House
Legislative
Analysis
Section

Olds Plaza Building, 10th Floor
Lansing, Michigan 48909
Phone: 517/373-6466

DEFINED CONTRIB. PLAN FOR SERS, PSERS AND LRS MEMBERS; EARLY-OUT FOR STATE WORKERS

House Bill 6206 (Substitute H-1)
Sponsor: Rep. Barbara Dobb

House Bill 6207 (Substitute H-1)
Sponsor: Rep. Gary L.Randall

House Bill 6229 (Substitute H-5)
Sponsor: Rep. Kim Rhead

House Bill 6230 (Substitute H-5)
Sponsor: Rep. Walter J.DeLange

First Analysis (12-5-96)

Committee: Appropriations

THE APPARENT PROBLEM:

Michigan, like most states, currently administers various public pension plans covering state employees, public school employees and elected officials--each of which is governed by a separate retirement act--where each system is funded primarily by contributions made to it by the state on behalf of members, and the investment of accumulated retirement assets is directed by the state. (However, the Public School Employees Retirement System, or PSERS, has required all members hired since January 1, 1990, to contribute about four percent of their gross salary toward retirement, while those hired prior to this date were allowed to choose between this plan and another requiring no contribution.) Under each retirement act, once a member is vested in a system he or she is constitutionally guaranteed a pension benefit at retirement (paid either in a lump sum immediately or in smaller amounts on a monthly basis until the member or his or her beneficiary dies), which is calculated by multiplying the member's number of years of credited service by his or her "final average compensation"--the average of the three highest-paid years of service, and multiplying this product by 1.5 percent. This type of pension system is known as a "defined benefit" (DB) plan because system members are guaranteed pension benefits based on the formula regardless of future unexpected circumstances (i.e., a system's fiscal instability at any given point in time).

In recent years, however, many companies in the private sector--and a few public sector employers--have begun providing their employees what are known as "defined contribution" (DC) retirement plans, in which the employer is required to contribute a certain percentage of the employee's salary toward a retirement account established for him or her, while the employee may contribute to it up to a certain amount which is matched by the employer. Funds that accumulate in a DC account are invested by the employee in a so-called 401(k) or 403(b) retirement account (named for sections of the federal Internal Revenue Code under which they are regulated) and may be withdrawn by the employee at any time--usually at retirement or when he or she leaves the company. Because of the advantages some people feel DC plans offer to both employers and employees, legislation has been proposed to offer the DC plan as an alternative to the present DB plan to current vested members of various retirement systems and future members of the Public School Employees Retirement System (PSERS), and to establish DC as the retirement plan applicable to future members of the State Employees Retirement System (SERS) and the Legislative Retirement System (LRS).

In addition, the governor is proposing an "early-out" retirement incentive for state workers, in order to streamline the state work force and reduce state payroll costs.

THE CONTENT OF THE BILLS:

House Bills 6206, 6229 and 6230 would amend the acts governing the retirement systems for, respectively, legislators and the lieutenant governor, state employees, and public school employees to establish a two-tiered retirement system where persons who were members of one of these retirement systems prior to March 31, 1997, could choose to remain within the present "defined benefits" (DB) system or opt into a new "defined contribution" (DC) system that would be created by each bill. In addition, the bills specify that persons who became members of one of these systems on or after this date would be eligible to participate only in the DC retirement plan. (However, the provisions of House Bill 6230 would take effect only upon certain occurrences; see below.) House Bill 6207 would amend the Administrative Procedures Act to reflect the changes proposed under House Bill 6229, and House Bill 6229 also includes language that would offer certain qualifying state employees the opportunity to apply for early (enhanced) retirement under special circumstances. None of the bills could be enacted unless all of them were.

House Bill 6229 would amend the State Employees' Retirement Act (MCL 38.1e et al.) to add provisions establishing a defined contribution retirement plan that would apply to members of the State Employees' Retirement System (SERS) who were hired on or after March 1, 1997, and would be optional for members hired prior to this date. In addition, the bill would offer SERS members who qualified a window of opportunity to retire from state employment early, and provide, as an incentive, an increased monthly pension amount based on increasing the so-called multiplier used to calculate pensions.

