State Notes

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Are Public Sector Retirement Benefits Sustainable? An Update on the State-Administered Retirement Systems
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Following contentious and protracted debate last year, the Michigan Legislature approved significant changes to the Michigan Public School Employees' Retirement System (MPSERS) and the State Employees' Retirement System (SERS). As the two largest of the State-administered retirement systems, the MPSERS and SERS are collectively responsible for financing pension and health benefits for more than 500,000 current and future retirees. Similar retirement programs that finance pension and health benefits for the Judiciary and State Police are also administered by the Michigan Office of Retirement Services. Also relevant to this discussion is the Michigan Legislative Retirement System, which provides retirement allowances and health benefits to former members of the Legislature. This system is administered by the Legislature itself in the form of an 11-member board of trustees.

It is essential to recognize the link between these State-administered retirement systems and the aggregate State budget. Revenue for the various retirement systems is drawn from three principal sources: employer contributions, employee contributions, and investment returns. In defined benefit systems[1], reductions in investment returns must be met by increases in either employer or employee contributions to maintain a constant stream of revenue; in the absence of increased employer and/or employee contributions, retirement systems begin to incur unfunded liabilities. Most states, including Michigan, have been forced to address this dilemma in light of declining investment returns and ambiguous economic forecasts. As Michigan lawmakers review budget reduction strategies, they may seek to offset State retirement contributions with increased employee contribution requirements, or make changes to retiree benefits.

Public Act 75 of 2010 modified the structure of the MPSERS to require that all members contribute 3.0% of their salaries to finance retiree health care benefits. Public Act 185 of 2010 extended this requirement to members of the SERS retirement system. If the cost of retirement benefits continues to outpace the revenue that supports the various systems, additional changes to the State-administered retirement programs may be examined. For the benefit of incoming legislators, a brief review of enrollment in the State's public retirement systems seems appropriate. In particular, this article attempts to highlight the long-term challenges facing the State-administered retirement systems. Moreover, this review serves as an update of sorts to a 10-year history of membership and contribution rates completed by the Senate Fiscal Agency (SFA) in 2005.[2]

Michigan Public School Employees' Retirement System

The MPSERS provides retirement benefits to public school employees who have satisfied the minimum age and/or years-of-service requirements established by the Public Schools Employees Retirement Act. These criteria were summarized in a recent SFA publication as follows:

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[1] For a more complete explanation of defined benefit and defined contribution systems, please see "Examining a Change from Defined Benefit to Defined Contribution for the Michigan Public School Employees' Retirement System", by Kathryn Summers, Senate Fiscal Agency, *State Notes* March/April 2009. http://www.senate.michigan.gov/sfa/Publications/Notes/2009Notes/NotesMarApr09ks2.pdf

[2] See "Membership and Contribution Rate Changes for Michigan's Two Largest Retirement Systems – A 10-Year History", by Joe Carrasco, Jr., Senate Fiscal Agency, *State Notes* March/April 2005. http://www.senate.michigan.gov/sfa/publications/notes/2005notes/notesmarapr05jc.pdf

Employees hired after January 1, 1990 (enrolled in the Member Investment Plan, or MIP) may retire with a full pension allowance at any age if they have 30 or more years of service; or at age 60 with 10 or more years of service; or at age 60 with five years of service, with the service credited in each of the last five years before retirement and through age 60.

Employees hired before January 1, 1990 (enrolled in the Basic plan) may retire with a full pension allowance at age 55 with 30 or more years of service, or age 60 with 10 or more years of service.[3]

Public Act 75 of 2010 revised the above criteria for all public school employees hired on or after July 1, 2010. The earliest age at which these employees may draw pension benefits is 60. In addition, the pension plan now contains a defined contribution component that applies to all MPSERS members. As a targeted retirement incentive, the Act offered an additional option for individuals who chose to retire between July 1 and September 1 of 2010. Individuals whose age and years of service equaled 80 years or more were eligible to become MPSERS beneficiaries.[4]

Table 1 provides a recent history of enrollment and contribution data for the MPSERS.

