

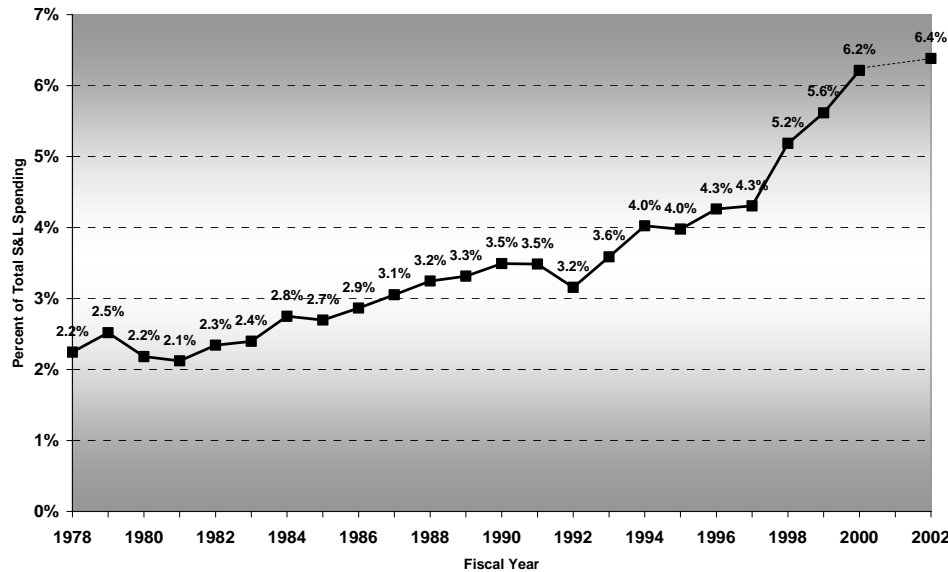
Introduction

As an area of government spending, public employee pensions seldom receive much in the way of public attention. It is easy to understand why. Defined benefit pension plans, the kind most often provided for public employees, are extraordinarily complicated, the monies that fund them are largely out of the public eye, and taxpayers don't see the results of this spending in their daily lives.

But public pension obligations are growing rapidly around the country. According to the United States Census Bureau, major public pension plans paid out \$78.5 billion in the 12 months that ended in September 2000. By the same period in 2004, pension payouts had grown by 50% to \$118 billion.¹ In 2003, states and municipalities contributed \$46.3 billion to pension plans, a 19 percent increase over 2002 levels. In several states, essential services like education are being squeezed by increasing pension obligations.²

Minnesota's own spending from government retirement trust funds has grown significantly from the late 1970s. As Figure 1 shows, total expenditures from all state and local retirement funds in the state grew from only 2.2% of state and local spending in 1978 to 6.4% in 2002, the latest year available from the Census Bureau for state specific data. Though most of the increase was paid for by investment earnings and not tax dollars, the increase points to a corresponding increase in long-term liabilities.

Figure 1. Minnesota's Retirement Fund Payments as a Percent of Total State and Local Spending*



*Pension benefits are financed primarily by investment returns, not tax dollars, but pension checks are still considered government spending by the Census Bureau. 2001 data is not available. The dashed line is an interpolation. Payments include "cash outs" from those leaving government employment early. Source: Census Bureau, Government Finances, respective years. Calculations by MCPFR/MTA 4/2006.

¹ Presentation by Michael Moskow, President and CEO, Federal Reserve Bank of Chicago, State and Local Government Pension Forum, February 28, 2006

² Sinkhole! How Public Pension Promises are Draining State and City Budgets, Business Week, June 13, 2005

Introduction

In September 2005, the Council of State Governments estimated that the liabilities owed by state government-operated retirement plans nationwide exceeded assets by some \$292.4 billion.³ Unfunded pension liabilities present a very real risk to taxpayers, and must be made up in one of three ways: decreased pension benefits, increased payments into retirement funds (through increased employee/employer contributions), or greater-than-expected return on fund investments. These “solutions” illustrate the inherent challenges of fixing the problem of unfunded pension liabilities. Pension benefits are considered contractual – those already earned can’t be reduced – and the state can only reduce benefits going forward. Increased payments are politically difficult because of the potential need for tax increases or cuts in other programs. The third solution – higher investment returns – is largely out of the control of legislators and other policy makers.

Are Minnesota taxpayers being exposed to significant risks from pension liabilities? Or is Minnesota successfully avoiding the problems other state and local governments are struggling with? What are the current and long-term costs of our public pension decision-making? Are there reforms we can pursue to improve both the financial health of the public pension system and the accountability of pension decision-making to state taxpayers? These questions are addressed in this report.

This report is divided into four sections:

Section 1 provides background information on how public pensions work and an overview of Minnesota’s public pension systems.

Section 2 examines Minnesota’s public pension liabilities. It includes a review of the current status and financial health of the state’s major public pension plans, a description and analysis of the legislative decision-making that has brought the state’s pension plans to their current condition, and an examination of the design features and assumptions underlying the state’s pension systems that pose the greatest risks to taxpayers in the future.

Section 3 examines public pension asset management in Minnesota. It critiques the current system used to review and monitor the investment performance of public pension plans in the state and discusses investment trends which may present more risk to taxpayers moving forward.

Section 4 provides recommendations on improving public pension health and accountability.

³ *Pensions Pose Time Bombs for Budgets*, Stateline.org, September 22, 2005.

