House Legislative Analysis Section

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LOCAL GOVT. PENSION CHANGES

House Bill 5728 as enrolled
Public Act 728 of 2002
Sponsor: Rep. Jerry Vander Roest

House Bill 5729 as enrolled
Public Act 729 of 2002
Sponsor: Rep. Gary Woronchak

House Bill 5730 as enrolled
Public act 730 of 2002
Sponsor: Rep. Carl M. Williams

House Committee: Senior Health, Security and Retirement
Senate Committee: Appropriations

Second Analysis (1-7-03)

THE APPARENT PROBLEM:

In Executive Order 1999-13, Governor Engler established the Michigan Commission on Public Pension and Retiree Health Benefits to conduct a comprehensive review of relevant practices and issues regarding the funding, management, oversight, and fiscal integrity of public pension and retirement systems in Michigan. The commission was charged with reviewing state laws that govern or affect public pension systems, reviewing the adequacy of funding of pension systems and the extent of unfunded accrued liabilities, and recommending appropriate changes.

On February 1, 2001, the commission issued its report and recommendations. The commission reported that most state and local pension systems appear to be adequately funded at this time, and that most are well managed. However, there appear to be at least some instances of local governments borrowing from pension funds to pay operating expenses, and a few governmental units that have failed to adequately fund the employer share of pension benefits. There may be disagreement over how much is needed to fund the employer share, or budgetary restraints or other factors may result in underfunding. And, local units may adopt benefit increases without sufficient consideration of how to pay the future costs that will be incurred. Apparently, however, the state has very little authority to require that local governments meet their pension obligations, despite a constitutional requirement that pension benefits be fully funded each year to meet future obligations (benefits must be "prefunded"). Among the commission's recommendations, then, are the addition of several means of enforcing fiscal responsibility of local governments toward their pension systems. Legislation has been introduced to implement some of these recommendations.

THE CONTENT OF THE BILLS:

<u>House Bill 5728</u> would amend the Public Employee Retirement System Investment Act (MCL 38.1140h and 38.1140m) to require state and local government retirement systems to provide a supplemental actuarial analysis prior to adopting pension benefit changes. The bill would require that such an analysis be provided by the retirement system's actuary, and that it include an analysis of the long term costs associated with any proposed benefit change. The supplemental actuarial analysis would have to be provided to the retirement system's board and to the decision making body charged with approving the proposed pension benefit change at least seven days before the change is adopted. (A "proposed pension benefit change" would be defined as a proposal to change the amount of pension benefits received by persons entitled to benefits, and would not include a proposed change in health care plans or health benefits.)

Further, the bill would require that the governing board vested with the general administration, management, and operation of a system (or other decision making body that is responsible for implementation and supervision of any system) confirm in its annual actuarial valuation and the summary annual report required by the act that the plan provides for the payment of the required employer contribution. Further, the board (or decision making body) would have to confirm in its summary annual report that the system has received the required employer contribution for the year covered in the summary annual report.

The bill specifies that the required employer contribution is the actuarially determined contribution amount, and that it would consist of a current service cost payment and a payment of at least the annual accrued amortized interest on any unfunded actuarial liability and the payment of the annual accrued amortized portion of the unfunded principal liability. For fiscal years beginning before January 1, 2006, the required employer contribution would have to be determined using an amortization period of no greater than 40 years. After that time, the amortization period could be no greater than 30 years.

In a plan year, any current service cost payment could be offset by a credit for amortization of accrued assets, if any, in excess of actuarial accrued liability. A required employer contribution would have to allocate the actuarial present value of future plan benefits between the current service costs to be paid in the future and the actuarial accrued liability.

The bill would require the board (or other decision making body) to act upon the recommendation of an actuary, and the board and the actuary would be required to take into account the standards of practice of the actuarial standards board of the American Academy of Actuaries in determining the required employer contribution.

House Bill 5729. Under the Uniform Budgeting and Accounting Act (MCL 141.424), local governmental units are required to compile an annual financial report, and to file a copy with the state treasurer within six months after the end of the local unit's fiscal year. The bill would amend the act to specify that the state treasurer could require that an annual financial report by the pension system for any defined benefit plan of the local unit be submitted in electronic format, after timely notice.

