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BILL ANALYSIS

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Senate Bill 546 (as reported without amendment)
Senate Bill 547 (Substitute S-1 as reported)
Sponsor: Senator Wayne Kuipers
Committee: Education

Date Completed: 6-19-07

RATIONALE

The Michigan Public School Employees Retirement System (MPSERS) is a defined benefit plan open to employees of public schools, public school academies, district libraries, community colleges, and certain public universities. Since 1990, new members have been required to participate in the Member Investment Plan (MIP), under which a member must contribute a portion of his or her salary to the plan, based on his or her level of compensation. The employer also must contribute to the plan in an amount based on the value of the plan's assets and the projected costs of providing benefits. For a number of years, the rising cost of health care and other factors have increased the contribution costs for local school districts and other employers, while the amount of money available for public education has not similarly grown. The system has taken a number of steps to keep costs as low as possible, including revaluing the system's assets in 1997 to take advantage of high stock market values, and using revenue from a stabilization fund to cover costs of benefits. Nevertheless, the plan's accrued unfunded liabilities continue to grow, and are projected to increase indefinitely unless changes are made. It has been suggested that the benefit structure should be modified for new members, to put the retirement system on a sound financial footing, and to reduce the projected costs of those benefits going forward.

CONTENT

Senate Bill 546 would amend the Public School Employees Retirement Act to require MPSERS to pay 90%, rather than 100%, of health insurance premiums for a retirant who became a member of the system after June 30, 2008; require the retiree to be at least 60 years old; and provide for a reduced payment if the retiree had at least 10 but less than 30 years of service credit.

Senate Bill 547 (S-1) would amend the Public School Employees Retirement Act to do the following:

-- Increase the required contribution to the Member Investment Plan for a person who first became a member of MPSERS on or after July 1, 2008, and who earned over $15,000.
-- Require a member aged 60 or older to have at least 10 years of credited service before being entitled to a retirement allowance, if he or she joined MPSERS on or after July 1, 2008.
-- Require a person who became a member on or after July 1, 2008, to complete at least 10 years of service before purchasing service credit.
-- Require MPSERS to pay 90%, rather than 100%, of health insurance premiums for a retirant who became a member after June 30, 2008, and who was at least 60 and had at least 30 years of service credit (as proposed by Senate Bill 546).
-- Remove current limitations on the benefit amount that a retirant may receive annually, and instead provide that benefits could not exceed limitations set forth in Section 415 of the Internal Revenue Code.
-- Provide that if any section of the Act were held to be invalid or

unconstitutional for any reason, the holding would not affect the validity of the remainder of the Act or the Act in its entirety.

Senate Bill 546 is tie-barred to Senate Bill 547. The bills are described in detail below.

Senate Bill 546

Under the Act, except as otherwise provided, MPSERS must pay the entire monthly premium or membership or subscription fee for hospital, medical-surgical, and sick care benefits for a retirant or retirement allowance beneficiary who elects coverage in the plan authorized by the retirement board and the Department of Management and Budget (DMB). The system also must pay up to 90% of the maximum amount payable under these provisions for hospital, medical-surgical, and sick care benefits coverage for each health insurance dependent of a retirant receiving benefits.

In addition, MPSERS must pay 90% of the monthly premium or membership or subscription fee for dental, vision, and hearing benefits for the benefit of a retirant or retirement allowance beneficiary who elects coverage in the authorized plan, as well as 90% of the monthly premium or membership or subscription fee for dental, vision, and hearing benefits for the benefit of each health insurance dependent of a retirant receiving those benefits.

Under the bill, these provisions would not apply to a retirant who first became a member of MPSERS after June 30, 2008.

Instead, for a member or deferred member who first became a member after June 30, 2008, MPSERS would have to pay up to 90% of the monthly premium or membership or subscription fee for the hospital, medical-surgical, and sick care benefits plan, the dental plan, vision plan, or hearing plan, or any combination of the plans for the benefit of the retirant and his or her health insurance beneficiaries, or for the benefit of the retirant's or deceased member's retirement allowance beneficiary, if the retirant or deceased member had at least 30 years of service credit or employment with a reporting unit or units under the Act, and the retirant or deceased member were at least 60 years of age at the time of the application for benefits.

If a retirant or deceased member had 10 or more but less than 30 years of service credit or employment with a reporting unit or units, and the retirant or deceased member were at least 60 years of age at the time of application for benefits, MPSERS would have to pay a portion of the monthly premium or membership or subscription fee for the plans or combination of plans equal to the product of 3% and the retirant's or deceased member's years of service.

