being received in retirement is adequate.

Minnesota general employee plans are the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General), the Teachers Retirement Association (TRA), and the first class city teacher plans. For individuals retiring at normal retirement age, MSRS-General and PERA-General provide a benefit of 1.7% of the highest five years' average salary for each year of service.

That would create an annual benefit from the plan for the person retiring with 30 years of service equal to 51% of the high-five, if the person elects a single life annuity. But, the person might choose to provide survivor coverage to a spouse, which would require an actuarial reduction in the annual and monthly benefits to offset the cost of providing continue benefits to the second person covered by the joint-and-survivor annuity following the death of the primary annuitant. The necessary monthly reduction would depend on the level of income to be provided following the death of the primary annuitant. A 100% joint-and-survivor annuity (which continues income to secondary annuitant at the same level) would require a larger reduction than one providing 75% of that continuing income, or 50%. The amount of the reduction would also depend on the age of the spouse; the younger the spouse, the larger the reduction necessary to provide continuing coverage to that spouse. Thus, a considerable array of different monthly benefits is generated, depending on whether the a single life annuity is chosen or a joint-and-survivor annuity, with joint-and-survivor annuity results varying based on the extent of continuing benefit to be provided in the event of death to the primary annuitant and the age of the covered spouse.

TRA and the first class city teacher plans had a 1.7% accrual rate, like MSRS-General and PERA-General, but the teacher plans were recently provided with a benefit improvement, a shift to a 1.9% accrual rate applicable for new service only. The TRA increase applies to post-June 30, 2006, service, while the increases for the first class city teacher plans will begin in 2014. With these plans, any review of income replacement would need to take into account when an individual retired. Depending on when the person retired, all the benefit might be at a 1.7% accrual rate, while those retiring at later dates would have an increasing percentage of the annuity computed using the higher 1.9% rate. In addition there is the same survivor coverage issues just mentioned.

Ignoring the impact of joint-and survivor coverage on monthly benefits received, and phased-in benefit improvements like those just mentioned for teacher plans, we can say that for an individual retiring with 30 years of service and at normal retirement age the Minnesota plan is paying a fixed percentage of the high-five average salary as a benefit and that percentage does not vary with income level. An individual retiring from a given plan with a $20,000 high-five average salary will of course receive a lesser monthly benefit amount than an otherwise similar individual with a $50,000 high-five, but they will both have a benefit which is the same percentage of the high-five. Therefore, regardless of pre-retirement income level, the Minnesota public pension plan is replacing the same percentage of pre-retirement salary. In contrast, Social Security old age benefits replace different percentages of pre-retirement salary, depending upon the income level. The reason is that the Social Security old age program was designed as an anti-poverty program, intended to reduce or eliminate poverty in old age. To achieve that, Social Security provides very high income replacement at low income levels with progressively less income replacement as a person’s pre-retirement income rises. (The Social Security benefit computation can be divided into three tiers. For those retiring in 2013, the Social Security benefit would be 90% of the first $791 of average monthly earnings, 32% of the next $3,977, and 15% of any higher income. The salaries defining the end of one tier and the beginning of the next are revised periodically due to inflation.) When payments from the Minnesota plan are combined with payments from Social Security, to review the percentage of pre-retirement income replaced by these combined sources, the results will vary considerably depending upon income level. Those with very low incomes will have nearly complete income replacement from Social Security alone. For these individuals, the combination of Social Security plus the Minnesota pension plan may result in income which exceeds the pre-retirement standard of living. For individuals at higher pre-retirement income levels, the benefit combination of Social Security plus the Minnesota plan might leave the individual well below the pre-retirement standard of living, requiring distributions from personal savings to boost the living standard. In addition to the combined impact of the Minnesota retirement plan and Social Security that the retired Minnesota employee receives, Social Security spousal benefits may need to be considered, at least in the case of a non-working spouse. A non-working spouse would be eligible to receive a Social Security benefit equal to 50 % of the retired employee’s earned Social Security benefit. Thus, a totally different set of income replacement results occurs if the retiree is single rather than married with a non-working spouse.

In addition to general employee plans, Minnesota has two correctional employee plans, the Correctional State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-Correctional) and the Local Government Correctional Service Retirement Plan (PERA-Correctional), whose members are also covered by Social Security for the Minnesota public employment. However, these Minnesota plans, because of the quasi-public-safety nature of the employment, use an age 55 normal retirement age rather than the age 65 or 66 normal retirement ages used in general employee plans. Reviewing the combined effect of the benefits from the Minnesota plan and Social Security for retirees of these plans will yield different results than for the general plans, and will yield different results if the years before Social Security benefits commence are examined rather than the years after. (The earliest age for receipt of Social Security old age benefits is age 62, and the benefits would be reduced due to receipt prior to the Social Security normal retirement age of 65 or later.)

The State Patrol Retirement Plan and the Public Employees Police and Fire Retirement Plan (PERA-P&F) are public safety plans which do not include Social Security old age benefit coverage. For these two plans, there is no need to consider the impact of combining the impact of the Minnesota plan's benefit with that of an anti-poverty program, but other complexities would remain.

Whatever standard the Commission might choose to apply for Minnesota public plans, it is the income which people have to spend (their purchasing power) which matters, and not gross income. Whether the objective is to maintain the same living standard or a lesser one, differences in pre-retirement versus post-retirement tax treatment would need to be considered. Exemptions increase in old age, and income from Social Security (if any), is taxed differently than other income. It is also necessary to make adjustments for deductions applicable to pre-retirement income but not post-retirement. For instance, after retirement the individual does not make employee contributions to Social Security programs, including Medicare, but is likely to be incurring expenditures to supplement the Medicare coverage. The retired individual is no longer making contributions to the Minnesota retirement plan. As a retiree, the individual is not incurring certain employee-related expenses, such as recurring parking expenses, certain clothing or uniform expenses, and may no longer be purchasing life insurance. Thus, whatever the standard, it cannot be measured by straightforward comparisons of pre-retirement and post-retirement income. In all probability, less income will be needed post-retirement than before, whatever the standard, but there is no unique answer. Even if we are only considering results at normal retirement age with 30 years of service, results differ based on whether the plan is coordinated with Social Security, marital status, and pre-retirement income level.

If the Commission did agree on a specific income replacement standard and how to measure compliance with that standard, that may shed light on the adequacy of income at retirement. The next question would be whether that income remains adequate during retirement, requiring a review of the adequacy of post-retirement adjustment procedures. Commission Policy Principle II.C.8. states that adjustments ought to match inflation to maintain purchasing power:

> II.C.8. Postretirement Benefit Increases
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> a. Retirement benefits should be increased during the period of retirement to offset the impact of economic inflation over time in order to maintain a retirement benefit that was adequate at the time of retirement.
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> b. The system of periodic post retirement increases should be funded on an actuarial basis.