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STATE EMPLOYEES RETIREMENT CHANGES; 'EARLY OUT' PLAN

House Bill 5732 as enrolled
Public Act 93 of 2002
Second Analysis (4-5-02)

Sponsor: Rep. Paul DeWeese
House Committee: Senior Health, Security and Retirement
Senate Committee: Appropriations

THE APPARENT PROBLEM:

One way that governments (and other employers) can reduce their operating costs is to offer incentives for more senior, highly paid employees to retire earlier, and then replace them (or some of them) with entry-level, lower paid workers. As part of the executive budget proposal for fiscal year 2002-2003, in which there is a estimated $970 million shortfall, one of the measures that has been proposed to cut spending is an "early out" retirement plan for state employees. Members of the retirement system who are participants in the defined benefit program (generally, those hired before March 1997) are eligible to retire at age 60 with 10 years of service, or at age 55 with 30 years of service, or may retire at 55 with fewer than 30 years but with a reduced retirement allowance. Pensions are calculated based on a formula that multiplies a person's years of service credit by his or her final average compensation by a factor of 1.5 percent. As an incentive to retire early, the governor proposes an early retirement program that would increase the "multiplier" in the pension formula to 1.75 percent, and waive the age requirement for retirement for those with at least 80 years of combined age and service credit.

In addition, the governor has proposed several other changes to the State Employees' Retirement Act. One issue concerns the way in which the retirement system funds health benefits for retirees. Under current law, the retirement system pays 95 percent of the premiums for health insurance coverage, and 90 percent of the premiums for dental and vision coverage. Funding of these health care benefits is paid on a cash basis; in other words, each year the employer contribution pays only for the health care costs incurred that year for current retirees. This differs from the funding of pension benefits, which are constitutionally guaranteed and are "prefunded" (the employer prepays an amount which, together with investment income, is sufficient to pay for the *future* costs being incurred on behalf of current employees and retirees). According to the most recent financial report of the retirement system, if health care benefits were prefunded, the unfunded accrued liability of the system would be $6.6 billion. The governor has proposed setting up a mechanism to partially address this very expensive proposition, by establishing an account to receive employer contributions toward the goal of prefunding health benefits in years when the basic pension benefit funds are fully funded.

The Office of Retirement Services also seeks amendments to the statute to update provisions required by the Internal Revenue Service so that the retirement system retains its tax-exempt status, and changes to implement new provisions allowed by recent federal tax law changes that allow expanded options for "rollover" of retirement accounts into other accounts without incurring tax penalties. (Some of these amendments allow for the recent addition of the option for state employees to use pre-tax payroll deductions to purchase service credit in the retirement system, and likewise to use lump sum amounts in so-called 401(k) retirement savings accounts to purchase service credit.)

In addition, the administration seeks amendments to address several minor administrative matters, and several amendments to clarify and correct the statute. Among these are provisions to allow a survivorship pension to be paid to minor children of a retiree if the retiree dies and leaves no surviving spouse (a provision contained in other state-administered retirement systems but lacking in the SERS statute). Further, the administration proposes certain changes for disability retirements, including the implementation of a one-year time period (with an extension to two years in certain cases) for applying for disability benefits, and flexibility in the requirements for periodic medical examinations for disability retirees. And, the administration seeks to overturn two recent court of appeals decisions concerning the tax treatment of payments made at retirement for unused sick leave and annual leave.

THE CONTENT OF THE BILL:

The bill would amend the State Employees' Retirement Act to:

- establish an early retirement plan;

- create an advance health funding account and provide for prefunding of health benefits when that account was fully funded;

- revise duty disability provisions;

- make certain changes concerning the tax exempt status of the retirement system;

- overturn two court of appeals decisions regarding the tax treatment of payments for sick leave and annual leave at retirement;

- add a provision concerning survivorship pensions for minor children;

- delete provisions that that require a specific time period for applying for (regular) retirement benefits;

- provide for certain members to transfer or purchase service credit for employment with the former Detroit Recorder's Court;

- change a provision concerning compensation of retirement board members; and,

- make changes to conform with amendments added by House Bill 5109, which is part of a package of bills concerning the issue of bankruptcy protection for public pension recipients and that also addresses certain issues regarding the tax exempt status of the various pension systems (see the House Legislative Analysis Section's analysis of House Bills 5109-5114). House Bill 5732 is tie-barred to House Bill 5109.

