Senate Fiscal Agency
P. O. Box 30036
Lansing, Michigan 48909-7536

BILL ANALYSIS

Telephone: (517) 373-5383
Fax: (517) 373-1986
TDD: (517) 373-0543

Senate Bills 546 and 547 (as enacted)
Sponsor: Senator Wayne Kuipers
Senate Committee: Education
House Committee: Education

PUBLIC ACTS 110 & 111 of 2007

Date Completed: 10-5-07

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. Typically, MPSERS pays 100% of the premiums for retirants' health care costs. Members with at least 30 years of service credit may retire regardless of their age, and members over 60 may retire with five years of service credit.

For a number of years, the rising cost of health care and other factors have increased the contributions to the system from 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 its 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 have continued to grow, and were projected to increase indefinitely unless changes were made. It was suggested that the health care benefit structure should be modified for new members, to put the retirement system on a sound financial footing, and to reduce its projected costs for those benefits going forward.

CONTENT

Senate Bill 546 amended the Public School Employees Retirement Act to require MPSERS to pay the following for a member who joins the system after June 30, 2008:

-- For a retirant who is at least 60 years old at the time of application for benefits and has 25 years of service credit under the Act, 90% of health insurance premiums.
-- For a retirant who is less than 60 at the time of application for benefits, who has at least 25 years of service credit excluding purchased service credit, 90% of health insurance premiums.
-- For a retirant who is at least 60 at the time of application for benefits, who has at least 10 but less than 25 years of service credit, a percentage of health insurance premiums equal to 30% for the first 10 years of service plus 4% for each additional year of service beyond 10 years.

The bill also does the following:

-- Provides that a member who purchases service credit after June 30, 2008, is not eligible for health premium payments until he or she would have been eligible to retire without purchasing service credit.

-- **Prohibits MPSERS from paying retirement health benefits to a member unless he or she earned at least half a year of service credit during the two school fiscal years immediately preceding his or her retirement, or at least 1/10 of a year of service credit during each of the previous five school fiscal years.**

<u>Senate Bill 547</u> amended the Public School Employees Retirement Act to do the following:

-- **Require a person who first becomes a member of MPSERS on or after July 1, 2008, to contribute to the Member Investment Plan 6.4% (rather than 4.3%) of income above $15,000.**
-- **Require a member, beginning July 1, 2008, to complete at least two years of service before purchasing service credit.**

The bills were tie-barred to House Bills 5194 and 5198. (House Bill 5194 (Public Act 94 of 2007) amended the Income Tax Act to do the following:

-- Increase the income tax rate from 3.9% to 4.35%, effective October 1, 2007.
-- Reduce the rate from 4.35% by 0.1 each October 1, beginning in 2011, until it is 3.95%.
-- Reduce the rate from 3.95% to 3.9% on October 1, 2015.

House Bill 5198 (Public Act 93 of 2007) amended the Use Tax Act to extend the 6% use tax to the use or consumption of certain services.)

The bills took effect on October 1, 2007, and are described in detail below.

<u>Senate Bill 546</u>

Under the Public School Employees Retirement 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, except as otherwise provided, these provisions do not apply to a retirant who first becomes a member of MPSERS after June 30, 2008.

Instead, for those members, if the retirant or deceased member has 25 years or more of service credit under the Act, and the retirant, deceased retirant, or deceased member were at least 60 years of age at the time of application for benefits, MPSERS must 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, and hearing plan, or any combination of those plans for the benefit of the retirant and his or her retirement allowance beneficiary and health insurance dependents, or for the benefit of the deceased member's retirement allowance beneficiary.

If the retirant or deceased member is less than 60 years of age at the time of application for benefits and has at least 25 years of service credit granted under Section 68 of the Act (which pertains to service credit earned for services performed, rather than purchased service credit), MPSERS must pay 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, and hearing plan, or any combination of the plans for the benefit of the retirant and his or her retirement allowance beneficiary and his or her health insurance dependents, or for the benefit of the deceased member's retirement allowance beneficiary.

If a retirant has 10 or more but less than 25 years of service credit under the Act and the retirant was at least 60 years of age at the time of application for benefits, MPSERS must 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, deceased retirant's, or deceased member's years of service for the first 10 years and 4% for each year of service beyond 10 years.

These provisions do not apply to a member who receives 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 a reduction for early retirement does not apply.)

For purposes of these provisions, not more than one year's service credit may be counted in any one school fiscal year.

The bill prohibits MPSERS from paying the premiums or membership or subscription fees described above until the retirant or beneficiary requests enrollment in the plans or combination of plans in writing in the manner prescribed by the retirement system.

Under the bill, a member who retires under the Member Investment Plan or under the defined benefit plan and who elects to purchase service credit on or after July 1, 2008, is not eligible for payments for the hospital, medical-surgical, and sick care benefits plan, the dental plan, vision plan, or hearing plan, or any combination of those plans until the first date that the member would have been eligible to retire if he or she had not purchased the service credit and had accrued a sufficient amount of service credit under Section 68 (described below). A member who first becomes a member on or after July 1, 2008, is not eligible for health benefits under these provisions until at least the time of application. The retirement system must apply a method enabling it to make the determination under these provisions.

