INFORMATION BRIEF
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Minnesota Public Pensions

Funding Principles

This information brief discusses funding principles for Minnesota public pension plans. A table at the end shows the funding status of the major Minnesota public pension plans.

The largest Minnesota public pension plans pay benefits that are based on an employee's salary, years of service, and age at time of retirement. Upon retirement, benefits are paid for the rest of the former employee's life, and in some cases, for the life of a designated survivor. An important part of the design of these pension plans is determining how to pay for benefits.

There are three major sources of pension funding.

- Employee contributions
- Employer contributions
- Investment earnings on employee and employer contributions between the time the contributions are made and benefits are paid.

Minnesota prefunds pension benefits.

Minnesota pension plans put aside money each year to pay for benefits that employees have earned that year, even though the benefits will not be paid until future years. Thus each year, taxpayers pay for the benefits that public employees have earned that year.

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The amount of money that must be contributed each year to pay for the benefits that pension plan members have earned that year is referred to as the normal cost. The normal cost is generally expressed as a percentage of payroll. The normal cost is calculated using a number of assumptions concerning the cost of benefits to be paid in the future and the accumulation of assets to meet those benefit obligations. The legislature usually provides for the employer and the employee each to pay approximately half of the normal cost.

An alternative approach to pension funding, not commonly used in Minnesota, is pay-as-you-go funding. In that system, a benefit is not funded until the time the person retires or the time each benefit payment is due. Under pay-as-you-go funding, taxpayers in a given year may pay more or less than the amount needed to fund benefits public employees earned in that year.

The exact amount of required funding is unknown.

All of the important variables needed to calculate the cost of an employee's pension benefit are unknown at the time the employee and the employer make contributions to the pension plan. The pension plan does not know how many years the employee will work, the employee's final salary, how long the person will live after retirement, or how much money will be earned on the employee and employer contributions before benefits are paid to the member.

Pension plans make assumptions about these unknown variables. The legislature establishes assumptions in law concerning employee salaries and the rate of return on investments. Pension plans establish other assumptions, such as mortality rates and the number of people who will leave public employment before working the minimum amount of time required to receive a pension benefit at the required minimum age.

In addition to the actuarial assumptions, there are various techniques for estimating the cost of benefits earned each year and for estimating a pension plan's total future benefit obligations to its members. Minnesota uses a method of estimating those costs that generally requires more funding in the earlier years of a public employee's service than alternative measures.

Pension funds annually estimate their funding status.

Each year an actuary compares the estimated future benefit obligations for each pension fund to the value of the assets projected to be available to pay those future obligations. Just as there are various methods of estimating future benefit obligations, there also are different ways of determining the value of the investment assets held by a pension plan. These assets can be valued at their original cost, at their original market value, or, as is currently the case in Minnesota, at some combination of cost and market value.

Pension funds must pay off unfunded liabilities.

A pension fund's estimated benefit obligations may exceed the assets projected to be available to pay those benefits. This condition is known as an unfunded accrued liability.

Several factors may create an unfunded accrued liability:

- Contribution rates initially may be set too low to pay for promised benefits.

- One or more of the funding assumptions may be wrong. For example, investment returns may be lower than expected, or people may live longer than expected.

- New benefit improvements may be applied to past service, in which case the normal cost paid in past years does not cover the improved benefit level.

An unfunded accrued liability does not necessarily mean that the fund does not have enough money to pay its current obligations. Rather, it is a comparison of future obligations to future projected assets. A pension fund with an unfunded liability may be in good financial health if the plan's financing ensures that the unfunded liability will be paid off in a reasonable time period. Unfunded liabilities are paid off, or amortized, in much the same way as a mortgage on a house is paid. Because the unfunded liability may have been established over a period of years and all benefits need not be paid out immediately, it is not equitable to require taxpayers in any one year to pay the entire liability. Instead, the legislature establishes target dates for paying off the unfunded liabilities, and requires periodic payments necessary to eliminate the liability by that date.

The legislature generally has provided that paying off the unfunded liability should be accomplished to some extent by increased employer contributions. Thus pension plans with an unfunded liability sometimes require an "additional employer contribution," on top of the employer payment of part of the normal cost. Like the normal cost, this additional contribution is expressed as a percentage of payroll. In 2010, the legislature enacted a variety of measures designed to reduce unfunded liabilities in public pension plans. These measures varied among plans, and included increased employer and employee contributions and benefit reductions.

Funding Status of Major Public Pension Plans

Pension Plan	Assets (millions)	Liabilities (millions)
State Employee Plans		
Minnesota State Retirement System (state employees)	$9,030	$10,513
State Patrol	585	725
State Correctional Employees	590	821
Local Government Plans		
Public Employees Retirement Association (local government employees, other than police and fire)	13,158	18,799
Public Employees Retirement Association (police and fire)	5,240	6,296
Local Government Correctional Plan	218	229
Minneapolis Employees Retirement Fund	880	1,575
Teacher Plans		
Teachers Retirement Association (teachers and administrators outside of St. Paul and Duluth)	17,882	23,115
St. Paul Teachers Retirement Association	1,050	1,454
Duluth Teachers Retirement Association	279	365

Source: Actuarial valuations for July 1, 2009.

For more information about public employees, visit the state government operations area of our web site, www.house.mn/hrd/hrd.htm.