Current retirement age requirements. Under current law, a member of the State Employees Retirement System who is a participant in the defined benefit program is entitled to retire with a full retirement benefit upon meeting one of the following age and service requirements:

- At age 60 with 10 or more years of credited service (or five years in certain circumstances); or,

- At age 55 with at least 30 years of service credit.

In addition, a member who is at least 55 years old with 15 to 30 years of service credit may retire, but the retirement allowance is reduced by .5 percent for each month the member is less than 60 years old.

Early retirement option. House Bill 5732 would add language to create an early retirement option that would apply during 2002. Under the bill, a member whose combined age and length of credited service was equal to at least 80 years, as of November 1, 2002 or on the effective date of retirement, whichever was earlier, could retire with a full (unreduced) retirement allowance. There would be no minimum age requirement. An application would have to be filed between April 1 and April 30, 2002, and the member would have to state a retirement date between July 1 and November 1, 2002. A member could withdraw an application until May 15, 2002, or within seven days after the rejection of a request for an extended retirement date (see below), but after that date the application would be irrevocable.

Eligibility. To be eligible, a person would have to be employed by the state (or be on layoff status) for the six-month period ending on the effective date of his or her retirement. In addition, former members of the retirement system who were employed by the former Department of Mental Health on January 1, 1996 and went on layoff status before January 1, 1997 would be eligible, as would persons who had been employees of the State Judicial Council on September 30, 1996. Members of the classified civil service, employees of the judicial and legislative branches, employees of the governor's office, and unclassified employees would be eligible for the early retirement program. In addition, former members of the retirement system who had previously transferred from the defined benefit program to the defined contribution program could retire under the early retirement program if they met the "80 and out" requirements.

Conservation officers would not be eligible under the bill. Further, members in "covered" positions (certain Corrections Department positions) would be eligible only if they were not eligible for a supplemental early retirement as a covered employee on or after July 1, 2002 through the effective date of the member's retirement under the early retirement program proposed in the bill.

Enhanced benefit formula. A retirement allowance under the defined benefit program is calculated according to a formula that multiplies the member's number of years of credited service by his or her final average compensation by a factor of 1.5 percent. The benefit formula for a retirement allowance under the bill would instead use a 1.75 percent factor. (The enhanced benefit formula would also apply to those who retired during the July-November period under the existing age 60 with ten years of service option.) Those who are participants in the defined contribution program but who met the "80 and out" requirement could retire under the defined benefit formula with a .25 percent retirement factor (i.e., years of service x final average compensation x .25 percent).

Payments for sick leave and annual leave. Any amount that a member retiring under the bill would otherwise be entitled to receive in a lump sum at retirement on account of unused sick leave would be paid in monthly installments over five years. The bill specifies that payments received under this provision could not be used to purchase service credit under the act. Payments for sick leave would be paid from funds appropriated to the person's employer (e.g., principal department, legislature, judiciary), and not from funds of the retirement system. Any amount that a member retiring under the bill was entitled to receive in a lump sum at retirement on account of accumulated annual leave would be paid on or after October 1, 2002. Payments for sick leave or annual leave would *not* be exempt from taxation (see below).

Tax treatment of sick leave and annual leave payments. The bill specifies that payments for sick and annual leave made under this early retirement plan, and payments for sick leave made after September 31, 1991 under preceding early retirement plans were *not* to be considered to be pensions, annuities, retirement allowances, optional benefits, or any other rights described in the act as being exempt from state and local tax and not subject to garnishment, attachment, bankruptcy laws, or other process of law, and in fact, the bill would further specify that these payments *were not* exempt from taxation and *were* subject to execution, garnishment, attachment, and so forth. In an enacting section, the bill states that this provision is "curative" and intended to correct any misinterpretation of legislative intent by the court of appeals in *Stone v. State of Michigan, Department of Treasury*, and in *Liken v. State of Michigan, Department of Treasury*, and that this legislation "expresses the original intent of the legislature" that these payments were not made by the retirement system and thus were not exempt from taxation or from the process of law (e.g., garnishment, attachment, etc.).