(Section 68 requires the retirement board to grant one year of service credit to a member who has been employed and compensated for 1,020 hours of service performed in a school fiscal year. A part-time member or member employed for a fraction of a year must receive service credit for full-time service on the basis of 60 or more hours per biweekly period and proportionate credit for less than 60 hours per biweekly period. Not more than one year's service may be counted for retirement purposes under this section in any fiscal year.)

The bill prohibits MPSERS from paying medical, dental, vision, or hearing benefits for a retirant unless the member was employed and has received a minimum total of half a year of service credit granted under Section 68 during the two school fiscal years immediately preceding the member's retirement allowance effective date, or a minimum of 1/10 of a year of service credit granted under Section 68 during each of the five school fiscal years immediately preceding the member's retirement allowance effective date. These provisions do not apply to a member who receives a disability retirement allowance; a deceased member's retirement allowance beneficiary under Section 90; a member or deferred member who first joins MPSERS after June 30, 2008; or a retiring Section 82 deferred member (a member who terminates service before age 60 other than for death or retirement, does not withdraw accumulated contributions, and has at least 10 years of credited service).

Senate Bill 547

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

The Act requires 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 to contribute to MIP as described above. Under the bill, that provision applies only to a member who returns to membership service before July 1, 2008.

Purchase of Service Credit

Notwithstanding any other provision of the Act, beginning July 1, 2008, the bill prohibits a member from purchasing service credit unless the member has been granted at least two years of service credit under Section 68 (i.e., service credit granted for services performed while employed at a school district).

MCL 38.1391 (S.B. 546)
38.1343a & 38.1360 (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 significant share 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 who are 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 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 increases the contribution rate to MIP for individuals who became members after June 30, 2008. The higher contribution rate is more in line with the actual cost of providing the retirement benefits, and will help to reduce some of the unfunded accrued

liabilities. That additional revenue will help to cover the rising cost of the benefits, and will 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 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 receives 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 will help to address these problems in a number of ways. First, for members joining the system on or after June 30, 2008, Senate Bill 546 requires a retirant who retires before age 60 to have at least 25 years of earned service credit (excluding purchased credit), and requires a person retiring at 60 or older to have 25 years of service credit, in order to have 90% of his or her health care premium paid. The bill requires the retirant to pay 10% of his or her health premium, reducing the cost of health benefits to the plan. Also, for new members, the bill implements graduated health care benefits upon retirement, 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 bill, the level of benefits will be determined by the number of years of service credit earned, producing a more equitable benefit structure, and encouraging members to stay in service longer to receive the maximum benefit. The bill also prohibits any member who purchases service credit after June 30, 2008, from receiving a retirement health benefit until he or she otherwise would have been eligible to retire under the Act without purchasing the credit. Under Senate Bill 547, beginning July 1, 2008, members must earn at least two years of service credit before purchasing credit under the Act, which will help stem misuse of those provisions.

Although the bills will not yield immediate savings, the long-term advantage may be significant, and will help to restore financial stability to MPSERS. If no corrections were made, the continually rising costs would become unmanageable for school districts, and the unfunded accrued liability would continue to grow, eventually impairing the system's ability to provide promised benefits. Rapid changes to the system are not possible, however, because the rights of members currently in the system must be considered when any adjustments are made.

Therefore, action taken now, before these challenges become critical, will put MPSERS on the road to financial stability.

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

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 is unfair to raise the member contribution rate without providing any additional benefit. The employers are responsible for funding the plan adequately, but Senate Bill 547 instead charges members more for the same benefits, and uses 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 will hurt MPSERS members, and will 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 do nothing to address.

Legislative Analyst: Curtis Walker

FISCAL IMPACT

Senate Bill 546

The bill will have a small fiscal impact on the State. The Office of Retirement Services (ORS) already administers MPSERS, but might 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 will see significant savings due to lower MPSERS contribution rates for retiree health benefits. However, there will be no savings in the first 10 years of the program. Savings gradually will increase over the course of 30 to 40 years, when all retirees will be covered under the graded premium program.

The provision in this bill that places an age requirement on the receipt of health care benefits, unless a retiree has 25 years of service, also will produce savings for districts in the long term. There will be no savings in the first 10 years of the program, since the earliest any newly hired employee can retire with benefits will be after 10 years of service when he or she is at least 60 years old. After 10 years, there will be gradually increasing savings for the next 20 to 25 years. Like the graded premium program, full savings will not be realized for 30 to 40 years, when all retirees fall under the plan and subsequently retire.

The ORS estimates that in the long term (40 years), combined savings from the graded health care and age requirement will total around 45%. To put this in perspective, if these provisions had been in place the past 40 years, then public school employee retiree health care costs in FY 2004-05 would have been $418 million rather than the $760 million actually paid out.

Finally, ORS estimates that the provision prohibiting a retiree to draw down health care benefits during the time of retirement

attributable to purchased service credit will save approximately $45.4 million per year. This will apply to current and future employees who purchase service credit on or after July 1, 2008.

Senate Bill 547

The bill may have a small fiscal impact on the State. The ORS might 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% will 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 will decrease the amount required from the district. The ORS estimates savings of $5.0 million in the first year, growing to $29 million by the sixth year, and continuing to grow over 30 to 40 years until the entire workforce becomes subject to the increased contribution rate.

The provision in this bill requiring a member to have two years of service before being able to purchase service credit will generate savings of at least $5.7 million per year for local districts, as estimated by the ORS.

Fiscal Analyst: Kathryn Summers-Coty

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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.