FISCAL SENATE AGENCY

SENATE FISCAL AGENCY
MEMORANDUM

DATE: February 23, 2010

TO: Members of the Senate

FROM: Matthew Grabowski, Fiscal Analyst

RE: Reforms/Incentives Proposed for the State Employees' Retirement System

In addition to the reforms proposed in the various departmental budget bills, the Governor has proposed a collection of changes to the State Employees' Retirement System (SERS). According to documentation prepared by the Office of the State Budget (OSB), these five initiatives would cumulatively produce $758.2 million in General Fund savings over the next 10 fiscal years. In presenting a balanced budget for fiscal year FY 2010-11, the Governor assumed that $98.2 million General Fund would accrue as a result of the SERS pension reforms. Whether the State can expect to generate this level of savings is largely dependent upon the actualization of several assumptions used by the OSB in the preparation of its estimates.

Most notably, the Governor has proposed the reinstatement of a 3% employee salary contribution for SERS participants, effective October 1, 2010. An equivalent contribution requirement was in place prior to 1974, but this recommendation is the first of its kind to emerge in many years. In addition, the Governor has recommended that SERS plan service credit be capped at 30 years. Individuals would be transferred to the defined contribution plan for any additional years of service earned after September 30, 2010. Employees who have already accrued more than 30 years of service would not be required to forfeit earned service time, but would be required to transfer to the defined contribution plan on this date.

- **Impact on the Pension System.** Estimates from the OSB suggest that a required 3% contribution from State employees would produce $23.6 million in gross savings during fiscal year 2010-11 and a total of $289.6 million gross savings in the period between FY 2010-11 and FY 2019-2020. It is apparent that requiring an employee contribution to SERS would reduce the State share of retirement costs, both now and in the future. The cap on defined benefit enrollment is expected to produce $14.8 million in savings over 10 fiscal years. The OSB calculations were based on the assumption that 85% of eligible employees would elect to retire in light of the proposed changes – closer scrutiny of this assumption and others will be necessary to determine the full impact of the proposed reforms.

In lieu of full retirement, the Governor has also proposed the establishment of a phased retirement option. Employees who elected to pursue this option would be allowed to draw down their SERS pension while still maintaining part-time employment. Employees would be required to reduce their hours worked by at least 50%, to a maximum of 1,040 annual hours. This option would be offered at the discretion of the employer, and available to employees age 60 and older. While this option would be offered for a single year, it could be renewed annually for up to three years.

- **Impact on the Pension System.** Because the phased retirement option would be at the discretion of management and expected participation levels are unknown, the OSB did not include any savings estimates for this policy change.

In an effort to further control costs, the Governor has proposed the elimination of the State subsidy for retiree dental and vision coverage under SERS. Future retirees would still have the option to purchase this coverage in the absence of State subsidies.

- **Impact on the Pension System.** Estimates from the OSB indicate that this reduction in benefits would produce $0.5 million in gross savings during fiscal year 2010-11 and a total of $49.6 million gross savings over the course of 10 fiscal years. Absent the obligation of providing subsidized dental and vision coverage, one would expect some level of savings to accrue to the State.

Finally, the Governor has recommended that employees eligible for retirement under current rules be given an additional incentive to retire during the current fiscal year. For currently eligible employees who retired between July 1, 2010 and September 30, 2010, the traditional multiplier of 1.5% would be increased to 1.6%. Eligibility for this enhanced multiplier would be contingent upon employees' deferring their annual leave, sick leave, and other deferred leave payouts over five years.

- **Impact on the Pension System.** The OSB estimates that the combination of the enhanced multiplier and deferred leave costs would approach $716.0 million between FY 2010-11 and FY 2016-17. As shown in Table 1, both deferred leave costs and pension costs would be spread across five fiscal years; with deferred leave costs ending in FY 2014-15 and pension costs eliminated following FY 2016-17. As the primary "incentive" portion of the Governor's proposed reforms, the enhanced multiplier is thus associated with the greatest State costs. The OSB assumes that this cost would be outweighed by a permanent reduction in the State workforce. If the OSB assumptions hold, these increased retirement costs should not prevent the State from fortifying the fiscal standing of the SERS system.

Key Assumptions and SFA Concerns

In calculating the impact of the proposed changes on the State workforce, the OSB assumed that 85% of eligible employees would choose to retire when presented with the combination of incentives and benefit/contribution changes described above. Under such a scenario, approximately 6,300 current State employees would opt to retire by the end of the current fiscal year. The estimated participation rate used by the OSB may not, however, accurately reflect the decision-making calculus that would be applied by individual employees faced with the choice of continued employment or earlier-than-anticipated retirement.