Scope of this Report

Minnesota's public pension system is among the largest in the nation in terms of the number of individual public pension plans. There are a total of eighteen statewide public pension plans and four other plans that cover the employees of individual cities (see Appendix C for a listing). There are also several hundred locally administered volunteer firefighter pension plans and some locally administered plans whose members are police and professional firefighters.

There are two major reasons for this proliferation of public pension plans. First, pension benefits have only become standard over time. At the beginning of the twentieth century, pension coverage was added by employee group or by municipality as the need arose, with no overall coordination or vision at the state level. Secondly, larger statewide pension plans have “spun off” other plans, usually because a group of employees was given enough of a different set of benefits to require administration separate from the larger group of employees.

This report focuses on the three first-class⁴ city independent teacher plans and the three major statewide general employee plans. Although a review of the status and performance of the other state and local pension plans is beyond the scope of this report, the taxpayer risk issues discussed in this study apply to these plans as well.

Following is a brief description of the funds included in this report:

**Duluth Teachers' Retirement Fund Association (DTRFA),
Minneapolis Teachers' Retirement Fund Association (MTRFA)
Saint Paul Teachers' Retirement Fund Association (SPTRFA)**

Minnesota adopted legislation authorizing these pension plans in 1909, and they began operation in 1910. With certain exceptions, eligibility is restricted to school district employees in these cities with valid Minnesota teaching licensure. Employees without licensure, such as clerical and custodial staff, are currently covered under the Public Employees Retirement Association General Plan (see below). These plans are operated by private not-for-profit corporations that invest the plans' funds.

Teachers Retirement Association (TRA)

The precursor to this fund was created in 1915, became insolvent, and was replaced by the current plan in 1931. Eligibility is restricted to persons licensed to teach or work (such as nurses, social workers, therapists, school administrators, etc.) in a primary or secondary school. Eligibility also extends to many faculty members of the Minnesota State Colleges and Universities System (MnSCU). Unlike the first-class city teachers' funds that manage their own assets, this fund's assets are managed by the State Board of Investment (SBI). SBI manages and invests the assets for all statewide pension systems, and its governing board consists of the state's four constitutional officers (governor, auditor, secretary of state and attorney general).

⁴ The term “first-class city” is not a qualitative judgment by the authors of this report. Rather, the state classifies cities in Minnesota Statutes 2004, Section 410.01 based on population size. “First-class” cities in Minnesota are those that currently have or once had at least 100,000 in population. Currently, three cities inhabit this class: Duluth (which had a population of 100,578 for the 1970 census), Minneapolis and Saint Paul. We use the term “first-class city” throughout the report to refer to these three cities collectively.

Introduction

Public Employees Retirement Association (PERA) General Plan

PERA was established in 1931, and administers a general pension plan for most local government employees, including certain school district employees not part of TRA. (PERA also administers separate plans for police officers, firefighters and local correctional officers which are outside the scope of this report.) The fund's assets are managed by the State Board of Investment (SBI).

Minnesota State Retirement System (MSRS) General Plan

Established in 1929, MSRS administers pensions for state government employees through its general pension plan. MSRS also administers smaller individual plans for correctional officers, many University of Minnesota employees⁵, legislators, judges, elected executive branch officers, and other small groups of state employees that are beyond the scope of this report. The fund's assets are managed by SBI.

Study Assumption: Defined Benefit Plans Will Continue to be the Foundation for Minnesota's Public Employee Retirement System

A final introductory comment on one of the premises underlying this report should be noted. There is a substantial debate taking place around the nation about the continued merits of having defined benefit plans for public employees. Many critics are using the current funding crisis in several state and local pension plans to argue for replacing defined benefit plans with self-managed defined contribution plans.

We believe this debate is important, and the pros and cons of such a transition deserve a full examination, but this study is based on the assumption that a designed benefit system will continue to be the primary means of providing retirement benefits for Minnesota public employees into the foreseeable future. Our objective in this study is to identify ways to reduce taxpayer risk and improve fund health within the context of the current defined benefit pension system, rather than argue the merits of one type of plan versus another.

⁵ Some University of Minnesota employees are members of the University-operated Faculty Retirement Plan, while University police officers are covered under PERA's Police and Fire Plan.

Section 1: Understanding Public Pensions and How They Work

Public employee pensions have existed in Minnesota since the late 1800's. Originally, pensions were used by police and fire departments to retain and reward employees for engaging in risk-filled employment. Over time pensions have become a standard benefit for virtually every public employee of the state of Minnesota.

Why are public employee pensions an issue for taxpayers to be concerned about? Simply because tax dollars help pay for pension benefits. With Minnesota's pension plans investing billions of dollars, the potential impact on Minnesota taxpayers is enormous. It is both a current cost and potential risk that too few taxpayers understand or even know about.

This section attempts to de-mystify Minnesota's public pension systems and the world of defined benefit pension plans—the type of pension nearly all Minnesota public employees have—by examining a small number of public plans.

Public Pension Basics: Five Questions Regarding Minnesota's Public Pensions

What is a Defined Benefit Plan?

A ***defined benefit plan***⁶ is one that has fixed retiree benefits that are pre-determined based on an established formula. An employee at virtually any time can determine his or her annual retirement benefit based on the formula. Importantly, the formula-based benefits are guaranteed to members and will be paid even if member and employer contributions must be increased to do it. With a defined benefit plan retirees are provided with a constant and predictable stream of income for the remainder of their lives, and should they so choose, the lives of their surviving spouses⁷.