House Bill 5730. Public Act 156 of 1851 (MCL 46.112a) authorizes counties to create pension plans for their employees, and requires that county pension plans be approved by a committee consisting of the attorney general, the state treasurer, and the executive secretary of the State Employees' Retirement System. The act also requires that each county plan be approved by the committee as complying with the act biennially, and requires each county plan to submit an annual financial statement to the committee. Further, the state treasurer is required to audit the funds and accounts of county retirement plans established under the act. The bill would amend the act to eliminate the county pension plan committee provisions.

BACKGROUND INFORMATION:

Commission recommendations. The governor's commission made a number of recommendations, including:

- The state should develop a comprehensive report card on governmental retirement plans.

- The legislature should clarify what is an appropriate required employer contribution and how the contribution should be determined. (This recommendation is addressed by House Bill 5728.)

- The state treasurer should be authorized to withhold revenue sharing or other funds to governmental units that fail to adequately fund retirement programs, and those payments should be applied to retirement plan shortfalls.

- The state should have increased power to address mismanaged retirement systems.

- There should be mandatory evaluation of the long-term impact of increased benefit costs, and the public should be informed about increased benefit costs before benefits are adopted. (This is addressed in House Bill 5728.)

- Penalties for improper use of retirement funds should be increased.

- The state should support ongoing education for trustees of public retirement systems.

- The state should encourage plan sponsors to educate employees enrolled in defined contribution programs, and plan sponsors should be required to offer a minimum number of "model" portfolios for participants' investment choices.

• The county pension plan committee should be eliminated. (This is addressed by House Bill 5730.)

• Retirement system trustees and participants should understand liabilities for retiree health benefits, and more study should be done on the issue of retiree health benefits.

State administered retirement systems. The state administers retirement systems for state employees, public school employees, judges, legislators, and state troopers. Benefits are funded by a combination of employer contributions, investment earnings, and, in some cases, employee contributions. Statutes govern the structure of these plans, benefit levels, funding requirements, and so on.

Local government retirement systems. Local governments have broad powers to establish retirement systems for their employees under their general statutory and charter operating authority. Some municipalities and courts offer retirement plans for their employees under the auspices of the Municipal Employee Retirement System (MERS) Act. Formerly a state-administered retirement system, MERS now operates as an independent public corporation. Counties are authorized to establish retirement systems for county employees under Public Act 156 of 1851. While the statutory framework outlines benefit plans and employer contribution requirements, many local governments operate their own plans outside of this framework, and even within the statutes there are several optional benefit plans that may or may not be offered by a local unit. According to the commission's report, "a vast array of local governmental units – counties, cities, villages, townships, county road commissions, library boards and others – provide some sort of retirement benefits to their employees. The benefits offered include pension, health care and savings packages."

There appears to be no comprehensive listing of local government pension plans; no person or government agency collects information about the existence of plans, and their financial health. One of the commission's recommendations is for the state to develop a comprehensive "report card" on governmental retirement plans.

FISCAL IMPLICATIONS:

According to the House Fiscal Agency, House Bill 5728 would have no fiscal impact on the state, and would have an indeterminate impact on local governments. House Bill 5729 would have no significant fiscal impact. And, House Bill 5730 would have minimal fiscal impact. (4-10-02 and 4-17-02)

ARGUMENTS:

For:
Pension benefits are often negotiated as part of labor contracts, and at times these changes may be swiftly implemented as part of the contract negotiation process, without full consideration of the long-term costs the benefits may impose on a retirement system. (It may be somewhat easier for elected officials to "spend" future dollars – in the form of promised pension benefit increases – than to raise salaries of employees, necessitating immediate budget increases.) According to the commission, "officials who find it easy to vote for increased benefits should also be made aware of the need for higher tax revenues to cover these improved benefits." Thus, it recommended that there be mandatory evaluation of the long-term impact of increased benefit costs, and also that this information be available to the public prior to the adoption of new benefits. House Bill 5728 would address this issue by requiring that an actuarial analysis of proposed new benefits be prepared and provided to the board or decision making body at least seven days before changes are adopted.