The retirement system could not pay the premiums or membership or subscription fees described above until the retirant or beneficiary requested enrollment in the plans or combination of plans in writing in the manner prescribed by MPSERS. The above provisions would not apply to a member who received a disability retirement allowance under the Act or to a deceased member's retirement allowance under Section 90.

(That section provides for the payment of benefits to the surviving spouse of a deceased member receiving worker's compensation, and requires the retirement allowance beneficiary's retirement allowance to be computed as otherwise provided in the Act, except that the reduction for early retirement does not apply.)

Senate Bill 547 (S-1)

Retirement Plan Contributions

Under the Act, except as otherwise provided, a member of MPSERS who first became a member on or after January 1, 1990, must make the following contributions to MIP:

- -- If the member's annual earned compensation for the school fiscal year is not over $5,000: 3% of the member's compensation.
- -- If the member's annual earned compensation for the school fiscal year is over $5,000 but not over $15,000: $150 plus 3.6% of the excess over $5,000.
- -- If the member's annual earned compensation for the school fiscal year is over $15,000: $510 plus 4.3% of the excess over $15,000.

Under the bill, for a member who first became a member on or after July 1, 2008, if his or her annual earned compensation for the school fiscal year were over $15,000, the required contribution would be increased to $510 plus 6.4% (rather than 4.3%) of the excess over $15,000.

Currently, a person who first became a member on or before December 31, 1986, but did not perform membership service between that date and January 1, 1990, and who returns to membership service on or after January 1, 1990, also must contribute to MIP as described above.

Under the bill, that provision would apply only to a member who first became a member before July 1, 2008.

Years of Service

Under the Act, a member of the retirement system who is no longer working as a public school employee or in any other capacity for which service credit is allowed under the Act is entitled to a retirement allowance if, among other things, the member is 60 years of age or older and has accumulated 10 or more years of credited service as a public school employee.

For a member who contributes to MIP, the 10 years of credited service is reduced to five years if the member is working as a public school employee and received credited service in each of the five school fiscal years immediately preceding the retirement allowance effective date. Under the bill, this provision would apply only to a member who became a member on or before June 30, 2008.

Purchase of Service Credit

Universal Buy-In. The Act allows a member to purchase up to five years of service credit, upon request and payment to MPSERS of the actuarial cost, less the number of years of service credit purchased under certain other provisions (under which credit had to be purchased before January 31, 1991), upon request and payment to MPSERS of the actuarial cost.

Under the bill, a member who became a member on or after July 1, 2008, would have to complete at least 10 years of reporting unit service before purchasing service credit under this provision.

Maternity & Paternity. A member who left or leaves service as a public school employee for purposes of maternity or paternity or child rearing, and returns to service as a public school employee, or a person performing out-of-system public education service who leaves that service for maternity, paternity, or child rearing and who subsequently becomes a member of MPSERS, without intervening employment of more than 20 hours per week for each week for which service credit is claimed, may purchase service credit for the time period or periods during which he or she was separated from service.

Under the bill, a member who became a member on or after July 1, 2008, would have to complete at least 10 years of reporting unit service before purchasing service credit under this provision.

Credit for Other Service. A member is not entitled to a retirement allowance based on out-of-system public education service that was performed after July 1, 1974, unless he or she purchases service credit for those years by paying into MPSERS an amount based on the member's compensation in the preceding school fiscal year, multiplied by the years of service that the member elects to purchase, and unless that service is followed by five years of reporting unit service.

Similar provisions apply to a member purchasing service credit for service performed as an employee in a nonpublic elementary or secondary educational institution or a nonpublic two- or four-year institution of higher education in the State, in other states, or in the territorial possessions of the U.S.; an employee in a foreign country at a school for U.S. military personnel or U.S. Department of State personnel; a full-time teacher with the Jobs Corps; a teacher in a trust territory or former trust territory of the United States; or a teacher on an Indian reservation in this country.

Under the bill, service credit could not be purchased under those provisions by a member who became a member on or after July 1, 2008, unless he or she completed at

least 10 years of reporting unit service before purchasing the service credit.

Limitations on Benefits

Currently, unless otherwise provided, employer-financed benefits provided by MPSERS may not exceed $10,000 per year for a retirant who has 15 or more years of credited service at retirement.