State Employees' Retirement System

The SERS provides retirement benefits to State employees who have satisfied the minimum age and years-of-service requirements established by the State Employees' Retirement Act. Only those State employees hired before April 1, 1997, are members of the SERS defined benefit retirement system. State employees hired on or after that date participate in a defined contribution retirement program that requires both employer and employee payments. Under normal circumstances, SERS defined benefit members become eligible for retirement benefits at age 55 with 30 or more years of service or at age 60 with 10 or more years of service.

Public Act 185 of 2010 provided a retirement incentive to select SERS members similar to the option offered to public school employees by Public Act 75 of 2010. Members of the SERS whose age and years of service equaled 80 years or more and SERS members who had accrued at least 30 years of service (regardless of age) were eligible for full benefits (and an increased pension) if they retired between November 1, 2010, and January 1, 2011.

Table 2 provides a recent history of enrollment and contribution data for the SERS.

[3] Summers, March/April 2009.
http://www.senate.michigan.gov/sfa/Publications/Notes/2009Notes/NotesMarApr09ks2.pdf

[4] Further details about the impact of Public Act 75 of 2010 can be found in "Retirement Incentive and Pension Reform of the Michigan Public School Employees' Retirement System", by Kathryn Summers, Senate Fiscal Agency, *State Notes* Summer 2010.
http://www.senate.michigan.gov/sfa/Publications/Notes/2010Notes/NotesSum10ks.pdf

Table 1

MICHIGAN PUBLIC SCHOOL EMPLOYEES RETIREMENT SYSTEM
MEMBERS, WAGES, AND EMPLOYER CONTRIBUTION DATA FY 2000-01 to FY 2009-10
(Dollars in Thousands)

	Fiscal Years									
Defined Benefit	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**
Active Members	318,538	326,350	326,938	322,494	316,151	308,233	295,984	278,642	268,208	242,568
Retired Members	130,790	135,277	139,814	145,378	151,706	157,163	162,844	167,265	171,922	187,722
Total Members	**449,328**	**461,627**	**466,752**	**467,872**	**467,857**	**465,396**	**458,828**	**445,907**	**440,130**	**430,290**
Employer Contribution Rates										
Pension Normal Rate	6.42%	6.06%	6.26%	6.26%	6.31%	5.47%	5.49%	5.28%	5.17%	3.98%
Pension UAAL Rate	0.19%	0.06%	0.68%	0.68%	2.01%	4.32%	5.70%	4.89%	4.56%	6.15%
Health Rate	5.55%	6.05%	6.05%	6.05%	6.55%	6.55%	6.55%	6.55%	6.81%	6.81%
Total Rate	**12.16%**	**12.17%**	**12.99%**	**12.99%**	**14.87%**	**16.34%**	**17.74%**	**16.72%**	**16.54%**	**16.94%**
Wages (DB)	$9,264,183	$9,707,281	$10,043,862	$10,407,072	$10,205,972	$9,806,452	$9,851,471	$9,958,132	$9,883,674	NA
Employer Contributions										
Pension Contribution	$612,362	$594,086	$697,044	$722,251	$849,137	$960,052	$1,102,380	$1,012,742	$961,681	NA
Health Contribution	$514,162	$587,291	$607,654	$633,439	$668,491	$642,323	$645,271	$652,258	$673,078	NA
Total Contribution	**$1,126,524**	**$1,181,377**	**$1,304,698**	**$1,355,690**	**$1,517,628**	**$1,602,375**	**$1,747,651**	**$1,665,000**	**$1,634,759**	**NA**

Note: Does not include employee contributions.

Source: Office of Retirement Services – Comprehensive Annual Financial Reports

Table 2

STATE EMPLOYEES RETIREMENT SYSTEM
MEMBERS, WAGES, AND EMPLOYER CONTRIBUTION DATA FY 2000-01 to FY 2009-10
(Dollars in Thousands)

