State Notes
TOPICS OF LEGISLATIVE INTEREST
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Retirement Incentive and Pension Reform of the Michigan Public School Employees' Retirement System
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Introduction

On May 19, 2010, Governor Granholm signed into law Senate Bill 1227, Public Act 75 of 2010, which amended the Michigan Public School Employees Retirement Act. This legislation provided a window for a retirement incentive, and also implemented long-term reforms to the system, including mandatory contributions for retiree health care and a hybrid defined benefit/defined contribution pension for new employees. This article examines the changes enacted, and discusses current legal action surrounding the reforms.

The Michigan Public School Employees' Retirement System (MPSERS) provides pensions and health care to its retirees, who were eligible employees of school districts, intermediate school districts, participating charter schools, and community colleges, as well as the employees of seven universities hired before those institutions left the system. Pensions and health care are funded by a combination of employer (school) contributions and employee contributions. Employers are told yearly what percentage of their payroll to remit to the State for funding these costs; that percentage is made up of three components: a pension normal cost, a retiree health care cost, and a cost to pay for the unfunded accrued liability.

Without the recent legislation, the employer contribution rate for fiscal year (FY) 2010-11 was estimated at 19.41% of payroll. The reforms enacted in this legislation were designed to partially control the growth in employer contribution costs by shifting a portion of retiree health care costs onto employees, and by enacting the hybrid pension plan. With the enactment of this legislation, the 19.41% MPSERS rate in FY 2010-11 may decrease somewhat (reflecting a blend of the cost of paying for the retirement incentive and the savings from the new 3.0% employee contributions for retiree health), but the effects of a lawsuit (discussed below) have frozen the rate at 19.41% for the time being.

Retirement Incentive for MPSERS Employees

Currently, public school employees who are members of MPSERS have to be age 55 with 30 years of service or age 60 with 10 years of service to be eligible to retire, or may retire at any age with 30 years of service if they are in the Member Investment Plan. Under current law, the pension multiplier is 1.5%.

A member's pension is calculated by multiplying years of service by the pension multiplier by the final average compensation (FAC). For example, a person with 30 years of service, and a FAC of $60,000 would receive a yearly pension equal to 30 X $60,000 X 1.5%, or $27,000 under the normal pension formula, without an increased multiplier.

Public Act 75 of 2010 (PA 75 below) provided an increase in the pension multiplier for members choosing to retire during the window (if they submitted an application before June 11, and retire between July 1 and September 1, 2010). Specifically, a 1.6% multiplier was offered to employees currently eligible to retire, and a 1.55% multiplier was offered for employees who have a combined age and years of service totaling 80 by August 31, 2010. However, the final average compensation is capped at $90,000 under the enhanced multipliers; any higher FAC is part of the pension calculation, but at the 1.5% multiplier.

One extension (for a retirement date no later than September 1, 2011) per reporting unit was allowed, if requested by the employer and employee, and another 2,500 of retiring employees could be granted an extension, with the Office of Retirement Services distributing the additional 2,500 extensions on a pro-rata basis. Pension costs will be amortized over a five-year period.

Roughly 30.0%, or 17,000, of the 56,000 eligible public school employees took advantage of the retirement incentive. In the previous year, without an incentive, approximately 5,000 workers retired. Approximately 1,300 extensions were used. The cost to the pension system to pay for this incentive is estimated at $792.0 million amortized over five years, plus $562.0 million to pay for the health care of the additional retirees, for a total of $1.35 billion.

Increased Employee Contributions

Before the enactment of PA 75, employees in the Basic Plan (those hired before January 1, 1990) paid nothing for retirement; employees hired before January 1, 1990, who switched to the Member Investment Plan (MIP) paid 3.9% of salary toward their retirement; employees hired after July 1, 1990, and before July 1, 2008, paid $510 annually plus 4.3% of salary above $15,000; and employees hired after July 1, 2008, paid $510 annually plus 6.4% of salary above $15,000.

Public Act 75 requires all employees in MPSERS to contribute 3.0% of salary (in addition to the pre-existing pension contributions described above) into a funding account, defined as an appropriate irrevocable trust established under PA 77 of 2010 (House Bill 4073), on wages earned after July 1, 2010. However, employees who worked and made less than $18,000 in the 2009-2010 school year or new employees who are expected to make less than $18,000 in the 2010-2011 school year will contribute 1.5%, rather than 3.0% during that school year, increasing to 3.0% yearly thereafter.

It is anticipated that the 3.0% employee contributions will save employers more than $300.0 million per year, or $3.5 billion over a 10-year period. These savings will be realized by a lower employer contribution rate than otherwise would have occurred in the absence of the employee contributions. However, at the present time, the judge presiding over a lawsuit in Ingham County Circuit Court has ordered that the employee contributions being remitted as of July 1, 2010, be placed in escrow until the lawsuit is resolved. Therefore, the Office of Retirement Services will continue to charge MPSERS employers 19.41% of their payroll to be remitted for support of the pension system, until the lawsuit is resolved, at which time the actuary will again re-examine the system and determine if the rate should be adjusted, and in which direction.

In general terms, the lawsuit (*McMillan, et al.* vs. *MPSERS, et al.*) alleges that the new 3.0% employee contributions for retiree health care are a violation of the State's contract with the members of the Retirement System. Since there was no corresponding increase in benefits, the lawsuit alleges that the increased employee contributions impair or violate the State's contractual obligation to provide health care benefits as prescribed in the Retirement Act. If the lawsuit is decided in favor of the plaintiffs and the 3.0% employee contributions are disallowed, then there will be a net increase to schools to pay for the retirement incentive, since there will no longer be offsetting savings from employer contributions to pay for the incentive. If the lawsuit is decided in favor of the State, and the 3.0% employee contributions are allowed to be counted in FY 2010-11, the MPSERS employer contribution rate may fall somewhat below the 19.41% currently being charged.