How are the Size of Benefits Determined?

In Minnesota, benefits are determined by using an average of the highest five successive ***annual salaries*** — referred to as the "***high five average***" — and multiplying this amount by a specified percentage. This percentage is known as the ***multiplier***. For members of the plans in this report, the multiplier is currently 1.7% for each ***year of service*** as a member of the retirement system. Employees taking early retirement (usually before age 65) have smaller multipliers. The final product of these calculations determines the annual retirement benefit.

For example, assume County Employee A will retire at age 65 with a high five average salary of \$60,000. Assume further that this employee has 37 years of service as a vested employee. Using the multiplier of 1.7% for each year of service (1.7% times 37), here is how this employee's retirement benefits would be calculated:

⁶ Terms in ***bold italic*** are defined in the Glossary of Terms found in Appendix A to this report.

⁷ Because this option results in a smaller monthly benefit, some retirees do not chose it.

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(“High five” salary) x (Multiplier) x (Years of service)

\$60,000 x 1.7% x 37 years = \$37,740 expected retirement benefit in first year of retirement.

This annual retirement amount of \$37,740 cannot be reduced during the employee’s retirement, but as shown later in this report, it can be, and typically is, increased.⁸

Where Does the Money Come From?

Minnesota’s public employee pensions are funded using three different sources. First, a portion of each employee’s earnings are deducted from his or her paycheck and allocated to the appropriate pension fund. This is known as the *member contribution*. For the plans in this report, the member contribution ranges from between 4% and 9% of salary. The average contribution for members of the plans in this report was 4.97% for fiscal year (FY) 2005⁹, which resulted in \$522.5 million in total contributions.

The second element of public pension funding consists of an *employer contribution*, in which the public employer contributes a percentage of each employee’s earnings into his or her pension fund. In FY 2005, employer contributions to plans in this report ranged from 4% to 11%, with an average of 5.29% and a total of \$557.0 million. In MSRS and TRA, employers and employees make matching contributions, but for the other plans, employers contribute more into the system than do

Who Oversees Minnesota’s Public Pension System in the Legislature?

In 1965 the Legislative Commission on Pensions and Retirement (hereafter referred to as the Pension Commission) was created as a permanent body. Part of the Pension Commission’s role was to end the fragmented process of policy development. From this point forward, the Pension Commission would serve as a *de facto* pension subcommittee in both houses of the Legislature. The Pension Commission is comprised of ten members, with five members from both the House and Senate. The House members are appointed by the Speaker of the House, while Senate members are appointed by the Subcommittee on Committees of the Senate Rules Committee (effectively, by the Majority Leader of the Senate). The Commission elects a chair, who sets the general direction of the Commission. The chair position alternates every two years between House and Senate members. Information on 2005-2006 Pension Commission members and past Commission chairs is appended to the end of this report as Appendix B.

The role of the Pension Commission is four-fold: (1) to review proposed pension legislation; (2) to research pension policy issues; (3) to provide legislative oversight of Minnesota’s pension plans; and (4) to assess whether pension funding is adequate.

As pension bills are introduced, they are typically assigned to the Government Operations Committees of each chamber. By tradition, the Government Operations Committees immediately refer these bills to the Pension Commission for review. The Government Operations Committees will normally not consider a pension bill unless it is first recommended by the Pension Commission. In order for a pension bill to receive a recommendation by the Commission, a majority vote of members from both the House and Senate delegations are required, which means that three votes from members of each body (a six-vote minimum) are required to pass a bill out of the Pension Commission. Recommended bills are usually accompanied with amendments approved by the Commission, as well as, when necessary, an actuarial cost estimate prepared by actuaries retained by the state’s pension plans.

The volume of proposed pension bills is prodigious. In the period from 2001-2005 an average of sixty-nine pension bills (not including companion bills) were introduced annually, or 345 pension bills during this five year period. An average of 31 bills per year were passed on to the Government Operations Committees for further consideration.¹

¹ Information provided by Pension Commission staff.

⁸ The pension can be reduced if the recipient becomes reemployed in the public sector. The ability of the Legislature to reduce earned pension benefits in Minnesota is a function of the legal theory used by the courts to view pensions. In Minnesota, public pensions are viewed by the court as either a function of a unilateral contract and not open to impairment under the Federal constitution under Sylvestre v State, 314 NW2d 658 (1973) or a function of a quasi contract/promissory estoppel rule under Christensen v Minneapolis Municipal Employees Retirement Fund, 331 NW2d 740 (1983). Pension Commission staff communication of April 20, 2006.

⁹ Fiscal years begin on July 1 annually and end June 30, and are named for the year in which they end. Hence, fiscal year 2005 began on July 1, 2004 and ended June 30, 2005.

employees.

The final element of pension funding consists of *investment gains*. As contributions are made by members and employers, fund managers invest the proceeds. The investment gains are added to the pension fund to pay for future retirement benefits. Naturally, investment performance varies greatly depending on numerous factors, including economic conditions, asset mix, active versus passive management, etc. Recurring investment losses and gains have inverse effects on the level of member and employer contributions required to sustain the level of benefits offered by a pension plan.

Occasionally, state government may make special contributions to pension funds in the form of **state aids**. In FY 2005, \$22.6 million of state aid was paid into the Minneapolis and Saint Paul teachers' pension funds in the form of separate appropriations from the state's General Fund. The city of Minneapolis also contributed \$2.5 million to the city's teachers' pension fund, for a total of \$25.1 million in total state and local aids paid to these two funds.¹⁰

How are Future Pension Costs Paid For?