Early retirement option. The act currently provides that a member is eligible to retire at age 60 if he or she has at least 10 years of credited service, or at age 55 with at least 15 years of credited service. A retiring member's retirement allowance is calculated by multiplying his or her years of service by 1.5 percent of his or her "final average compensation" (FAC), which is the average of his or her highest three years of state compensation. The bill specifies that, notwithstanding these provisions, a member could retire and receive a retirement allowance equal to his or her number of years and any partial year of credited service multiplied by 1.75 percent of his or her FAC if he or she met all of the following criteria:

* On the effective date of retiring, he or she was 1) age 60 or older and had 10 or more years of credited service, 2) age 55 or older with 15 or more years of credited service, or 3) age 50 or older with 25 or more years of credited service.

* The member had been employed by the state for the six-month period ending on the effective date of his or her retirement, although a member who had been restored to active service during this period or was on layoff status from state employment would qualify under this provision.

* The member filed a written application with the State Retirement Board--on or after March 1, 1997, but no later than April 30, 1997--stating a desired retirement date, which would have to be at least 30 days after the execution and filing of the application but no later than June 1, 1997.

* The member had not been employed in certain "covered positions" (i.e., as corrections officers, prison personnel, or similar positions).

* The member was not employed as a conservation officer.

(It should also be noted that employees of the Michigan State Police receive a pension under their own separate retirement system act and, thus, would not qualify for early retirement under the bill's provisions.)

The director of a principal department could request that the effective date of retirement of a departmental employee be extended to a date not later than June 1, 1998. To make such a request, he or she would have to submit a written request along with the member's written concurrence to the Department of Management and Budget on or before April 30, 1997. Upon receiving this, the DMB could extend the effective date of retirement of a member who would otherwise be eligible to retire to a date no later than June 1, 1998. Any amount that a member retiring under the bill would otherwise be entitled to receive in a lump sum at retirement due to accumulated sick leave would be paid in 60 consecutive equal monthly installments.

The early retirement option would also be available to legislative employees who met the age and service requirements described above, although the application period would be December 15, 1996 to April 30, 1997, for an effective retirement date of no later than June 1, 1997.

The bill specifies that, for the fiscal year ending September 30, 1997, $750,000 would be appropriated to the DMB from pension trust funds to pay expenses associated with providing early retirement under the bill.

Opt-in to DC by current members. The bill would require SERS to provide each member who was a member on March 30, 1997, the opportunity to elect in writing to terminate membership in the DB plan (referred to in the bill as "tier 1") and participate in the DC plan (referred to as "tier 2"), which would be an irrevocable election. SERS would have to accept such an election from members during the period beginning on January 2, 1998, and ending on April 30, 1998. Members who chose not to opt into the DC plan would continue to be a member of the DB plan, and members who opted into the DC plan would elect to 1) cease to be a member of the DB plan effective 12:00 midnight on May 31, 1998, 2) become a qualified participant in the DC plan effective 12:01 a.m., June 1, 1998, and, generally, 3) waive all or his or her rights to a pension, annuity, retirement allowance, insurance benefit, or any other benefit under the act effective at midnight on May 31, 1998 (except for a transfer of accumulated amounts and except for health benefits; see below). The bill includes similar provisions that would apply to persons who were vested members of SERS on March 30, 1997, who terminated employment with the state on or after March 31, 1997, but on or before May 31, 1998, and for certain persons who, after termination, later became reemployed by the state.

The bill includes numerous other provisions governing the transfer of accumulated amounts (when a member opts into the DC plan) out of a member's DB account and into his or her DC account, recomputation of certain retirement amounts that would have to be performed by SERS on behalf of members opting into DC, and actuarial valuations of the accumulated lump sum of a member who opted out of the DB plan and into the DC plan.

The bill would require the DMB, after consulting with the actuary for SERS, to calculate for each fiscal year any cost savings that had accrued to the state as a result of implementing the bill over the costs that would have been incurred by the state to fund SERS if the bill had not been adopted and implemented. The total amount of such cost savings would have to be submitted in the executive budget to the legislature for appropriation in the next succeeding state fiscal year to the Health Insurance Reserve Fund, and any amount appropriated could not be expended until the actuarial accrued liability for health benefits was 100 percent funded.

Defined contribution provisions. The state treasurer would administer this plan and invest its assets, and would be the plan's fiduciary and trustee. Also, the state treasurer could appoint an advisory board to assist him or her in carrying out his or her duties as fiduciary or trustee, and would be granted various other responsibilities related to establishing the plan and contracting out services necessary for its administration and investment.