Extended retirement date. The bill would allow an extension, until no later than February 1, 2004, of the retirement date of members eligible to retire under the bill's provisions, upon the request of a department director or upon designation by the legislature or the judiciary. For executive branch employees, a request by a department director would have to be submitted to the Office of the State Employer and the state budget office by May 31, 2002, and that request would have to be approved by the Office of the State Employer and by the budget office. For legislative and judicial employees, such an extension would require the approval of the legislative leaders or the chief justice, as applicable. Extensions for legislative and judicial employees would have to be submitted to the Office of Retirement Services by May 31, 2002.

Service credit purchase/transfer. The bill would also add language allowing certain members to purchase or transfer service credit from a city with a population of 750,000 or more (Detroit) if they met certain conditions. This provision would apply if a member became a member of the retirement system on September 1, 1981, was employed by the city of Detroit on August 31, 1981, and the city's pension system or the member agrees to contribute the actuarial cost of the service credit transferred or purchased to the retirement system. And, in a provision concerning the calculation of actuarial cost for purchasing service credit, the bill would clarify that "compensation" would be full-time or equated full-time compensation.

Retirement dates, generally. Several provisions of the act require that applications for retirement (generally, and not just for the early retirement program) must specify a retirement date that is at least 30 days but less than 90 days after the filing of the application. The bill would delete these requirements.

Health advance funding subaccount. The bill would create a new health advance funding subaccount in the retirement system. Under the bill, in years in which the pension system was fully funded (for payment of basic retirement benefits), employer contributions could be deposited into the health advance funding subaccount, rather than into the other accounts dedicated to funding basic retirement benefits. In those years, the requirements for an annual comparison and reconciliation of actual and budgeted amounts of needed employer contributions would not apply.

Assets and any earnings on the assets in the health advance funding subaccount could not be treated as pension assets for any purpose. Further, assets and earnings in the subaccount could not be expended until the actuarial accrued liability for health benefits was fully funded. However, the bill would allow the Department of Management and Budget to transfer funds from the health care subaccount to the pension fund, if the pension fund was underfunded, but this would require the approval of the House and Senate Appropriations Committees. When the assets in the health care subaccount reached a level sufficient to fully fund health care benefits, money in the subaccount would be used to pay for health care benefits of retirees. Also at that time, the contribution rate for health care benefits would be computed using an individual projected benefit entry age normal cost method of valuation (i.e., health benefits would be "pre-funded", meaning that the benefits earned in a given year would be funded for the future in that year), instead of using a cash disbursement method (a "pay as you go" method of funding from year to year).

Under current law, the Department of Management and Budget is required to annually calculate the amount of cost savings to the state as a result of the implementation of the new defined contribution retirement plan (adopted in 1996, and mandatory for all employees hired after March 1, 1997), and that amount must be included as part of the executive budget recommendations for the next fiscal year, for appropriation into the health insurance reserve fund. The bill would amend this provision to delete this requirement, and specify instead that in years in which employer contributions were not deposited into the health advance funding subaccount (i.e., employer contributions were needed to fund pension benefits), the department could deposit all or part of the cost savings due to the 1996 legislation into the health advance funding subaccount by reducing contributions for pension benefits and increasing contributions for health care by the same amount (but not to the extent that the funds dedicated to pay pension benefits were funded at less than 100 percent).

In addition, the bill would require that any savings in *health premium* costs attributable to *changes in health benefits* payable to defined contribution plan participants under the 1996 legislation would be deposited into the health advance funding subaccount.