Active employees earn benefits that will be paid for years, if not decades, into the future. There are two possible methods of paying for these future benefits. One method is a "pay-as-you-go" system. The Social Security system is an example of this funding method; where current employee and employer contributions are used to pay current retiree benefits. When today's employees retire, it is assumed that the next generation of employees and employers will be able to meet the cost. This next generation may not be able to meet this challenge, thus exposing the risk of pay-as-you-go funding.

Like most states, Minnesota does not use the pay-as-you-go system to fund pension benefits. Rather, pension benefits are accounted for using *actuarial funding*. Actuarial funding is an accounting tool which *accrues* pension benefits as employees earn them. As soon as active employees in a defined benefit plan become members of a retirement association, they begin to accrue retirement benefits. Each year, actuaries determine the *normal cost*, or liability incurred by covering employees for the current year's operations. Actuaries also determine the total value of pension benefits that are currently owed to active and retired plan members. That total value is known as the *accrued liability*. Actuaries also determine the total current value of pension assets. The state's actuary does this by phasing in market returns over a five-year period, in order to limit market volatility. These are known as the *current assets*.

Actuarial funding employs complex mathematical modeling based on probabilities and uses a large number of assumptions. It is both art and science. Actuaries apply various assumptions such as salary growth rates, investment return rates, mortality rates, employee turnover rates, early retirement rates, and other demographic variables to plan for future pension costs. An actuarial report is an estimate, based on the assumptions mentioned above, of the accrued liabilities of a pension fund. In Minnesota, actuarial reports are prepared each year to measure the funding adequacy of major defined benefit

¹⁰ If the local relief associations outside the scope of this report are counted, the state provides aid to nearly all public pension funds. In addition to the Minneapolis and Saint Paul teacher pension funds, the state also makes direct aid payments to employers who contribute to PERA's General Plan.

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plans.¹¹ Currently, Minnesota's statewide and other larger public pension plans (including those in this report) have contracted with The Segal Company to provide actuarial services.

Periodically, actuaries will conduct "experience studies" for pension plans (generally every four years) to determine how accurate these assumptions are. Actuaries can and do recommend changes to these assumptions based on these experience studies in order to better reflect expected reality going forward. The state must approve changes to salary growth and rate of investment return assumptions, while the Pension Commission may approve changes to other actuarial assumptions on its own initiative¹². Actuaries have no direct control over the actuarial assumptions used in evaluating the health and well-being of the pension plans in this report.

Sometimes the accrued liability of a public pension fund in Minnesota is greater than its current assets. When this happens, an *unfunded liability* is created. Any unfunded liability must ultimately be accounted for in defined benefit systems, since employees have already earned the future retirement benefits that are unfunded. Sooner or later these employees will be entitled to collect those benefits.

Unfunded liabilities, like home mortgages, are not necessarily harmful, and can be amortized over a certain number of years. Minnesota's pension systems use this amortization approach. According to the 2005 actuarial reports, the dates by which the unfunded liabilities of these pension funds must be fully paid varies between 2020 and 2032¹³. But taxpayers should be mindful of the size and scope of unfunded liabilities. If the unfunded liability grows to be so large that existing contribution levels and investment returns cannot make up the difference, taxpayers may be forced to shoulder a heavier burden.

The following are recent examples of how other states have addressed unfunded pension liabilities:

- In June 2005, driven by unfunded pension liabilities of \$43 billion, the governor of Illinois signed legislation designed to save the state pension system \$30 billion dollars over the next 40 years, in part by reducing benefits to newly-hired employees.
- In Washington State, legislators plan to devote a portion of the fiscal year 2005 \$1.45 billion surplus to alleviate the state's \$4 billion unfunded pension liabilities.
- During a special session, Alaska enacted a bill mandating that new state employees be placed in a 401(k) type plan instead of the state's defined benefit pension plan, in an attempt to stop the growth of its \$5.7 billion of unfunded liabilities.

¹¹ Lump sum volunteer firefighter relief (pension) associations use a "cookbook" actuarial approach as specified in statute, and no actuarial reports are provided to them. Volunteer fire relief associations that provide a monthly benefit can retain any qualified actuary, who will periodically prepare an actuarial report.

¹² M.S. 356.215, subdivision 18.

¹³ The current dates by fund are: June 30, 2020 for MSRS, TRA and MTRFA; June 30, 2021 for SPTRFA; June 30, 2031 for PERA; and June 30, 2032 for DTRFA.

How do you know if a pension fund is healthy or not?

There are two primary measures of pension fund health—the funded ratio and the contribution deficiency. A rough analogy can help illustrate how these two measures work.

Imagine taking a long canoe trip in the Boundary Waters. You need to be at your final destination 100 miles away and have identified several appropriate stopping points given your normal level of effort. One way to measure whether or not you are on schedule is to measure your progress against these stopping points. Each campsite is effectively a snapshot in time of your progress and a measure of whether or not you are on schedule to arrive at your destination on time.