Under the bill, each "qualified participant, former qualified participant, and refund beneficiary" (all terms that are defined under the bill and, for purposes of this analysis, are referred to as DC participants) would direct the investment of his or her accumulated employer and employee contributions and earnings to one or more investment choices within available categories of investment provided by the state treasurer. Limitations on the percentage of total assets that may be invested in certain financial instruments (as specified under Public Act 314 of 1965, which governs the investment of public employee retirement system funds) would not apply to the DC plan. The bill includes numerous other provisions pertaining to amounts that would have to be appropriated to pay for administrative start-up costs for establishing the DC plan, prohibitions against participating in other public sector retirement systems applicable to DC participants under the bill, elected or appointed officials who decided not to participate or to discontinue participation in the DC plan, and requiring the state treasurer to credit amounts from members' former DB accounts into the DC account created when they opted into this system.

DC contributions. Currently, all contributions made toward a vested member's retirement under the act are provided by the "employer" (i.e., the state). Under the bill, the state would have to contribute to a qualified participating employee's DC account an amount equal to four percent of his or her compensation, and a qualified participant could periodically elect to contribute up to three percent of his or her compensation to the account. Also, the employer would have to match the amount contributed by the employee to his or her account with a contribution of an equal amount to the account. Participants could make additional contributions (beyond three percent) as allowed by the state treasurer and the Internal Revenue Code, although an employer would not have to match such contributions.

Vesting provisions. At present, to vest in the current DB system generally requires at least 10 years of service, although certain other employees are vested with as few as five years of service. Under the bill, a qualified participant in the DC plan would be immediately 100 percent vested in his or her own contributions made to the DC plan account, and for employer contributions made to the account on his or her behalf the participant would be vested 50 percent upon completing two years of service,

75 percent after three years of service, and 100 percent after four years of service.

In addition, a qualified participant would be vested in the health insurance coverage provided under the bill if he or she 1) had completed 10 years of service as a qualified participant and was not a member, deferred member, or former nonvested member of the DB plan, or 2) was a member, deferred member, or former nonvested member of the DB plan who elected to participate in the DC plan and who had met the service requirements he or she would have been required to meet in order to vest in health benefits under the current system.

Health insurance premiums. Currently, the act provides for 100 percent of the cost of hospitalization and medical coverage insurance premiums to be paid on behalf of retired vested members or their beneficiaries or dependents out of the Health Insurance Reserve Fund, and for 90 percent of the cost of these persons' dental or vision coverage, or both, to be paid out of this fund. Under the bill, however, the fund would pay 90 percent of the annual health insurance premium for a member who had at least 30 years of service credit, but only 30 percent for a member who had 10 years. In each year of service over 10 the fund's contribution would increase by three percent, and a member would have to have at least 10 years of service to receive any subsidy from the fund. Health care benefits under the bill would be paid on an annual cash basis.

Other provisions. The bill contains numerous other provisions pertaining to distributions to members under the DC plan, duty and non-duty disability benefits for injuries or death, health insurance and the tax-exempt status of DC accounts, among other things.

House Bill 6230 would amend the Public School Employees Retirement Act (MCL 38.1308 et al.) to give public school employees first employed on or after July 1, 1997, the option of participating in either the DC or DB retirement plans, and to make this optional for employees hired prior to this date. (However, the bill specifies that the implementation date for the defined benefit system would be July 1, 1997 only if the system's unfunded accrued liabilities are fully paid by that date. If the system was fully funded between July 1, 1997 and January 1, 1998, then the retirement board would set the date for implementation. The bill specifies that the new plan would not take effect if the system were not fully funded by January 1, 1998.) The bill includes many of the same provisions contained in House Bill 6229 pertaining to transferring from a DB plan to a DC plan and for the establishment and administration of a DC plan and criteria that would have to be met to participate and vest in it.

In addition, the bill would enlarge the retirement board, from seven members to ten members.

House Bill 6206 would amend the Michigan Legislative Retirement System Act (MCL 38.1006 et al.) to establish a similar defined contribution retirement plan for legislators and lieutenant governors who began serving in this capacity for the first time on or after January 1, 1997; under the bill, the DC plan would be optional for such elected officials who were participants in the current DB plan before this date. The bill includes provisions generally the same as those contained in House Bills 6229 and 6230 pertaining to the establishment and administration of a DC plan and criteria that would have to be met to participate and vest in it, except for vesting requirements. Under the bill, a member would be partially vested for purposes of receiving health insurance subsidies from the state after four years of service as a qualified participant. After four years of service, 50 percent of health care premiums would be paid by the retirement system. After five years of service, the system would pay 75 percent, and after six years of service, 90 percent. (Currently, legislators are vested in the retirement system after five years of service and election to the House of Representatives three times, election to the Senate twice, or an equivalent combination of service in the House and Senate.)