<u>Duty disability provisions</u>. Under current law, a member of the retirement system is eligible for a duty disability retirement if he or she becomes totally incapacitated for duty "without willful negligence" on his or her part, because of a personal injury or disease that occurred as the natural and proximate result of the member's employment. There is no minimum service requirement for a duty disability retirement. To receive a duty disability retirement, a person must be examined by the system's medical advisor, the advisor must certify that the member is mentally or physically totally incapacitated for further performance of duty and that the incapacity is likely to be permanent, and the board must approve the retirement. The maximum benefit payable on a duty disability pension is $6,000 per year (and may be less); at age 60 the pension is recalculated based on the regular pension formula, with service credit given for the time the member was receiving a duty disability pension. (<u>Note</u>: According to the "Retirement Guidelines" published by the retirement system, application for a duty disability pension must be made within two years of separation from state service; however, this is not a statutory requirement.)

The bill would rewrite these provisions in substantially the same manner, making one substantive change. Under the bill, an application for a duty disability retirement would have to be filed no later than one year after termination of the member's state employment. However, the bill would specify that, upon appeal to the retirement board, the board could accept ("for good cause") an application for a disability retirement allowance not later than two years after termination of the member's state employment.

<u>Non-duty disability provisions</u>. Under current law, a member of the retirement system is eligible for a non-duty disability retirement if he or she has at least 10 years of service credit, becomes totally and permanently incapacitated for duty as the result of a cause not related to state employment, the system's medical advisor certifies that the person is mentally or physically incapacitated for duty and that the incapacity is likely to be permanent, and the retirement board approves the retirement. A nonduty disability pension is calculated under the same formula used for determining standard retirement benefits. (<u>Note</u>: As noted above, according to the "Retirement Guidelines" published by the retirement system, application for a nonduty disability pension must be made within two years of separation from state service; however, this is not a statutory requirement.)

The bill would rewrite these provisions in a similar manner. Under the bill, the incapacity would have to be because of a "personal injury or disease that is not the natural and proximate result" of the member's employment. Further, the bill would require that an application for a nonduty disability retirement be filed no later than one year after termination of the member's state employment. However, it would specify that, upon appeal to the retirement board, the board could accept ("for good cause") an application for a disability retirement allowance not later than two years after termination of the member's state employment.

Continuing medical examinations for disability retirees; restoration of employment. Under current law, the retirement board may require any disability retiree under age 60 to undergo a medical examination once each year during the first five years following retirement, and at least once every three years thereafter. The retiree may also request and must be granted such a medical examination. A retiree who refuses the exam (and continues the refusal for one year) may lose his or her disability pension. If the medical advisor reports, and the board concurs, that the retiree is physically able and capable of resuming employment, the statute requires that the retiree be restored to state employment and that the disability retirement allowance be ended. The bill would amend this provision to delete the specific requirement for medical exams, and specify instead that the retirement board could require a person to be examined, but the board could not require a retiree to undergo more than one medical exam in any calendar year. As under current law, a disability retiree who is found to be physically able to resume employment would be required to be restored to state employment, and his or her disability retirement allowance would end.

Survivorship pension. The bill would add language allowing a survivorship pension to be paid to the minor children of a vested member dies and there is no surviving spouse. Under this provision, each surviving child under age 18 would receive an equal share of the retirement allowance that would have been paid had the member died and left a surviving spouse. Payments would end when each child was married, was adopted, or reached 18 years of age, whichever occurred first.

Internal Revenue Code provisions. The retirement act contains several provisions required under federal law in order to maintain the tax-exempt status of the retirement system. The bill would amend several of these provisions, as follows.

• The definition of "compensation" would be amended to delete language referring to the compensation limit established in the federal Internal Revenue Code; however, the bill would add language stating that, notwithstanding any other provision of the act, the compensation of a member of the retirement system would be taken into account for any year under the retirement system only to the extent that it does not exceed the compensation limit established in the Internal Revenue Code, as adjusted by the commissioner of revenue. The new provision would apply to any person who first becomes a member of the retirement system on or after October 1, 1996.

• The bill would add language specifying that, notwithstanding any other provision of the act, contributions, benefits, and service credit with respect to qualified military service will be provided under the retirement system in accordance with the Internal Revenue Code. This provision would apply to all qualified military service on or after December 12, 1994.

• Beginning January 1, 2002, the definition of "eligible retirement plan" (for purposes of rollover distribution of eligible distributions of employee contributions) would be amended to include annuity contracts described in section 403(b) of the IRC, or an eligible plan under section 457(b) of the IRC that is maintained by a state or local government, so long as amounts transferred into eligible retirement plans from the State Employees' Retirement System are separately accounted for by the plan provider.