Similarly, pension funds will take a snapshot in time to see whether they are on track to meet their future liabilities. At any point in time they can compare their accrued liabilities with the current pension plan assets. A plan's *funded ratio* is expressed as its total current assets divided by total accrued liabilities, and is one measure of pension health. A funded ratio of 100% indicates that a pension plan has exactly enough assets to offset future claims. The lower the funded ratio, the more its accrued liabilities exceed the plan assets (i.e. unfunded liabilities)

Returning to the canoe trip analogy, suppose bad weather strikes and causes you to fall behind schedule. To arrive at your destination on time, you will need to work harder. You need to paddle hard enough not only to cover the distance you were supposed to cover today but also at least some of the additional distance you fell behind.

In the pension world, contribution deficiency (or surplus) is a measure of how hard you are paddling. The “distance” you need to travel is made up of three items:

1. the *normal cost* (pension liability for the current year)
2. *amortization costs* (costs of paying off the plan's unfunded liabilities by a certain date); and
3. pension administrative costs

Actual contributions made to the fund during the year as required by law can be compared with these costs, and the *contribution deficiency (surplus)*, is calculated based on the difference between the two numbers. Thus, the contribution deficiency or surplus helps predict a plan's future ability to pay future obligations. Since contributions to pension plans are made as a percent of payroll, contribution deficiencies or surpluses are expressed in the same fashion and thus allow for comparisons over time.

Taken together funded ratios and contribution deficiencies capture the relative health of the fund. A pension fund may have a funded ratio above 100%, meaning that at that particular point in time the fund has more than enough assets to meet its obligations. But if there is a contribution deficiency rather than a surplus, the fund is “paddling too slowly” which spells potential trouble for the future. Similarly, a fund may have a funded ratio less than 100%, but if there is a contribution surplus, then the unfunded liability problem is improving over time. If both are negative, the fund does not have assets to meet its projected obligations *and* it is losing ground, adding unfunded liabilities.

“Taken together funded ratios and contribution deficiencies capture the relative health of the fund.”

Understanding Public Pensions and How They Work

How do investment returns fit in? They are like the current of the river in the canoeing analogy. If the current is working with you, you don't have to paddle as hard. If investment returns are excellent, it reduces pressure on employee and employer contributions. However, if the current is working against you, you have to paddle harder. Similarly, if investment returns are poor, there is greater pressure to increase contribution rates.

The Status of Minnesota's State and Teacher Pension Funds in 2005

Table 1 presents the funding status of the six plans in this report as of June 30, 2005 (the last day of each plan's fiscal year). None of the plans is fully funded at this time, although two (TRA and MSRS) appear in good shape with funded ratios exceeding 95%. Just as important, every plan but one has a contribution deficiency, meaning that they will likely add additional unfunded liabilities during FY 2006. The funded ratios in Table 1 represent a total of \$6.1 billion in unfunded pension liabilities as of June 30, 2005 for these six plans.

Table 1: 2005 Unfunded Liability, Funded Ratio and Contribution Deficiency (Sufficiency) for Selected Statewide and Major Minnesota Public Pension Plans, as of June 30, 2005

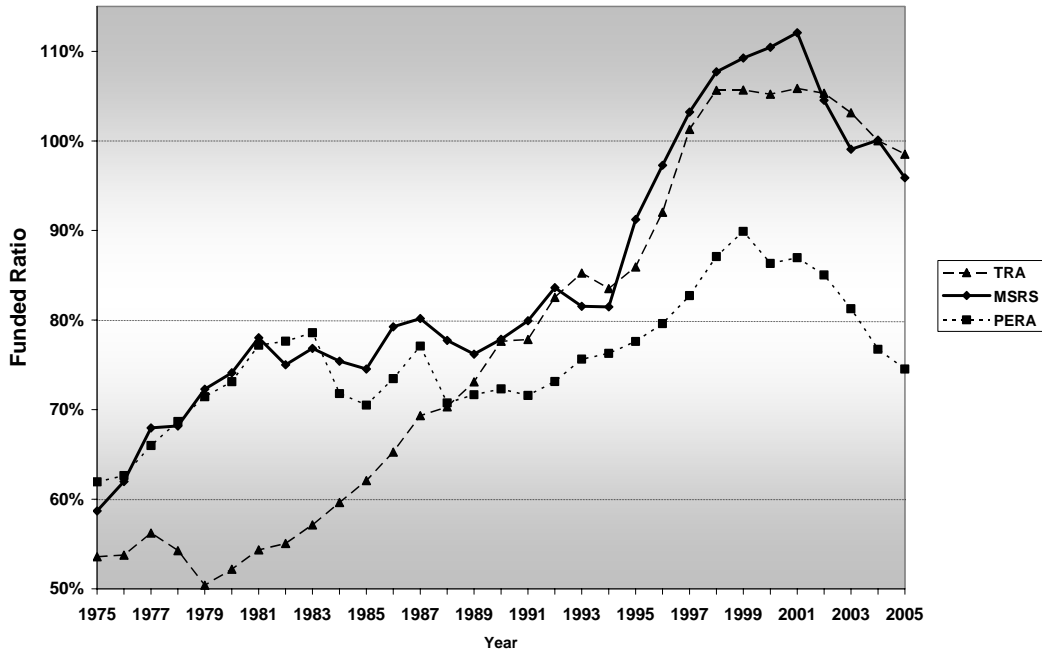
| Pension Plan | Unfunded Liability | Funded Ratio | Contribution Deficiency (Sufficiency) |
|--------------|------------------------|--------------|---------------------------------------|
| MTRFA | \$972,558,837 | 44.61% | 23.30% |
| SPTRFA | 394,539,070 | 69.65% | 7.29% |
| DTRFA | 42,443,108 | 86.35% | 2.87% |
| MSRS | 373,599,624 | 95.58% | 2.55% |
| PERA | 4,048,618,923 | 74.53% | 1.67% |
| TRA | 268,492,748 | 98.51% | (0.95%) |
| Total | \$6,100,252,310 | -- | -- |

Source: 2005 Actuarial Reports by Fund, Pension Commission.