The benefits may not exceed that limitation unless one of the provisions described below results in a higher limitation. In that case, the employer-financed benefits provided by MPSERS may not exceed the lesser of the following:

1) One of the following amounts as applicable to the member:

-- If a member retires at age 62 or older, $90,000 or the amount adjusted for increases in cost of living.
-- If a member retires at or after age 55 but before age 62, the actuarially reduced amount of the limit provided above (calculated with an interest rate of 5% per year compounded annually) although the limitation may not be reduced actuarially below $75,000.
-- If a member retires before the age of 55, the actuarially reduced amount of the preceding limit (calculated with an interest rate of 5% per year compounded annually).

2) 100% of the member's average compensation for the high three years as described in Section 415(b)(3) of the Internal Revenue Code (IRC).

(The IRC limits a recipient's compensation to 100% of the recipient's average compensation for his or her high three years, which Section 415(b)(3) defines as a period of not more than three consecutive calendar years during which the participant was an active participant in the plan and had the greatest aggregate compensation from the employer.)

The Act provides that the higher limitation under these provisions applies to employer-financed benefits provided by MPSERS, and, for the purposes of Section 415(b) of the IRC, applies to aggregated benefits received from all qualified pensions plans administered by the Office of Retirement Systems in the DMB. These provisions must be administered using the limitations applicable to each calendar year as adjusted by the Secretary of the Treasury or his or her delegate under Section 415(d) of the IRC. The retirement system must adjust the benefits subject to the limitation each year to conform with the adjusted limitation. (Section 415 of the IRC provides limits on benefits and contributions under qualified retirement plans. Section 415(d) provides for annual cost-of-living adjustments to those limitations. Section 415(b) specifically deals with limitations for defined benefit plans.)

The bill would remove those provisions. Instead, employer-financed benefits provided by MPSERS could not exceed the applicable limitations set forth in Section 415, as adjusted by the Commissioner of Internal Revenue to reflect cost-of-living increases, and MPSERS would have to adjust the benefits subject to the limitation each calendar year to conform with the adjusted limitation.

For the purposes of Section 415(b) of the IRC, the applicable limitation would apply to aggregated benefits received from all qualified pension plans for which the Office of Retirement Services coordinated administration of that limitation.

As currently required, MPSERS would have to be administered in compliance with the provisions of Section 415 of the IRC and regulations under that section that apply to governmental plans.

MCL 38.1391 (S.B. 546)
38.1343a et al. (S.B. 547)

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

Public school employees and other members receive excellent retirement benefits through MPSERS, one of the few remaining defined benefit plans in the State (meaning they receive a specific retirement allowance based on salary and years of service). A study by Standard & Poor's found that in 2004 Michigan public schools spent $2,165 per student on employee benefits, about

42% more than the national average. While that figure includes all benefits, not just retirement, MPSERS benefits are a large portion of that amount. At the same time, the rising costs to school districts have absorbed a large portion of any increases in per-pupil funding in recent years, leaving little if any additional money to be spent in the classroom. Public schools already are struggling to meet the escalating costs of their contributions to the system, which, if current trends continue, are projected to reach 30% of payroll costs by 2020, up from the current level of 17.7%. Those increases are likely to continue, even while schools are being asked to reduce expenses and find more efficient ways of operating.

Despite the fact that employers are paying more into the system, MPSERS faces $16 billion in unfunded accrued liabilities. The reasons for the financial stress on the system are complex, but the most common causes cited are the past poor performance of the plan's investments, increasing health care costs, and greater numbers of retirees receiving benefits while the number of active members remains stable.

The stock market downturn of 2001 and 2002 had a significant effect on the performance of the system's investments, which is still is being felt. The plan's investment managers assume an average 8% annual return on investments over the long term, although in any given year the return may be greater or less than that amount. In the early part of the decade, as stocks lost value, the system was left with much less revenue than was expected. Because employer contribution rates are calculated based on the plan's assets as well as its projected costs, those contribution rates have had to increase to compensate for the poor investment performance.

Although the stock market has since returned to pre-2001 levels, the employer contribution rates have remained high, in part because those rates are determined using a five-year average of the system's asset value. The five-year smoothing prevents contribution rates from rising sharply during a down market, but it also has caused the effects of the 2001-2002 recession to linger.

