FISCAL SENATE AGENCY

SENATE FISCAL AGENCY
MEMORANDUM

DATE: February 22, 2010

TO: Members of the Senate

FROM: Kathryn Summers, Chief Analyst

RE: Reforms/Incentives Proposed for Public School Employees' Retirement System

As part of the fiscal year (FY) 2010-11 budget recommendation, Governor Granholm proposed numerous long-term reforms and short-term incentives for the State's two largest pension systems: the State Employees' Retirement System (SERS) and the Michigan Public School Employees' Retirement System (MPSERS). This memo will detail the Governor's proposals for the MPSERS, include the State Budget Office's estimates of fiscal impacts on the system, and raise potential questions about the plan. The SERS changes will be discussed in a separate memo.

MPSERS Proposals for Existing Employees

There are numerous reforms proposed, both for existing employees and for new hires. There are approximately 280,000 employees working in the system now, who would be affected by the following changes:

- **Increase Employee Contribution to Pension.** The Governor is proposing to increase most existing members' contributions by 3% of salary, such that all "basic" members, who were hired before July 1, 1990 and who currently contribute nothing but have stricter retirement eligibility guidelines and no cost-of-living adjustments, would pay 3% of salary, and all Member Investment Plan ("MIP") and "MIP Plus" members (hired after July 1, 1990) would pay 7.3% of salary toward the cost of funding pensions. MIP members hired before July 1, 2008 currently pay 4.3% of salary; MIP Plus members hired after July 1, 2008 pay 6.4%, so this proposal would increase their contributions to 7.3% of salary.
    - **Affect on Pension System.** The State Budget Office (SBO) analysis indicates this would provide local savings to schools of $207.0 million in FY 2010-11. After 10 years, this proposal is estimated by the SBO to save $2.4 billion.
- **Cap Years of Service in Pension System at 30/Transfer to DC Plan Thereafter.** The Governor is proposing to cap existing employees' years of service at 30 (or the amount they currently have, if higher than 30), and transfer those employees' additional years of service into a new defined contribution (e.g., 401k) plan. The new defined contribution (DC) plan would mirror the existing DC plan for State employees: the State would contribute 4% of an employee's salary into a 401k and match up to another 3% of an employee's contribution.
    - **Affect on Pension System.** The SBO analysis indicates this would provide local savings to schools of $41.0 million in FY 2010-11. After 10 years, this proposal is estimated by the SBO to save $479.0 million.
- **Eliminate Retiree Dental/Vision Coverage.** The Governor is proposing to eliminate retiree dental and vision insurance for any employee who doesn't retire by September 30, 2010. Future retirees would have the option to purchase vision and dental care offered to covered

201 N. Washington Square • Suite 800 - The Victor Center • Lansing, Michigan
Telephone: (517) 373-2768 • TDD: (517) 373-0543 • Fax: (517) 373-1986

retirees, but out-of-pocket. Currently, the monthly cost for vision and dental combined ranges from $35 for a single person to $70 for a retiree plus spouse.

- **Affect on Pension System.** The SBO analysis indicates this would provide local savings to schools of $1.0 million in FY 2010-11. After 10 years, this proposal is estimated by the SBO to save $206.4 million.

For all of the proposals described above, the only way the savings estimated by the SBO could be achieved for schools in FY 2010-11 would be to lower the already-published employer contribution rate from 19.41% to a rate that would reflect the increased employee contributions. In future years, this reform would reduce the MPSERS employer contribution rate that otherwise will occur, though in the near term the rate likely would continue to increase due to relatively recent investment losses in the stock market.

MPSERS Proposals for New Hires

The Governor also is proposing substantial changes for new hires, in addition to the elimination of dental and vision care and the capping of service credit at 30 years, detailed above. The proposal includes:

- **Hybrid Defined Benefit/Defined Contribution for New Hires.** Anyone hired on or after October 1, 2010 would be placed into a new hybrid DB/DC plan. This plan would have a much later retirement age (not younger than 65), would not provide cost-of-living adjustments in the pension, and would calculate final average compensation (FAC) using nine years instead of three (thus likely lowering the FAC on which the pension is calculated). The employee would pay 7.3% of salary to finance the defined benefits (DB) portion of the plan, and could earn a 1% State match on salary if contributing another 2% into a separate 401k or similar defined contribution plan.

