ADDENDUM

This section was intended to be included at the end of Part VII, but was inadvertently omitted when the draft report was emailed to legislators, stakeholders, and others on November 20, 2020. It will be included in the final draft when it is submitted to the LCPR at the end of December, 2020.

E. Private Sector COLAs

What can we learn from the private sector about COLAs in defined benefit pension plans? Based on the scant research and commentary available, it appears that COLAs in private sector defined benefit plans have, for the most part, disappeared for two reasons:

- When required to maintain full funding, employers will jettison expensive ancillary benefits, such as COLAs: In the private sector, employers that sponsor defined benefit pension plans are subject, under federal law, to substantial penalties if they do not make the annual required minimum funding contribution. Private sector employers do not have the option of maintaining an underfunded defined benefit plan, as public employers do. This means that private sector employers focus on providing the core benefit, forgoing or phasing out expensive ancillary benefits such as COLAs.

- When an ancillary and expensive benefit, such as a COLA, cannot be eliminated or reduced from year to year to be responsive to the employer's reduced financial circumstances or the plan's poor investment returns, employers will opt to phase out the benefit: Under federal law applicable to private sector retirement plans, "protected benefits" cannot be reduced or eliminated without risking the plan's qualified status under the Internal Revenue Code. COLAs are considered protected benefits to the extent of already accrued benefits. Even ad hoc COLAs, given on an intermittent basis, have been found to be protected benefits that cannot be reduced or eliminated. With no flexibility to reduce or eliminate a COLA as the employer's financial condition or the plan's investment earnings ebbs, private sector employers have opted to phase out COLAs entirely for new hires and future accrued benefits.

In the private sector, with only about one in ten workers covered by a pension plan, an employee is rarely covered by a pension plan, much less a one increased every year to keep up with inflation. The prevalence of defined benefit plans and defined contribution plans in the private sector versus public sector looked like this in 2019[45]:

Figure 25

Prevalence of Defined Benefit Plans and Defined Contribution Plans in the Private Sector vs. Public Sector in 2019

	All Workers Private + State & Local Govt. Workers	Private Sector Workers	State & Local Government Workers
Number of full- and part-time workers	139 million	120 million	19 million
Percentage of workers participating in a:			
workplace retirement plan	56%	52%	83%
pension plan	21%	**12**%	**76**%
retirement savings plan (defined contribution)	43%	47%	17%
retirement plan who are in a pension plan	37%*	23%**	92%**

**29.1 million workers   **14.4 million workers*

One detailed comparison of the differences between public and private pensions, published in 1997, analyzed data from the Bureau of Labor Statistics' Employee Benefits Survey conducted in 1993-1994.46 In 1993-1994, 91% of public employees participated in defined benefit pension plans compared to 56% of private sector employees. Among the differences noted:

- Virtually all employees in the private sector are covered by Social Security, while approximately 76% of employees in the public sector are covered by Social Security
- Employees in the private sector do not contribute to their defined benefit pension plans; private sector plans are wholly funded by employer contributions.
- The typical benefit formula and average final earnings in the private sector is less generous than in the public sector; on average, the highest five years are taken into account in the private sector versus the highest three years in the public sector, and the average multiplier in the private sector was 1.48% versus 1.85% in the public sector.
- Many private sector plans are "integrated with Social Security" which means that the pension benefit is offset to take into account the employer's contribution to Social Security on behalf of its employees; this is virtually unheard of in the public sector, including for public sector employees who will receive Social Security benefits.

[45] Pension Rights Center calculations based on data from the Bureau of Labor Statistics' National Compensation Survey for 2019.

[46] "Public and Private Sector Defined Benefit Pensions: A Comparison," by Ann C. Foster, *Compensation and Working Conditions*, Summer 1997

- Private sector plans typically do not offer “rule of X” early retirement with a full pension and have later normal retirement ages to receive a full pension.

In addition to the foregoing differences, public sector and private sector plans differed markedly on the topic of COLAs:

- 53% of public sector plans provided an automatic COLA, whereas only 4% of private sector plans provided an automatic COLA provision.

- 13% of public sector plans provided for a discretionary or ad hoc COLA, whereas 6% provided for such a COLA.