Note: A positive number under "Contribution Deficiency (Sufficiency) indicates too few contributions were being made at the point in time of the measurement to close the funded ratio gap by the amortization date. A negative number indicates that contributions are more than adequate to close any gap.

Figures 2 through 5 provide some historical perspective on the evolution of plan health. Figures 2 and 3 present funded ratio trends since 1975.

Figure 2: Funded Ratios for Selected Statewide Public Pension Plans, 1975-2005

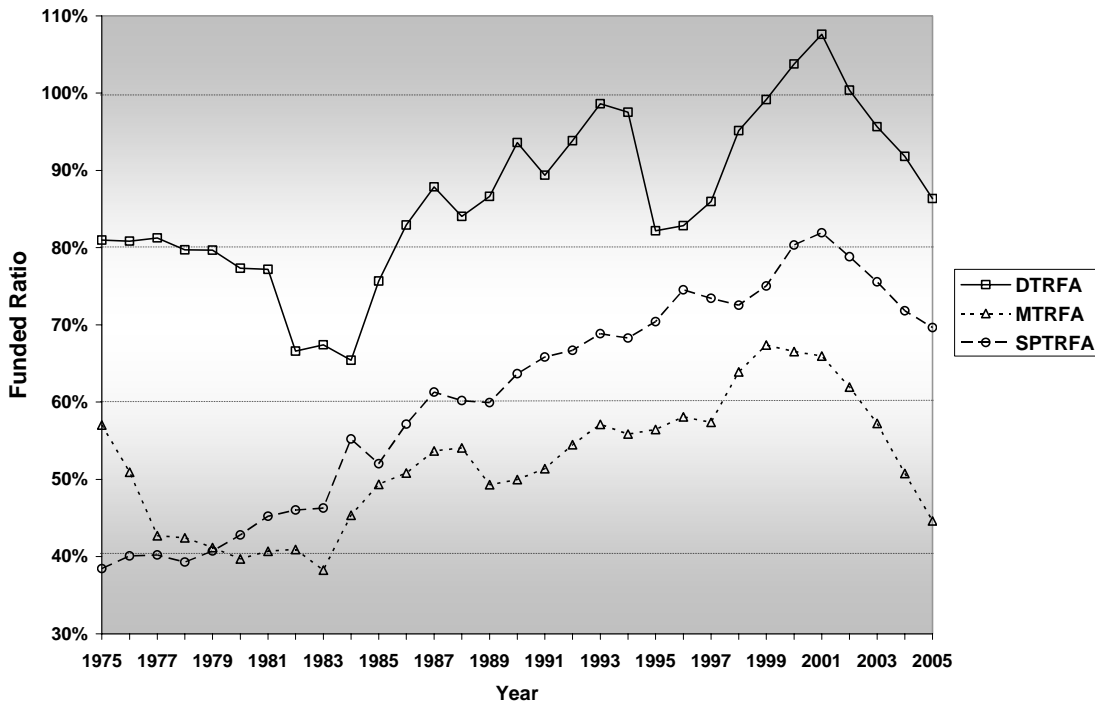


Source: Actuarial Reports by Fund, Various Years, Legislative Commission on Pensions and Retirement

As these figures illustrate, the funded ratios of the three statewide plans steadily improved through the 1980s and 1990s and significantly benefited from the strong stock market of the late 1990s. Similar progress was also made by two of the three first-class city teacher plans, though the trends for these plans were occasionally more volatile. Four of the six plans were actually “overfunded” (with funded ratios greater than 100%) near the time of the market’s peak in early 2001. Only the plan serving Minneapolis teachers had a lower funded ratio in 2005 than it did in 1975. However, the funded ratios of all six pension plans have been on a notable downward trend since 2001.

“...the funded ratios of all six pension plans have been on a notable downward trend since 2001.”

Figure 3: Funded Ratios for First-Class City Teacher Pension Plans, 1975-2005



Source: Actuarial Reports by Fund, Various Years, Legislative Commission on Pensions and Retirement

Two cautions need to be used when interpreting funded ratios. The first is based on the state-sanctioned method¹⁴ of calculating these ratios. The ratio is calculated using the “actuarial value of assets”, in which investment gains or losses in any given year are not realized immediately. Instead, gains or losses are divided into five equal parts and realized over the current and succeeding four years. This “smoothing” approach is designed to reduce the effects of investment volatility, but can mislead observers who may not know that significant gains or losses remain unrecognized due to the smoothing effects. For example, even though the SBI-managed funds in Figure 2 gained over 16% in FY 2004 and over 10% in 2005, they had significant unrealized losses from FY 2001 and 2002 that continued to depress the funded ratios.

The second and more important caution is that the funded ratio may not disclose all of a pension fund’s unfunded liabilities. This caution applies only to the three state managed funds and is due to the way Minnesota segregates MSRS, TRA, and PERA plan members into active employees and current retirees. As Section 2 will show, unfunded liabilities in these three plans are all greater than the reported funded ratios indicate.