  - **Affect on Pension System.** The SBO analysis indicates this would provide local savings to schools of $3.9 million in FY 2010-11. The only way this could be achieved for FY 2010-11 is to lower the already-published employer contribution rate from 19.41% to a rate that would reflect the increased employee contributions. In future years, this reform would reduce the MPSERS employer contribution rate that otherwise will occur, though in the near term the rate would continue to increase due to relatively recent investment losses in the stock market. After 10 years, this proposal is estimated by the SBO to save $410.6 million.

MPSERS Retirement Incentives for Employees Currently Eligible to Retire

The Governor is proposing an increased pension multiplier, in the hopes of accelerating the retirement of those persons already eligible to retire:

- **Increased Pension Multiplier.** In addition to the proposed long-term reforms to the MPSERS, the Governor is offering incentives to those employees currently eligible to retire, if they retire between July 1, 2010 and August 31, 2010. This should not be confused with an "early out", which typically lessens the age and/or years of service requirements to retire. Instead, "basic" plan employees age 55 or older with 30 years of service, "basic" plan employees age 60 or older with 10 years of service, "MIP" members any age with 30 years of service, or "MIP" members age 60 or older with 10 years of service would be considered eligible to retire. These members also could purchase service credit in order to become eligible. (The maximum amount of service credit that can be purchased is five years.)

There are currently roughly 32,300 employees who are eligible to retire, and another 6,300 who could retire with the purchase of service credit, bringing the pool of eligible school employees close to 39,000. Of this total pool, about 19,000 are over the age of 60. The incentive being offered is an increase in the pension multiplier from 1.5% to 1.6%, for eligible employees who retire between July 1, 2010 and August 31, 2010. The current formula for determining a person's pension is *Years of Service* X *Final Average Compensation* X *1.5%*, and the Governor's proposal would increase the 1.5% multiplier by 0.1 percentage point. For a person with 30 years of service and a FAC of $60,000, the increased multiplier would raise the pension from $27,000 to $28,800, or roughly 6-2/3%.

The administration assumes that 75% of members eligible to retire earlier than planned would do so, meaning that 29,000 out of the 39,000 total pool would leave service this upcoming summer.

- **Affect on Pension System.** The SBO analysis assumes wage savings from replacing older, more expensive employees with younger, less expensive employees ($20,000/person), and assumes 90% of employees who retired would be replaced. There would be increased health care costs for an estimated three years to cover these additional retirees, since health care would have to be provided to both the retiree and the new hire, and beginning in FY 2011-12, the five-year cost of paying for the increased multiplier would begin affecting schools. The net wage differential and replacement savings after payment of the additional health care costs, as estimated by the SBO, in FY 2010-11 total $448.2 million. After 10 years, this proposal is estimated by the SBO to save $2.8 billion.

- **Phased Retirement Option.** Due to some concerns over "brain drain", among other issues, the Governor is proposing to allow schools to re-hire on a part-time basis employees who choose to retire, and those employees would be allowed to draw their pension benefit and up to half-pay, but hours worked would have to be reduced by 50%. This would be for employees at least age 60, and schools could decide to do this one year at a time, renewed for up to three years. This phased retirement option would be an ongoing change to statute, affecting not only people who retired under the incentives being proposed, but any future retirees. No estimate of fiscal impact is currently available on this proposal.

Potential Questions on the Proposal

The numbers presented above and the full detailed table at the end of the document reflect estimates provided by the State Budget Office. There are numerous assumptions in the SBO analysis, and in the proposal itself, that bear noting:

- **Participation Rate.** The SBO assumes that 75% of eligible employees would choose to retire earlier than they otherwise are planning. Past history shows that employees, on average, work three to four years beyond their first eligibility date. Whether the increase to 1.6% in the multiplier combined with the removal of vision and dental insurance would be sufficient to encourage 75% of people to retire earlier than planned is up for debate. It is known that about 19,000 of the 39,000 potentially eligible employees are over age 60, and it's possible that the older employees in the cohort may choose retirement, but those who are younger might not. There is no past experience in MPSERS on how the incentives may affect people's retirement decisions.

