



To: Members of the Legislative Commission on Pensions and Retirement

From: Mark Haveman
Executive Director
Minnesota Center for Fiscal Excellence

Date: May 9, 2017

Re: MCFE Testimony on 2017 Omnibus Retirement Bill – Unintended Consequence of Proposed Solvency Repairs

Dear Members of the LCPR:

We are unable to offer testimony on the omnibus retirement bill this evening but want to comment on an overlooked policy issue with respect to the proposed solvency improvement efforts generally and the issue of augmentation specifically.

Two of the most unappreciated problems Minnesota's public pension plans face are the degree of cross subsidization between age cohorts and the degree to which the current defined benefit plan structure severely penalizes and disincentivizes anyone who prefers not to spend their entire career in the public sector. Early in their careers, public employees do not accumulate much in the way of retirement benefits due to their relatively lower salaries and years of service. At the same time, an employee's retirement contributions made early in his or her career are worth much more than contributions made later in life because they can be invested for longer periods of time.

Put these two facts together and, as the Urban Institute of Washington DC notes, "the value of required contributions often exceed future benefits until participants have worked long enough to receive more generous pensions."¹ In other words, it takes a very long time before defined pension benefits are worth more than just the employee's own contributions.

The length of time a public employee would have to work to reach the "break-even point" at which the pension benefits begin to exceed the value of his or her contributions would likely surprise defined benefit plan beneficiaries. The Urban Institute concluded that in half of state and local government pension plans public employees must work at least 20 years to receive a pension worth more than their own contributions; and more than 25 years in 1/5th of traditional plans. The challenge is especially acute for TRA. Based on the Institute's analysis Minnesota teachers hired after the Rule of 90 was revoked (June 30, 1989) **must work for 34 years just to break even.**²

We have attached our own example to illustrate how the economics work and the magnitude of the disincentive that exists. Our example uses actual Minnesota contract settlements and historical contribution rates to model an employee with 10 years of service to the state. As the example shows, if the employee simply takes a refund of his or her contributions, that refund is still worth \$7,000 more

¹ "How Long Must State and Local Employees Work to Accumulate Pension Benefits" Urban Institute Washington, DC, April 2014

² "Negative Returns: How State Pensions Shortchange Teachers" Urban Institute, September, 2015

than the present value of the benefit the employee would receive beginning at the normal retirement age of 67 (non-augmented). We also show that had the employee invested those same amounts over the same period, he or she would have an amount worth nearly \$10,000 more than the present value of the defined benefit. With a very modest 3% employer match over the ten years, the value of the employee's investment compared to the defined benefit would be more than double. The problem is exacerbated for anyone with a mid-career interest in government service. Working just for a portion of one's career in the public sector can be noble, fulfilling, and gratifying, but absent policies like augmentation it's also severely detrimental to one's retirement security.

There is an important equity issue here as well, stemming from the cross-subsidization occurring among plan members. As the lengthy break-even time periods indicate, employer pension contributions are heavily redistributed, with some employees receiving no benefit at all and others receiving benefits that cost far more than was contributed on their behalf. Public pensions may be helping state and local governments retain longer-term employees, but that could be because those employees cannot afford not to continue in public service for the years it will take for the pension benefit to pay off.

In conclusion, the Commission's proposals this session with respect to interest rate adjustments on refunds, contribution increases, and the elimination of augmentation clearly are needed and improve plan economics. However, an unintended consequence of all these efforts is to increase the break-even points and require public employees to work longer to accumulate any employer-financed pension benefits, raising critical equity and workforce-related issues in the process.

Continuing to tweak the state's pension plans in ways like this will make defined benefit plans a talent repellant rather than an attraction and retention tool while exacerbating the existing divide between the pension "haves" (near retirees and retirees) and the "have nots" (everyone else). We believe it is worth considering whether the teacher shortage concerns expressed last evening may be a function of having nearly 17% of a new teacher's compensation redirected away from salary toward a benefit that not only won't be realized for decades but also runs counter to the employee's own retirement self interest for decades.

Thank you for your consideration.

Economics of Non-Augmentation for a 10 Year Public Sector Employee

Assumptions

- Hire Date: 7/1/2007 at age 25
- Worked in public sector for ten years until 2017; leaves state service at age 35
- Hired at 7L (Research Analyst Intermediate; promoted to Research Analysis Specialist on 12/31/2013 with effective one step increase
- One step earned annually
- Beginning at age 67 (32 years from the present) begin 19 year pension benefit period (based on Social Security Administration life expectancy calculation)
- **No augmentation**
- 1% COLA during benefit period
- 6.0% discount rate assumed for present value of the future retirement annuity

High Five	\$55,052
Multiplier	1.7%
Yrs Service	10

Beginning	
Pension Benefit	\$9,359
Total Benefit Paid (19 years)	\$194,769

Present Value of Future	
Benefit Annuity	\$22,951

Employee's contribution refund for the 10 years (6% then 4% interest accrual)	\$29,551
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Hypothetical 401k balance based on 10 years of employee's contributions; 2007-2017 actual; 70/30 split stock/bonds; end of year investments reduced 2% for fees	\$31,665
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Hypothetical 401k balance with 3% employer match (2007-2017 actual returns, per above)	\$50,672
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