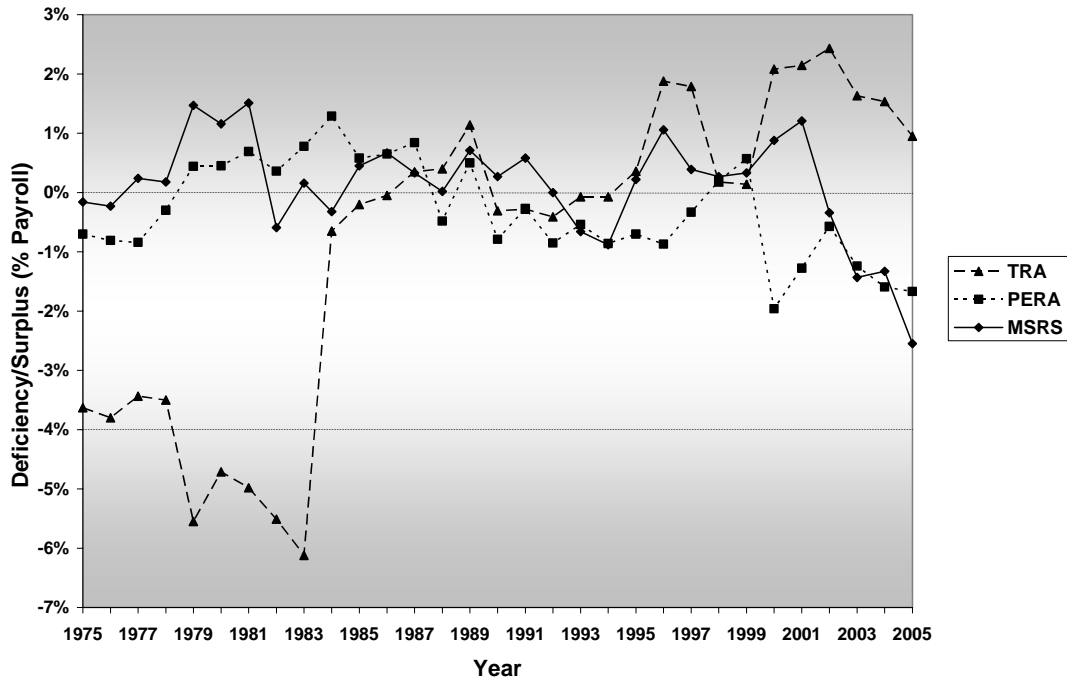
If funded ratios were significantly lower thirty years ago (as the figures show) and no pension crisis materialized then, why should taxpayers care about today’s relatively more modest unfunded liabilities? First, annual change in the unfunded ratios of these plans fails to capture the magnitude of the problem in terms of actual dollar liabilities. The funded ratios of 1975 represented \$1.13 billion in unfunded liabilities, or \$4.17 billion in 2005 dollars. The 2005 unfunded liability amount of \$6.1 billion is greater in real, inflation adjusted dollars than that of thirty years ago.

¹⁴ M.S. 356.215, Subdivision 1, Paragraph (f).

Second, and more disconcertingly, contribution deficiencies have worsened. Figures 4 and 5 provide contribution sufficiency trends over the last thirty years to illustrate this change.

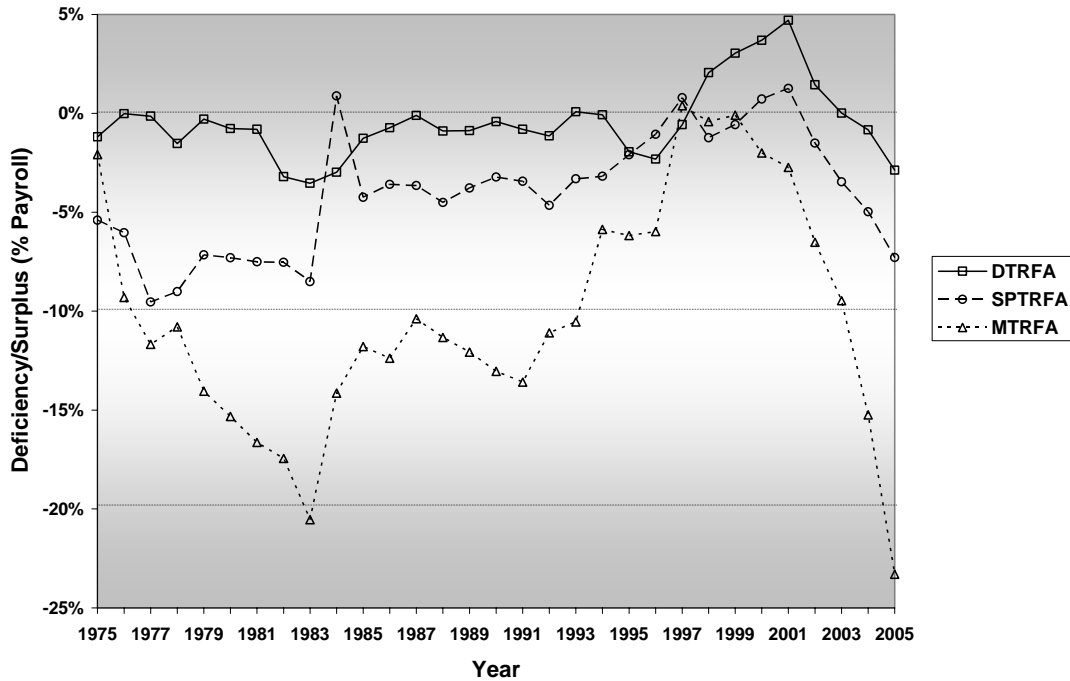
“Second, and more disconcertingly, contribution deficiencies have worsened.”