To address these problems, Senate Bill 547 (S-1) would increase the contribution rate to MIP for individuals who became members after June 30, 2008. The higher contribution rate would be more in line with the actual cost of providing the retirement benefits, and would help to reduce some of the unfunded accrued liabilities. That additional revenue would help to cover the rising cost of the benefits, and would free up more funds in school budgets to be directed to classrooms.

Supporting Argument

Under MIP, a member is eligible for retirement if he or she has at least 30 years of service credit, regardless of his or her age. (Other provisions permit a member over the age of 60 to retire with as little as five years of service credit.) Over the past 10 years, the proportion of retired members to active members has increased steadily, placing a greater burden on those members still paying into the system. The practice of allowing members to purchase service credit has exacerbated this problem, since those who purchase service credit are able to retire and begin to receive benefits at an earlier age.

According to an article in the *Detroit News*, the amount of service credit purchased by current retirees in the system equals 3.48 years of credit per member, on average ("Employees Buy Time, State Pays," 5-11-07). Although the Act requires a member to pay the actuarial cost of the retirement allowance, the calculated amount does not include the cost of the additional health care that the member will receive. Unlike the pension benefits, which are prefunded under the plan, the retirement health care benefits are covered on a pay-as-you-go basis, which means that the future health benefits owed to members are not taken into account when projected costs are calculated. Initially, when health benefits were first offered through the retirement system, their costs were only a small fraction of the amount provided for pensions, and it made sense to cover them on a pay-as-you-go basis. Now, however, those costs rival the total pension costs, and the amount that active members contribute to the system for health care actually is greater than the amount contributed for pension costs. As a result, when a member purchases years of service credit, he or she receive extra years of health benefits without paying the full cost, placing additional strain on the system.

In addition, some MPSERS members who have a separation in service are able to receive full health care benefits in retirement by returning to work part-time for a school district in the years just before reaching retirement age. Those individuals receive a benefit out of proportion with the amount they have contributed to the system, and place an undue burden on the financial health of the system, as well as on other members who have earned more years of service credit, and have contributed more to the system for the same benefit.

The bills would help to address these problems in a number of ways. First, the bills would require a retirant to be 60 years old before he or she would be eligible for a health benefit under the plan. In addition, the bills would require the retirant to pay 10% of his or her health premium, reducing the cost of health benefits to the plan. Also, the bills would implement graduated health care benefits, similar to those offered to members of the State Employees Retirement System. Currently, a member may work as little as five years and upon retirement receive full health care benefits, equal to the benefits of a member who performed 30 years of service. Under the bills, the level of benefits would be determined by the number of years of service credit earned, which would be more equitable, and would encourage members to stay in service longer to receive the maximum benefit.

Senate Bill 547 (S-1) also would require members to earn at least 10 years of service credit before purchasing credit under the Act, to help stem misuse of those provisions. All of these changes would apply only to individuals who became members on or after July 1, 2008. Current members would retain the same benefits with the same contribution rates as provided under existing law.

Although the bills would not yield immediate savings, the long-term advantage would be significant, and would help to restore financial stability to MPSERS. If no corrections were made, the continually rising costs will become unmanageable for school districts, and the unfunded accrued liability will continue to grow, eventually impairing the system's ability to provide promised benefits. Because changes to MPSERS must be made slowly, in order to protect the rights of those currently in the system, action is needed now, before these financial challenges become critical.

Supporting Argument

Since member contribution rates to MIP are set by statute, one of the few ways that school administrators have to reduce costs is to negotiate lower benefits with retired members, which is unfair to those members, especially if they have contributed to the system over their entire careers. Instead of placing the burden on members who have retired, the bill would require new active members to contribute more to the system, allowing MPSERS to meet its obligations both to current retirees and to those who will receive benefits in the future.

Opposing Argument

The changes to the provisions for purchasing service credit could hurt some part-time employees such as teacher's aides. Those employees do not get enough hours to qualify for a year of service credit for each year worked. Senate Bill 547 (S-1) would require a member to earn 10 years of service credit before purchasing credit, but part-time employees could take 20 years or more to earn 10 years of credit. The bill would make it not only more difficult for part-time employees to purchase service credit, but also more expensive, because the cost of purchasing credit increases the closer a member is to retirement.

Response: The bills would affect only new employees, who would come to the job aware of the benefits being offered, and could decide whether to take the job based on that information. The benefits to teachers and other school employees are significantly better than those offered in many other professions, even taking into account the proposed changes.