	Fiscal Year									
Defined Benefit	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**
Active Members	45,852	43,064	36,536	34,776	33,770	32,575	30,864	28,568	27,455	25,478
Retired Members	37,111	39,666	45,491	45,619	45,801	45,980	46,886	48,078	49,029	50,462
Total Members	**82,963**	**82,730**	**82,027**	**80,395**	**79,571**	**78,555**	**77,750**	**76,646**	**76,484**	**75,940**
Employer Contribution Rates										
Pension Rate	4.74%	3.68%	4.02%	7.87%	13.12%	14.30%	7.91%	18.72%	18.84%	13.12%
Health Rate	8.75%	9.00%	12.50%	13.05%	11.40%	12.50%	12.20%	11.40%	11.80%	11.40%
Total Rate	**13.49%**	**12.68%**	**16.52%**	**20.92%**	**24.52%**	**26.80%**	**20.11%**	**30.12%**	**30.64%**	**24.52%**
Wages (DB)	$2,230,562	$2,133,477	$1,859,555	$1,889,410	$1,880,179	$1,847,653	$1,825,889	$1,736,672	$1,734,300	NA
Employer Contributions										
Pension Contribution	$105,729	$78,512	$74,754	$148,697	$246,679	$264,214	$144,428	$325,105	$326,742	NA
Health Contribution	$195,174	$192,013	$232,444	$246,568	$214,340	$230,957	$222,758	$197,981	$204,647	NA
Total Contribution	**$300,903**	**$270,525**	**$307,198**	**$395,265**	**$461,019**	**$495,171**	**$367,186**	**$523,086**	**$531,389**	**NA**

Note: Defined benefit members did not make contributions to the retirement system before Public Act 185 of 2010 was enacted.

Source: Office of Retirement Services – Comprehensive Annual Financial Reports

Discussion

Around the country, an ongoing dialogue has focused on the perceived generosity of the retirement benefits available to public employees. Regardless of one's perspective on this issue, it has become increasingly apparent that the costs associated with pensions, heath care, and other retirement benefits represent a significant outlay of State funds. According to a February 2010 report by the Pew Center on the States, the past decade was marked by a significant decline in states' abilities to fully finance retirement benefits for public sector employees. While both public and private retirement funds have suffered investment losses during the recent recession, public retirement systems are also subject to fluctuations in the availability of public revenue. The Pew analysis summarized this vulnerability as follows:

> Although investment income and employee contributions help cover some of the costs, money to pay for public sector retirement benefits also comes from the same revenues that fund education, public safety, and other critical needs -- and the current fiscal crisis is putting a tight squeeze on those resources.[5]

The performance of Michigan's State-administered retirement systems over the past several years has been representative of the national trend toward large unfunded liabilities. (In the context of pension benefits, unfunded liabilities refer to future payout obligations for which projected funding will not be sufficient.) At the close of fiscal year (FY) 1999-2000, the State's five main retirement systems were in excellent standing. Only the MPSERS had accrued any unfunded liabilities, and the other four State-administered systems actually maintained surplus assets. By the end of FY 2008-09, however, the circumstances had changed quite dramatically. As shown in Table 3, pension obligations under the MPSERS, SERS, and State Police retirement system have outpaced contributions in the recent past. Collectively, the five retirement systems had accrued nearly $15.4 billion in unfunded pension liabilities by the end of FY 2008-09, largely due to several years of underperformance on investment returns.

An even greater dilemma emerges when one considers the anticipated costs of health care and other nonpension benefits that are expected to accrue to the State-administered retirement systems. As shown in Table 4, these systems had accrued approximately $41.2 billion in nonpension unfunded liabilities. Until very recently, retiree health care benefits had been funded on a pay-as-you-go basis – meaning that health care costs are paid by the State as they are incurred by beneficiaries. This method costs more than prefunding (which is the method used to finance pensions) because no money accrues from investment returns. Public Acts 75 and 185 of 2010 represented an initial effort by the Legislature to prefund retirement health benefits for State and public school employees. Pursuant to these Acts, MPSERS and SERS members are now required to contribute a portion of their total compensation for deposit in a retirement health care fund. While these employee contributions will not eliminate the long-term unfunded liabilities in the MPSERS and SERS, they constitute a first step toward safeguarding future benefits by establishing a mechanism to allow for prefunding.

[5] "The Trillion Dollar Gap: Underfunded State Retirement Systems and the Roads to Reform", Pew Center on the States, February 2010. http://downloads.pewcenteronthestates.org/The_Trillion_Dollar_Gap_final.pdf.