House Bill 6207 would amend the Administrative Procedures Act (MCL 24.207 and 24.315) to specify that provisions in the act governing guidelines, the rules promulgation process, and the authority to issue licenses which apply to state agencies would not apply to the establishment, implementation, administration, operation, investment or distribution of a defined contribution plan established pursuant to Sections 401(k) or 403(b) of the Internal Revenue Code under, respectively, the provisions of House Bills 6229 and 6230, nor to a DC plan established pursuant to the Internal Revenue Code under House Bill 6206.

FISCAL IMPLICATIONS:

The House Fiscal Agency says the defined contribution plan proposed in House Bills 6206 and 6229 would stabilize and, ultimately, significantly reduce retirement costs for the state; however, actuarial evaluations of the proposal were not available. Any savings resulting from adopting a DC plan would be directed to the health insurance reserve fund until it was 100 percent funded. Information on the fiscal impact of House Bill 6230 is not available. House Bill 6207 would have no state or local fiscal implications.

The agency also reports that the early retirement program proposed in House Bill 6229 for certain state employees

would result in significant savings to the state as long as the targeted positions remained vacant. According to the agency, the administration has indicated it plans to capture, in actual savings, 25 percent of the salary and fringe benefit cost of employees who retire under this window; departments could retain the remaining 75 percent of the funds, but could use only one-third of this money to replace workers. (Departments could, assuming replacement workers were paid less than those who retired, fill slightly more than one out of every four positions vacated.) Remaining funds could be expended for such things as automation enhancements, contractual services, and the like. Figures provided by the Department of Management and Budget indicate approximately 7,000 state employees would be eligible to retire under the bill, 50 percent (3,540) of whom are expected to participate. Based on these estimates, the bill's early retirement provisions would result in gross savings in succeeding fiscal years as follows: for 1996-97, $5.6 million; for 1997-98, $41.4 million; for 1998-99, $24.7 million; for 1999-00, $23.1; and for 2000-01, $21.2 million.

The HFA also says the DC plan under House Bill 6230 would stabilize local employer (i.e., public school districts') costs and could provide them some savings, depending on how many current and future employees opted to participate in this retirement plan as opposed to the current DB plan. (12-5-96)

ARGUMENTS:

For:

Several arguments can be made in favor of moving toward a defined contribution retirement system for public sector employees, including the following:

* DC plans offer public employees, many of whom today are likely to work for several employers over their careers, the ability to vest with a retirement system sooner and the flexibility to take whatever state contributions are made toward their retirements to another employment situation. Under the current DB system, it is estimated that anywhere from 40 to 60 percent of public sector employees--depending on the specific system and the type of employee--never vest in their respective systems due to job turnover. For many public school employees this means they begin contributing immediately to PSERS out of their own earnings even though they may never become vested and receive a pension. And even though members of the other systems are not required to contribute anything toward their pensions (the state begins making contributions toward their retirement when they are first hired), if they worked, say, nine years and then transferred to another job, they would not receive any kind of pension. Under the DC plans proposed in the bills, employees would be partially vested in employer contributions to their accounts after only two years of service and fully vested after four, and of course any amounts they contributed themselves to a 401(k) or 403(b) account would be theirs immediately. The portability of DC retirement plans make them a more attractive option for today's more mobile work force. Perhaps most importantly, however, establishing DC plans for public sector employees would encourage them, like their private sector counterparts, to begin thinking sooner and more seriously about how to provide for their own retirements.

* Historically, it has been reasonable for those working in a public sector job to expect generous fringe benefits such as those provided under a defined benefit retirement system to compensate for the lower wages paid to them compared to those in the private sector. Generally speaking, such salary disparities still exist. However, current trends suggest that while such generous retirement plans are fair to the many public sector employees who have earned them, they may be grossly unfair to the state's future taxpayers. This is particularly true in view of increasing life expectancy rates, which themselves are no doubt tied to modern advancements made in medicine and health care--made possible by increased expenditures on them. These realities have been cited as factors contributing, for instance, to the projected bankruptcy of the federal Medicare system within, by some accounts, five years. The generous DB plans, and in particular the health care benefits, currently offered to Michigan's public sector employees who are members of these retirement systems could lead to similar underfunding problems in future years for them. (PSERS, of course, is already severely underfunded.) This poses future financial risks for the state and its taxpayers.