Opposing Argument

Teachers and other public school employees are a valuable asset to the State, and although teachers' pay is less than that of comparable professions, their retirement benefits help to compensate for the lower income. Reducing those benefits could motivate some teachers to leave the profession, or could discourage young people from becoming teachers.

In addition, when MIP was first implemented in 1985, it was offered as a way for members to purchase additional benefits beyond those offered in the basic plan.

(Participation in MIP initially was voluntary, and became mandatory for new members in 1990.) In that context, it would be improper to raise the member contribution rate without providing any additional benefit. The employers are responsible for funding the plan adequately, but the bill instead would charge members more for the same benefits, and use that extra revenue to fully fund the plan.

Opposing Argument

The retirement benefits that teachers receive are not extravagant. The average retirement allowance is less than $18,000 a year, and almost one third of current pensions under the system amount to less than $10,000 a year, according to an article in the *Detroit News* (School Retirement System Needs Review", 5-25-07). Many retirees must continue to work at other jobs while receiving retirement benefits, in order to pay for their portion of health care premiums or to cover living expenses. Cutting those benefits would hurt members of the retirement system, and would provide only partial relief from the system's financial problems. The major cause of the retirement system's financial difficulties is the rising cost of health care, which the bills would do nothing to address.

Legislative Analyst: Curtis Walker

FISCAL IMPACT

Senate Bill 546

The bill would have a small fiscal impact on the State. The Office of Retirement Services (ORS) already administers MPSERS, but could need to increase staff or responsibilities associated with implementing the changes in this bill.

Under the bill's graded premium program provision, local districts eventually would see significant savings due to lower MPSERS contribution rates for retiree health benefits. However, there would be no savings in the first 10 years of the program. Savings gradually would increase over the course of 30 to 40 years, when all retirees would be covered under the graded premium program. The ORS estimates that in the long term, districts could save up to 43% of total health care costs once all retirees fell under the plan and subsequently retired.

If this program had been in place over the past 40 years, the State's health care expenses for MPSERS retirees would have been $433.2 million in FY 2005-06 rather than the $760.0 million actually incurred, savings of $326.8 million. Health benefit expenses have been increasing in recent years and are likely to continue to increase. Accordingly, the amount of savings generated by a 43% reduction in costs also would increase by the time the plan was fully developed and implemented.

The provision in this bill that would place an age requirement on the receipt of health care benefits also would produce savings for districts in the long term. There would be no savings in the first 10 years of the program, since the earliest any newly hired employee could retire with benefits would be after 10 years of service when he or she was at least 60 years old. After 10 years, there would be gradually increasing savings for the next 20 to 25 years. Like the graded premium program, full savings would not be realized for 30 to 40 years, when all retirees fell under the plan and subsequently retired. It is difficult to project savings that far into the future, but in the current fiscal year approximately $119 million will be paid for MPSERS retirees who are under 60 years old. Again, the actual savings likely would be higher due to increasing health care costs.

Senate Bill 547 (S-1)

The bill could have a small fiscal impact on the State. The ORS could need to increase staff or responsibilities associated with implementing the changes in this bill.

Increasing the member contribution rate from 4.3% of salary over $15,000 to 6.4% would produce savings for reporting units of MPSERS. The member contributions are credited against what a district owes to MPSERS for the normal cost portion of the retirement rate. Therefore, increasing member contribution would decrease the amount required from the district. Assuming 10,000 new public school employees are hired per year with an average starting salary of $35,000, this provision would generate savings of $7.35 million in the first year, with a similar additional cumulative amount in the following years.

The provision eliminating the "60 and 5" retirement provision also would create savings for districts. This provision allows a member to retire at age 60 with five years of service, provided the person worked through his or her 60th birthday and worked in each of the last five years. The total number of people falling under this age/service category is 3,345 out of a system with over 157,000 retirees, or about 2%. An estimate of cost savings is unavailable at this time. However, since the number of retirees who fall under this age/service category is a small percentage of the total, savings are likely to be small.

The provision in this bill requiring 10 years of service for purchased service credit would not generate savings for local districts. Under this bill, two different criteria would determine when a member could retire with full benefits. First, Member Investment Plan members may retire as soon as they have 30 years of credited service. The proposed change would not affect this group. A second group may retire at 60 with 10 years of service. Under current law, purchased years of credit cannot count toward the 10-year service requirement, so this group would not be affected by the proposed change.

The fiscal impact of the bill's graded premium program provision and age requirement would be as described above, under Senate Bill 546.

Fiscal Analyst: Kirk Sanderson

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.