Table 3

TOTAL ACCUMULATED PENSION UNFUNDED LIABILITIES

Fiscal Year	MPSERS Unfunded Liability	MPSERS Funded Ratio	SERS Unfunded Liability	SERS Funded Ratio	STATE POLICE Unfunded Liability	STATE POLICE Funded Ratio	JUDGES Unfunded Liability	JUDGES Funded Ratio	LEGISLATIVE Unfunded Liability	LEGISLATIVE Funded Ratio
1999-2000	$246,000,000	99.3%	($863,000,000)	109.1%	($72,400,000)	107.0%	($70,600,000)	134.6%	($31,782,000)	125.0%
2000-01	$1,375,000,000	96.5%	($755,000,000)	107.6%	($75,000,000)	107.0%	($66,300,000)	129.5%	($29,778,000)	121.0%
2001-02	$3,575,000,000	91.5%	$137,000,000	98.7%	($5,600,000)	100.5%	($62,500,000)	127.3%	($23,300,000)	116.0%
2002-03	$6,043,000,000	86.5%	$1,320,000,000	88.8%	$47,300,000	96.0%	($57,100,000)	124.3%	($17,519,000)	112.0%
2003-04	$7,533,000,000	83.7%	$1,855,000,000	84.5%	$138,100,000	89.0%	($50,500,000)	121.3%	($9,967,000)	107.0%
2004-05	$9,995,000,000	79.3%	$2,503,000,000	79.8%	$210,000,000	83.8%	($35,000,000)	114.4%	($2,806,000)	102.0%
2005-06	$6,141,000,000	87.5%	$1,909,000,000	85.1%	$181,700,000	86.9%	($39,100,000)	116.0%	($940,000)	101.0%
2006-07	$5,771,000,000	88.7%	$1,818,000,000	86.2%	$192,700,000	86.7%	($53,900,000)	121.8%	($4,437,000)	103.0%
2007-08	$8,931,000,000	83.6%	$2,363,000,000	82.8%	$230,600,000	84.6%	($56,700,000)	123.0%	($590,000)	100.0%
2008-09	$11,982,000,000	78.9%	$3,127,000,000	78.0%	$295,900,000	80.7%	($50,700,000)	120.7%	$5,631,000	97.0%

FY 2008-09 Total Accrued Unfunded Liability for the five retirement systems equals $15,359,800,000.

Note: Negative numbers in the unfunded liability column represent surplus assets in a retirement system.

Table 4

TOTAL ACCUMULATED HEALTH UNFUNDED LIABILITIES

Fiscal Year	MPSERS Unfunded Liability	MPSERS Funded Ratio	SERS Unfunded Liability	SERS Funded Ratio	STATE POLICE Unfunded Liability	STATE POLICE Funded Ratio	JUDGES Unfunded Liability	JUDGES Funded Ratio	LEGISLATIVE Unfunded Liability	LEGISLATIVE Funded Ratio
2005-06	$24,757,000,000	2.5%	$13,499,000,000	0.0%	$944,400,000	0.0%	$6,400,000	0.0%		
2006-07	$24,957,000,000	3.0%	$12,966,000,000	0.0%	$918,100,000	0.0%	$6,600,000	0.0%		
2007-08	$25,979,000,000	3.1%	$13,542,000,000	0.0%	$963,000,000	0.0%	$6,700,000	0.0%	$118,309,000	11.0%
2008-09	$27,582,000,000	2.5%	$12,618,000,000	0.0%	$882,300,000	0.0%	$6,600,000	0.0%	$122,282,000	11.0%

FY 2008-09 Total Accrued Unfunded Liability for the five retirement systems equals $41,211,200,000.

Conclusion

Given that the State of Michigan is projected to face an FY 2011-12 General Fund budget imbalance of approximately $1.1 billion[6], public employee retirement benefits may not be immune from further adjustments. As the 94th Legislature initiates efforts to reform State government operations, its members may be charged with the task of addressing the widening gap between public retirement obligations and assets. Michigan's current circumstances are not unique; several other states, including California, Illinois, and New Jersey, have accrued greater long-term unfunded liabilities. Accordingly, Michigan may benefit from a close observation of nationwide efforts to stabilize public sector retirement systems.

[6] Senate Fiscal Agency's Updated State Budget Year-End Balance Estimates, January 14, 2011. http://www.senate.michigan.gov/sfa/Publications/BudUpdates/YearEndBalance.pdf