- **Wage Savings.** The SBO analysis assumes continuous yearly wage savings from the incentives portion of the retirement proposal, but there would be wage savings only during the years in which people had retired earlier than they otherwise are planning. An SFA analysis would discontinue wage savings after the third year. The incentives portion of the MPSERS reforms is simply a different type of "cash for clunkers", such that any members motivated by the incentivizes to leave employment earlier than they were planning results in that many fewer jobs opening up down the road, when those people would have retired in the absence of incentives.

- **Replacement Ratio.** The SBO analysis assumes savings from a 90% replacement ratio, and calculates the savings compared to a full 100% replacement ratio. However, the State cannot impose a 90% replacement ratio on local schools, and, recent trends in school employment would suggest that a 95% replacement ratio is already occurring. Therefore, an SFA analysis would not claim any replacement ratio savings, since fewer people are being hired to replace retiring workers already, and the decision to hire is a local decision.

- **Legal Questions.** The imposition of new or additional contributions toward pensions for *existing* employees is an avenue that has not been explored to date. There may be questions on whether the imposition of such contributions for existing employees would violate any Constitutional guarantees to pensions by implicitly changing the terms of a person's employment contract. In the past, new or additional contribution rates have been imposed for new hires only.

Table 1 follows on the next page, and details the year-by-year fiscal impacts of the various components of the package, as estimated by the State Budget Office. Please feel free to call with any questions. The Governor has requested expedited legislative action to implement the retirement incentives, if the Legislature chooses to pursue this avenue. It should be noted that while this is a summary of the overall MPSERS proposal as advanced by the Executive, the Legislature may choose to enact some, all, or none of the recommendations.

/wm

c: Gary S. Olson, Director
Ellen Jeffries, Deputy Director

Table 1

School Employee Pension Reforms 10-Year Savings Analysis (in millions)	FY 11	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17	FY 18	FY 19	FY 20	Cumulative Savings TOTAL
Eliminate retiree dental/vision savings	$1.0	$5.0	$8.9	$13.1	$17.3	$22.1	$26.9	$32.0	$37.3	$42.8	$206.4
Increase employee contribution rate savings	$207.0	$214.3	$221.8	$229.5	$237.5	$245.9	$254.4	$263.3	$272.6	$282.2	$2,428.5
Hybrid plan for new employees savings	$3.9	$12.8	$20.5	$28.1	$35.8	$43.8	$52.2	$61.7	$71.2	$80.6	$410.6
Cap DB enrollment at 30 yrs - savings	$41.0	$42.0	$44.0	$45.0	$47.0	$48.0	$50.0	$52.0	$54.0	$56.0	$479.0
Retirement incentive – pension cost	$0.0	($285.0)	($285.0)	($285.0)	($285.0)	($285.0)	$0.0	$0.0	$0.0	$0.0	($1,425.0)
Increased health care costs on pension system	($292.5)	($292.5)	($292.5)	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	($877.5)
Replacement savings (ratio of 1:1.1 – 90%)	$740.7	$699.5	$651.6	$646.2	$548.4	$492.8	$434.6	$373.4	$309.1	$241.6	$5,137.9
Gross Savings	**$701.0**	**$396.0**	**$369.3**	**$676.9**	**$601.0**	**$567.7**	**$818.1**	**$782.4**	**$744.2**	**$703.2**	**$6,359.8**

Source: State Budget Office

Key Assumptions

- Retirement incentive cost includes the increased cost of health care for the first 3 years (until FY 2014)
- Pension amortization (5 year) cost eliminated in FY 2017
- 75% Participation Rate – 29,000 out of 39,000 eligible will retire
- 1:1.1 or 90% Replacement Ratio
- Avg. Retiree Salary=$55,000; Avg. Replacement Salary=$35,000 (Savings of $20,000 per employee)
- Replacement Salary is increased 5% annually for step increases

NOTE: Phased retirement not included – cost implications unknown due to it being at management discretion (limited participation anticipated)

-ORS estimates $4.5 million will be needed for implementation costs; built into FY 2011 savings figures.