Response:
Though the bill would require at least a seven-day period in which board members (or officials) would have cost information prior to adopting benefit changes, the commission has recommended that it should be available to both officials and to the public for at least 30 days, in order to allow proper consideration of the long-term impact.

Further, though the bill amends the Public Employee Retirement System Investment Act, which specifically applies to both *local* government retirement systems and to the *state* retirement systems, the bill's provisions are directed only at local governments. Pension benefit changes for state employees, public school employees, legislators, judges, and state police troopers should perhaps be given the same level of scrutiny.

For:
The commission notes that employer contributions, employee contributions, and investment income earned on a retirement system's assets generally support retirement benefits. Determining the "employer contribution" is a crucial matter. The state constitution requires that current service costs be paid

annually; sound pension management requires that the cost of new benefits and accrued liabilities (if any) also be paid. However, pension systems and local governments may disagree over the appropriate amount needed to meet these requirements, and local officials may face budgetary problems that discourage them from fully funding their pension systems. The commission recommends that the legislature create statutory guidelines for determining the required employer contribution, that the guidelines be based on the actuarial funding method which takes into account both current obligations and unfunded accrued liabilities, and that employers be required by law to make the required contributions. House Bill 5728 would implement this recommendation.

For:
It has been noted that there exist a vast array of public employee retirement systems in Michigan, yet no one seems to know how many or to be able to collect data on their financial soundness. The commission recommends that the state create a "report card" of public pension systems to make this information available. One way to build such a "report card" would be to use information submitted by local governments in their annual financial reports to the Department of Treasury. House Bill 5729 would require that certain pension information be submitted in electronic form to facilitate this effort.

For:
House Bill 5730 would eliminate the requirement in statute for the County Pension Plan Committee. This committee consists of the attorney general, the state treasurer, and the executive secretary of the State Employees' Retirement System, and is charged with reviewing plans established by counties to see if they conform to the requirements of state law (which requires that an actuarial summary and a cost estimate be prepared for each estimate or revision submitted to the committee). According to the commission's report and recommendations, this committee is an unneeded layer of government, as local units of government are increasingly sophisticated in seeing that pension plans conform to state law and in managing those plans.

Response:
If the purpose of the commission's recommendations (and the package of legislation) is to improve the performance of local pension systems and increase state oversight and enforcement, perhaps the committee could be used as a mechanism to provide better enforcement. It is puzzling to eliminate the only existing state oversight mechanism as part of a package designed to strengthen state oversight and enforcement.

Against:
The commission noted that a local pension system may become so mismanaged that it cannot meet its obligations. Under the Local Government Fiscal Responsibility Act, a preliminary review by the state treasurer of a local unit's financial problems can result if the unit fails to make the required minimum payment to its pension fund, but the act does not address the situation in when the local unit has made all of the necessary contributions but the trustees of the pension fund have failed to properly manage the fund. The commission recommended that the Local Government Fiscal Responsibility Act be amended to specifically provide that a public pension plan itself may be the subject of a review by state officials under the act. This package originally included a bill to do this, but that bill was not enacted.

In addition, despite constitutional mandates requiring governmental units to fund retirement plans, the public pension commission heard testimony about several local governments that had failed to make appropriate pension payments to their retirement systems, endangering the fiscal health of those systems and the financial future of workers counting on those benefits. The Municipal Employees Retirement System has no authority to compel local governments to make payments needed to fund retirement benefits without resorting to court orders. Such a court order can result in an extraordinary temporary millage imposed on local property taxpayers. Non-MERS retirement systems may also be subject to such court orders, or the state may be placed in the position of bailing out a mismanaged local pension system. Again, the package originally included legislation to give the state treasurer the authority to withhold revenue sharing or other payments if pension plans are not adequately funded, but this bill was not enacted.

The legislature may need to revisit these and other issues not addressed by this package of legislation.

Analyst: D. Martens

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.