* Under the defined benefit plan, individuals could invest money for their retirements any way they wished. Thus, if a current member of the DB system was dissatisfied with the investment approach used by the state--because he or she feels it is weighted too conservatively or, perhaps, invests in financial instruments considered too risky--he or she could alter the composition of investments to meet personal expectations. Moreover, some stocks currently included in the state's retirement portfolio are thought by some to be morally or socially unacceptable, such as so-called tobacco stocks. Retirement system members could steer clear of such stocks (or, as the case may be, invest more heavily in them) when establishing their own retirement accounts.

Against:

Arguments against adopting a defined contribution system for public sector employees would include the following:

* Some studies recently performed comparing a member of a DB system with one in a DC system--where each worked 30 years, had an ending salary of $35,000, and had similar amounts regularly contributed on their behalf--indicate that the resulting DC pension at retirement was substantially less than that obtained from a DB plan. The simple fact is, people given a choice between the two plans invariably opt for the DB plan because they know it provides more guarantees that they will have a secure retirement. Public sector employees, on average, receive compensation below that of private sector employees and it is this reality that traditionally has justified their receiving better fringe benefits such as that provided under the current DB plans for retirement. For the state to now change the terms of this tradeoff in regards to future state employees is morally and socially reprehensible. House Bill 6229 should at least be amended to give future state employees the same option as future public school employees would have under House Bill 6230 in deciding whether or not to participate in the DC plan.

* The bills would place the onus for investment outcomes on the employees themselves, rather than on the state. Many workers feel unprepared to take on the responsibility of investing their own retirement funds, as they may lack necessary knowledge and skills to protect their retirement nest eggs. Moreover, when individuals invest on their own, they tend to rely on more conservative options, rather than taking the kinds of agressive investment strategies needed to stay even with inflation and ensure an adequate retirement fund.

* If, as many expect, underfunding problems in the state's retirement systems will grow in future years--due primarily to increased numbers of retirees (i.e., the "baby-boom generation") and rising health care costs--moving future state employees out of the current DB system and into a DC system will only hasten this problem. This is because as fewer employees paid into the systems, each could have difficulty meeting increased funding liabilities. This fact may have contributed to the House Appropriations Committee's decision to amend House Bill 6230 so that the DC plan would be optional for future public school employees, since that system is already underfunded by several billion dollars.

* Considering the magnitude of this issue, more time is needed to study the proposal and allow for input from accountants, actuaries and other financial specialists to determine the impact to the current systems from moving public sector employees in those systems toward a DC plan. The bills were only introduced about two weeks ago, and only one public hearing on them has been held to date (not including hearings held on similar bills introduced in earlier legislative sessions).

For:

House Bill 6229 would give certain qualifying state employees a window of opportunity to retire early from state employment. This would save the state millions of dollars in future years as higher paid career employees could be replaced with a smaller number of lower paid employees. State officials anticipate they could utilize technology advancements to make up for the loss of experienced personnel and the fact that fewer employees would be hired to replace them. This is a good time for the state to downsize its workforce in light of the strong economy and the state's solid fiscal situation, and state officials anticipate the bill would encourage over 3,500 current state employees to retire early. Assuming this occurred, the state would still employ over 45,000 people.

Against:

Many state departments reportedly are already severely understaffed, after downsizings made in recent years and the hiring freeze imposed on them. The bill would make this situation worse. The bill could lead to an atmosphere of low morale for remaining state employees, not only due to the heavy work load they would be stuck with, but also because many may consider the disparately generous benefits provided to their former colleagues as unfair treatment.

Against:

House Bill 6206 proposes much more generous vesting provisions for retirement health benefits for legislators and lieutenant governors than that proposed for state employees and public school employees under House Bills 6229 and 6230. Under House Bill 6206, legislators and lieutenant governors would be vested at 50 percent for the payment of health insurance premiums at retirement after four years of service, 75 percent after five years, and 90 percent after six years; under the other bills, state and public school employees would need 10 years of credited service just to be vested at 30 percent, and it would take 30 years to be 90 percent vested. The provisions in House Bill 6206 were added in committee apparently because state representatives are limited by the state constitution to serving only three terms, or six years, and state senators are limited to two terms, or

eight years. However, term limits were imposed on legislators by voters at least in part due to perceptions that previous elected officials unfairly used the advantages of incumbency in order to secure reelection. The disparities in the bills regarding vesting for health retirement benefits is not only unfair, but would only feed public cynicism regarding elected officials' willingness to feather their own beds.

POSITIONS:

There are no positions on the bills.

Analyst: T. Iversen

■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.