Given the current economic conditions in Michigan, State employees might be unlikely to find alternative full-time or part-time employment in lieu of complete retirement. Moreover, employees who have experienced investment and retirement losses in the past several years might be unwilling to forego the security provided by continued employment with the State of Michigan. Participation in an early-out option offered to State employees in 2002 was approximately 65% - well short of the 85% rate assumed by the OSB in regard to the reform package in question. With these observations in mind, it seems unlikely that participation in the proposed retirement incentive program would approach the 85% threshold.

In addition, the OSB savings estimates assume an employee replacement rate of 1:2 for most positions. However, direct care and client staff are expected to be replaced at a 1:1 ratio. The OSB used a final blended replacement ratio of 68.5% in an effort to estimate State savings as a result of vacated positions. The OSB further assumed 10% salary savings on replacement hires and $2,000 per replacement hire on health benefit costs. While the State has the discretion to control departmental hiring practices, it is unclear whether the OSB assumptions could be maintained without reductions in vital services. The net employee reduction of nearly 2,000 estimated by the OSB could levy a severe penalty on those State departments that would be disproportionately affected by the early retirement option. Since savings derived from the 68.5% employee replacement rate represent the bulk of total State benefit estimated by the OSB, any deviations from that rate could limit the State's ability to achieve significant savings.

Finally, the State may be susceptible to legal challenges on the basis of changes made to the pension plans of existing State employees. While the State's ability to alter retirement plans made available to future employees is not in question, it is not fully evident that the State may take actions to amend the benefits that accrue to current employees. As other states consider similar cost-sharing measures, Michigan might want to pay close attention to any legal disputes that may arise.

<u>Final Thoughts</u>

In order to achieve full implementation of these reforms by October 1, 2010, the Governor has requested that the Senate and the House of Representatives enact relevant legislation by April 1. If the Legislature chooses to conform to this condensed schedule, it is essential to begin deliberations as soon as possible. Given the complexity of the issues at hand and the degree of uncertainty inherent in the OSB estimates, a careful review of these proposals seems appropriate.

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c: Gary S. Olson, Director
Ellen Jeffries, Deputy Director
Kathryn Summers, Chief Analyst

Table 1

Estimates Savings from SERS Reforms

	FY 2010-11	FY 2011-12	FY 2012-13	FY 2013-14	FY 2014-15	FY 2015-16	FY 2016-17	FY 2017-18	FY 2018-19	FY 2019-20	Cumulative
Salary 3% Contribution savings	$23.6	$39.7	$36.9	$35.1	$32.3	$29.6	$26.8	$24.9	$22.2	$18.5	$289.6
Cap SERS enrollement at 30 yrs	$2.2	$2.0	$1.8	$1.6	$1.5	$1.3	$1.1	$1.1	$1.1	$1.1	$14.8
Eliminate dental/vision coverage	$0.5	$1.5	$2.5	$3.4	$4.4	$5.4	$6.4	$7.4	$8.3	$9.8	$49.6
Retiree health overlap	($85.0)	($85.0)	($85.0)	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	($255.0)
Terminal leave deferral	($28.4)	($28.4)	($28.4)	($28.4)	($28.4)	$0.0	$0.0	$0.0	$0.0	$0.0	($142.0)
Retirement incentive - pension cost	$0.0	$0.0	($114.8)	($114.8)	($114.8)	($114.8)	($114.8)	$0.0	$0.0	$0.0	($574.0)
Overall retirement/replacement savings	$340.1	$247.9	$247.9	$247.9	$247.9	$247.9	$247.9	$247.9	$247.9	$247.9	$2,571.2
Gross Savings	**$253.0**	**$177.7**	**$60.9**	**$144.8**	**$142.9**	**$169.4**	**$167.4**	**$281.3**	**$279.5**	**$277.3**	**$1,954.2**
GF/GP Savings	**$98.2**	**$68.9**	**$23.6**	**$56.2**	**$55.4**	**$65.0**	**$65.7**	**$109.1**	**$108.4**	**$107.6**	**$758.2**

Source:State Budget Office

Key Assumptions

* FY 2010-11 employee costs - no inflationary factors applied
* Retiree health overlap costs eliminated in FY 2013-14
* 5-year terminal leave costs spread eliminated in FY 2015-16
* Pension amortization (5 year) cost eliminated in FY 2017-18
* GF/GP = 38.80%
* 85.0% of eligible employees retire
* Assumes replacement of two out of every three workers who retire resulting in a reduction in the State work force of 2,235 employees