• Further, beginning January 1, 2002, with regard to an "eligible rollover distribution", the bill specifies that if a portion of a distribution that is not included in federal gross income is paid to an individual retirement account or annuity described in sections 408(a) or 408(b) of the IRC or a qualified defined contribution plan described in section 401(a) or 403(a) of the IRC, and the plan providers agree to separately account for amounts paid, the portion of distribution that is not includable in federal gross income would be an eligible distribution under the State Employees' Retirement Act.

Changes to conform to Public Employee Retirement Benefit Protection Act. The bill would add language in several provisions of the act to conform to changes made in a package of bills, House Bills 5108-5114, which concern the "anti-alienation" clause of public pension plans. (See the House Legislative Analysis Section's analysis of House Bills 5108-5114.) One provision of House Bill 5108, which would create the

Public Employee Retirement Benefit Protection Act, would allow a public retirement system to create an arrangement and fund to pay accrued benefits of its members that would not otherwise be payable under the limitations of Section 415 of the Internal Revenue Code. House Bill 5732 would add language specifying how such benefits would be paid if the State Employees Retirement Board established such an arrangement and fund.

Retirement board member compensation. The retirement board has nine members, of which two are retirees. The act states that the members of the board are to serve without compensation, but must be reimbursed for actual necessary expenses incurred in performance of board duties. The act also states that notwithstanding this provision, the retired state employee member [sic] is to receive $35 per diem as fixed by the board. The bill would delete the specific dollar amount and specify that the member would receive the per diem compensation established annually by the legislature for the performance of official board duties.

MCL 38.1 et al.

BACKGROUND INFORMATION:

Previous "early out" legislation. The legislature has enacted several early retirement programs for state employees. In 1984 and 1987, state employees were offered "80 and out" programs, and in 1991 and 1992, there were "70 and out" provisions for limited periods of time. Then, in 1996, another early retirement program was offered in conjunction with legislation that created a new defined contribution retirement program, which was mandatory for all new employees. Generally, these programs have reduced the required age and/or years of service, increased the pension formula multiplier, or both. Most of the previous early retirement plans have required participants to be at least 50 years old.

Defined contribution program. The 1996 legislation created the defined contribution program, in which all employees hired after March, 1997 are participants. (Retirement systems for state employees, legislators, and judges were amended to implement the new plan.) Employees who were currently covered under the defined benefit program were offered an opportunity to convert their retirement assets into the new DC plan during a four-month "window" in 1998.

FISCAL IMPLICATIONS:

The House Fiscal Agency reports that the early retirement program will result in significant savings to the state as long as the targeted positions remain vacant. Though not part of this bill, the administration has indicated that its intent is to replace only one of every four employees who retire under the plan. The HFA reports that 8,738 classified and unclassified executive branch employees would be eligible for retirement under the bill. It is assumed that 60 percent, or 5,243, will participate. As a result, the HFA estimates net savings to the general fund of $61.9 million for fiscal year 2002-2003. (4-5-02)

ARGUMENTS:

For:

The early retirement plan is expected to save the state about $60 million in general fund money this fiscal year, and is an important part of the governor's plan to balance the state's budget. It is more humane to address the state's budget difficulties by providing some workers with a choice of retiring early, rather than having to lay off employees to cut costs. The bill would allow up to 8,000 state employees to retire right away, in some cases several years earlier than planned, and take advantage of a higher "multiplier", resulting in a 17 percent increase in their pensions. It is an innovative plan, in that it would also accommodate those who converted their pension to the defined contribution plan, by allowing these people to receive, in addition to their DC accounts, a small annuity based on the 80 and out formula. Veteran state employees will have the opportunity to retire earlier and take advantage of other opportunities, while state government administrators will be able to restructure operations and take advantage of technological improvements to replace many of the departing workers. The plan will result in continuing, long term savings, as more senior, well paid workers leave and a portion are replaced by entry level workers. This kind of restructuring also provides opportunities for younger workers to advance.