Finally, as mentioned above, a significant difference between private and public sector defined benefit pension plans is that private sector plans are subject to stringent funding requirements that are not applicable to governmental plans. Beginning with the passage in 1974 of Internal Revenue Code section 412 and the rest of the Employee Retirement Income Security Act (“ERISA”), Congress has focused on strengthening the funding of defined benefit plans in the private sector, making them increasingly more expensive to maintain. Today, Code section 412 requires the sponsoring employer to make an annual minimum required contribution, defined as an amount sufficient to cover the year's accrued benefits and amortize any shortfall over a 7-year period for a plan that is not 100% funded. The employer must make the contribution for each plan year or face an excise tax penalty of 10% per year of the unpaid minimum required contribution and, if the contribution is not paid or the deficiency is not corrected as of the end of the taxable period, an additional 100% of the unpaid contribution or deficiency. Code section 412 does not apply to governmental plans.

In addition to the annual contribution requirements, sponsors of private sector pension plans are also required to pay annual premiums to the Pension Benefit Guaranty Corporation (“PBGC”), which “insures” private sector defined benefit pension plans. Premiums, paid per participant and tied to the plan’s funding status, have increased substantially since 1974. Perversely, as a plan’s funding status declines, premiums increase. Finally, accounting standards issued by the Financial Accounting Standards Board, applicable to private sector financial statements, have required corporate balance sheets to recognize an underfunded pension plan as a liability, decades before similar changes to financial reporting in the public sector.

We were not able to track down any recent data on the prevalence of COLAs in private sector defined benefit pension plans. Recent mentions of COLAs in the private sector is anecdotal. For example, an actuary on a Q&A website called “BenefitsLink” reported:

> *Automatic COLAs in private sector DB plans were hardly ever seen. I encountered one or two among regulated utilities -- i.e., where plan costs were borne by rate payers -- but that was about it.*
>
> *In a variety of industries (finance, energy, manufacturing), occasionally granting an ad hoc COLA did not become uncommon until about 20 years ago. What happened? Obviously increasing cost pressure on DB sponsors was one factor. Another was plan*

design changes that made lump sum payouts common among new retirees -- corporate decision makers stopped seeing it as important to keep up a COLA precedent for the life annuitants. And starting in the 1990s (I think) the IRS started warning that a regular pattern of plan amendments, such as an ad hoc COLA every few years, could constitute an ongoing commitment to continue that pattern.

As mentioned above, when private sector employers attempted to help retirees with ad hoc COLAs, such as during periods of high inflation, the IRS issued guidance warning that ad hoc COLAs could become protected benefits if given frequently enough and thereafter could not be reduced or eliminated. As stated in Section 7.11.6 of the IRS' Internal Revenue Manual, which provides direction to IRS auditors, "Plans that adopt ad hoc COLAs (in other words, a one-time benefit increase for retirees in pay status) for several years in a row may violate [Internal Revenue Code section] 411(d)(6) in the first year that they don't adopt an ad hoc COLA."

The PBGC does not provide a COLA on the pension benefits it pays to participants in the private sector pension plans it assumes when the sponsoring employer has failed to fund the plan or has gone into bankruptcy.

At least two conclusions can be drawn from the information available on COLAs in defined benefit pension plans in the private sector:

- For the relatively few remaining private sector employers who sponsor a defined benefit plan, COLAs have been eliminated as the margin of error for maintaining a fully funded plan has tightened. Unlike public sector employers, private sector employers pay the entire cost of the plan, with no help from employee contributions, and are required to make the required minimum contribution as calculated by the plan's actuary every year. With no statutory requirement to fully fund public pension plans in Minnesota, public sector employers have little incentive to reduce or eliminate COLAs.

- The Internal Revenue Code prohibits the reduction or elimination of protected benefits, including a COLA, as a condition of plan qualification and ERISA gives participants the ability to enforce their right to those benefits. If a private sector employer's financial condition declines or the plan's investment earnings decline, a private sector employer does not have the option to reduce or eliminate a COLA. This has led private sector employers to phase out COLAs, by eliminating COLAs for future accruals and new hires.

  Under Minnesota law, with the possible exception of Minnesota judges, employees have no constitutional, contractual, quasi-contractual, or property ownership right in a COLA in public sector defined benefit pension plans. When public pension plan investments have underperformed, the legislature has reduced or frozen COLAs as determined necessary to maintain a level of underfunding that is considered sustainable. This ability to reduce or freeze COLAs without fear of litigation may be one reason Minnesota's public sector pension plans will not find it necessary to follow the lead of the private sector by eliminating COLAs altogether.