Figure 4: Contribution (Deficiency) Surplus for Selected Statewide Public Pension Plans, 1975-2005



Source: Actuarial Reports by Fund, Various Years, Legislative Commission on Pensions and Retirement.
 Note: The standard presentation of contribution sufficiencies or surpluses as negatives and deficiencies as positives was reversed for this figure for purposes of clarity in presentation.

Figure 5: Contribution (Deficiency) Surplus for First-Class Teacher Pension Plans, 1975-2005



Source: Actuarial Reports by Fund, Various Years, Legislative Commission on Pensions and Retirement. See Note under Figure 4.

“...changes in the investment climate since 2000 have had profound effects on the health of these funds.”

“Long-term contribution deficiencies [of the Minneapolis teachers fund] have eroded the funded ratio and have led to an effective ‘death spiral’ with ever-worsening funding ratios and ever-larger contribution deficiencies.”

During the last three decades, the three statewide pension plans frequently featured contribution surpluses, and were in relatively good health until 2001. In essence they were “traveling faster” (to refer back to the canoe analogy) helped by good investment markets, and were therefore able to make greater progress on reducing their unfunded liabilities. However, changes in the investment climate since 2000 have had profound effects on the health of these funds. All of the funds under consideration lost money in 2001 and 2002. This accounts for much of the drop in these plans’ funded ratios by creating additional unfunded liabilities, since fewer assets were available to fund them. Greater unfunded liabilities also created greater amortization requirements, and so without corresponding increases in contributions, contribution surpluses have turned to contribution deficiencies for two of the statewide funds. The size of these deficiencies for PERA and MSRS are the greatest in thirty years. TRA, the healthiest of all the pension funds studied, still has a contribution surplus, but the downward trend in its contribution surplus over the past five years merits attention.

The situation is worse for the three first-class city teacher plans. All have contribution deficiencies approaching or exceeding thirty-year lows, for reasons discussed above. The Minneapolis teachers fund merits special attention. Long-term contribution deficiencies have eroded the funded ratio and have led to an effective “death spiral” with ever-worsening funding ratios and ever-larger contribution deficiencies. In Fiscal Year 2005, every dollar of contributions from employees and government, nearly \$53 million, was paid out to retirees as benefits instead of being invested to pay for future benefits for current school employees. Should MTRFA default, it would likely trigger a school district default which would require a state takeover of the district and its liabilities.

Pending legislation¹⁵ proposes to resolve MTRFA's nearly \$1 billion in unfunded liabilities by merging it with TRA and eliminating the unfunded liabilities through a combination of: increased TRA contributions (0.5% of payroll), increased Minneapolis school district contributions (0.5% of payroll), investment returns and an extension of the combined funds' amortization date to 2037 (decreasing amortization costs). In return, the proposal provides MTRFA and TRA members an increase in the multiplier for years of service after July 1, 2006, from 1.7% to 1.9% per year of service

Contribution deficiency problems suggest that the problem could be addressed simply by requiring higher contributions from employers and employees. In fact, legislation in 2005¹⁶ will phase in contribution rate increases from 5.1% to 6.0% for most PERA General Plan members through January 2008. That legislation also increased the employer rate from 5.53% to 6.5% over the same period, and provided for additional employer rate increases in 2009 and 2010 if contribution deficiencies continue to recur. Pending legislation¹⁷ would phase in MSRS General Plan employer and employee contribution rate increases from 4.0% to 5.0% between 2006 and 2010. MSRS and PERA employees commendably agreed to these contribution rate increases without requesting any increases in benefits in return. Such a strategy will almost certainly improve each plan's financial health—although also at taxpayers' expense, since units of government have greater pension expenses.

For example, if all the approved increases to fix the PERA funding gap occur, city and county governments' pension contributions (the employers' share only) will increase \$41.8 million in FY2006, \$55.9 million in 2007, \$75.3 million in 2008, \$93.8 million in 2009, and \$113.2 million in 2010¹⁸. That is \$380 million in additional local government spending just on pensions in just five years. The employees' share of these increased contributions also create pressures for local governments to increase wages to compensate employees for lower net pay.

Payments into the system are just one of three factors affecting pension plan health. The other two factors—the size of Minnesota's pension plan liabilities, and pension plan investments—are also crucial pieces of the puzzle. If pension liabilities are properly controlled and investments are properly managed, there is no need to ask more of taxpayers, while preserving the basic benefits using the formula multiplier for both future and current retirees. Section 2 discusses the record of these six plans' management of assets as part of the strategy for controlling liabilities.

“MSRS and PERA employees commendably agreed to... contribution rate increases without requesting any increases in benefits in return... although also at taxpayers expense, since units of government have greater pension expenses.”

¹⁵ HF 2847, Article 3 (Ozment, R, Rosemount, 4306)

¹⁶ Laws 2005, First Special Session, Chapter 8, Article 5, Sections 2 and 3

¹⁷ SF 1057 (Pogemiller, DFL, Minneapolis, 7809); and HF 1120 (Powell, R, Burnsville, 4212)

¹⁸ Memo to the Pension Commission members from Ed Burek, Deputy Director, dated March 15, 2005.