Against:

A permanent reduction of 3,000 or more state workers is sure to take its toll on state services, and is unfair to remaining employees who will face heavier workloads and the "brain drain" left by departing senior employees. Perhaps the legislature should look closely at the kinds of cuts that will be necessitated in order to do without these 3,000 state employees. Will mental health services be cut? Will secretary of state branch offices have longer lines? Will prisons be less secure due to fewer guards? Will tax refunds be delayed? Will children wait longer for adoptive homes? These are just a few areas that could conceivably be affected by continuing to slash the state workforce. It is unrealistic to think that there will be no effect on citizens.

Against:
Whenever retirement benefits for one group are enhanced, issues of equity arise. With at least six early retirement programs offered in the last 20 years, all with differing eligibility requirements and enhancements, and the addition of the new defined contribution program for new state workers, the overall structure of retirement benefits for current and retired state workers has become less and less equitable. There are always those who miss out on age and service requirements by a month or two, or who have the misfortune of retiring just before a new program is announced. And, employees hired after March 1997 in the defined contribution plan have considerably less health insurance coverage than do more senior state employees. The legislature should address these inequities in a comprehensive way, rather than continually adding new layers of unfairness. Indeed, many would argue that, rather than provide more enhancements for current employees to retire, it would better to improve the benefits of those who have already retired at lower salary levels, and thus, have lower pension benefits. It should be noted that state retirees do not receive cost of living adjustments.

For:
The bill would make an important first step toward achieving the laudable goal of prefunding health benefits. Under the bill, excess employer contributions would be set aside into a health care advance funding subaccount in years that the pension system is completely funded, in order to help pay for future health care benefits. The explosion in health care costs is a trend that is likely to continue, and the current $6.6 billion unfunded liability for health care benefits is a ticking time bomb that must be addressed. Though the bill would only make a start, it would help to counter the impact of inflation and the growing retiree population by taking advantage of investment earnings, with a minimal impact on the state budget. The DMB estimates that the proposal could allocate over $122 million toward the unfunded liability each year that the pension fund was overfunded, plus investment earnings on those funds.

Response:
While it is good public policy to prefund health care benefits, this proposal falls far short of actually achieving that goal. With an unfunded liability of billions of dollars, it is unlikely that any of today's retirees will be helped by this proposal, as it will take so many years for the fund to reach the needed balance. In the meantime, the proposal "locks in" all surpluses in the pension system toward this one purpose, so that they will not be available to fund post-retirement increases for older retirees (as has sometimes been the custom). Since the retirement system is currently overfunded by $863 million, it is only fair that this proposal be coordinated with enhancements in benefits for current retirees.

In addition, the bill appears to allow the transfer of money out of the health funding subaccount in years in which funds are needed to fund pension benefits. This can be viewed as a kind of "rainy day fund" for employer contributions to the pension system, which could be used to supplement the general fund budget in tight economic times. State employees and retirees are wary of this use of their pension funds.

For:
The bill would make several reforms in the way that disability pensions are administered. It would require that applications for disability pensions be filed within one year of separation from state service, and it would provide the board with more flexibility in ensuring that those who receive disability payments are actually disabled, by allowing the board to request medical exams when appropriate, rather than at intervals strictly stated in statute.

Against:
The deadline for application for disability retirement is not necessary and may create hardship for some families. The vast majority of disabled employees apply quickly for retirement benefits in order to assure continued family income. However, some diseases may have symptoms that are not consistent or that arise more slowly.

For:
The bill would update several provisions of the act to reflect recent changes in federal law. These updates are necessary to assure that the retirement system's tax-exempt status will continue.

For:
The bill would correct an oversight that currently prevents the payment of a survivorship pension for

the dependent children of a retiree in the event of the retiree's death, if there is no surviving spouse.

For:

Public retirement benefits are exempt from state and local income taxes. However, payments for sick and annual leave that are payable to an employee at the time of separation from state service are rightly considered to be compensation, or taxable income, rather than retirement benefits. It is unlikely that the legislature intended that these payments be exempt from the income tax; the bill would correct a misinterpretation of this issue by overturning two court of appeals decisions to the contrary.

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.