Hybrid Plan for New Employees

Employees first hired on or after July 1, 2010, will be placed in a new "hybrid" pension plan, with a blending of defined benefit (DB) and defined contribution (Tier 2) components. A person under this plan will not be able to receive pension payments until age 60, and will be required to have worked at least 10 years as a public school employee. The purchase of service credit by these employees is prohibited, and cost-of-living adjustments to the pension are not provided. An employee will have to contribute $510 annually plus 6.4% of salary above $15,000, in addition to the Tier 2 contributions described below.

An employee under this plan will have to contribute 2.0% of salary to his or her Tier 2 account, unless affirmatively electing not to contribute or to contribute a lesser amount. The employer will have to match 50% of the employee's first 2.0% of salary contribution, for a maximum total employer payment of 1.0% of salary deposited into the Tier 2 account. This is in addition to the employer cost for the DB pension of this employee. The employee will be allowed to contribute more than 2.0% of salary, but the employer will not match more than 1.0%, unless choosing to do so under a locally negotiated agreement. An employee described here is immediately vested in his or her own contributions, and will vest in employer contributions as follows: 25% after two years of service, 75% after three years of service, and 100% after four years of service.

The DB side of this hybrid plan will use a five-year period on which to calculate the final average compensation, likely generating a lower FAC than is in current law. (For Basic Plan members, the time frame is five years; for MIP members, the time frame is three years.) Also, under this plan, the actuary will be required to assume a 7.0% rate of return on the investments in the portfolio (rather than the 8.0% rate under current law). The actuary may determine a different employer contribution rate for these members.

Any entity receiving full or partial, direct or indirect funding from the School Aid Fund, and not participating in MPSERS, may opt into the hybrid retirement plan for its employees, upon approval by the Internal Revenue Service. In addition, existing MPSERS employees hired before July 1, 2010 (i.e., not part of the hybrid plan) may opt into the Tier 2 component of the hybrid plan without an employer match. Hybrid plan employees may contribute more than 2.0%, and employers may locally negotiate higher matches than the required 1.0%, not to exceed a total match of 3.0% (for an employee contribution of 6.0%). However, any additional employer match beyond 1.0% is at the discretion of the employer, and must be decided annually. An employer may negotiate matches for nonhybrid employee contributions.

Third-Party Contracted Employees

Currently, members who retired before July 1, 2010, may return to work and avoid the earnings limitations in statute (roughly one-third of final average compensation) if they return to work as contractual employees, using a third-party employer. The employer also does not have to pay contributions to MPSERS for these employees.

Public Act 75 closed this avoidance of the earnings limitation cap. Members retiring on or after July 1, 2010, who draw a pension and return to work directly for a MPSERS reporting unit will remain subject to the current earnings limitation cap, meaning they may draw a pension and retiree health care and still earn a working salary equal to roughly one-third of their FAC. However, if a retiree working directly for a reporting unit exceeds that earnings cap, then the retiree will forfeit pension and retiree health care, until he or she ceases employment. Also, new retirees who return to work indirectly (either via a third party or as an independent contractor) will have their pension and retiree health care suspended (i.e., not provided) for the period of time they are performing core services.

Detailed Fiscal Analysis

Public Act 75 includes an increase in the pension multiplier from 1.5% to 1.6% for people already eligible to retire, and allows an "early out" for people with a combined age and years of service equal to 80, with a pension multiplier of 1.55%. With the known participation rate of 30%, the estimated cost of these provisions is $1.35 billion, distributed over the next six years, but will be partially offset by estimated wage and replacement savings of $1.04 billion, leaving a net cost of the incentive estimated at $317.0 million over 10 years. This analysis assumes the 30% participation rate for those retiring with the enhanced multipliers, that 90% of employees will be replaced (compared with the current 95% average replacement), and that wage savings will accrue during the years these people otherwise would have worked. Clearly, the assumptions on replacement and wage savings are merely that, since each local school will determine its own replacement and salary schedules for its retirees.

If found to be legal, requiring all employees to pay 3.0% of salary toward retirement health care will create savings for employers, because these employee contributions will be used to help pay for current-year retiree health care costs, and will reduce the employer contribution rate from what it otherwise would have been. The estimated employee contributions total $300.0 million in the first year, and $3.5 billion over 10 years (as shown in the attached table).

The revised hybrid plan is estimated to save $1.2 million in the first year, and $129.4 million over 10 years.

The combined effects of the three components described above (assuming 3.0% employee contributions to support current retiree health care costs are allowable, the pension incentive, and the hybrid plan for new employees) are estimated to save schools and other MPSERS reporting units $553.0 million in the aggregate for FY 2010-11, totaling an estimated $3.33 billion over 10 years. These savings will vary from employer to employer, and will depend upon the number of additional people who retire because of the incentive, and the wage and replacement decisions made by schools. At the extreme ends of the scale, a school with no retirees could see additional costs during the first six years (to pay for the enhanced incentives provided to other schools' retirees), while a school with large numbers of retirees who are not replaced could see substantial savings, even after netting out the extra cost of the incentives.

Local savings in the initial years will not be affected via a lower MPSERS contribution rate, because the pension system will have to pay for the enhanced multiplier and the early out. In fact, the contribution rate may increase in the short term, above what it otherwise would have been, and certainly will increase if resolution of the lawsuit determines that employee contributions may not be collected. Any local savings in the initial years will be driven entirely by local decisions: employees retiring (or not) and the wage and replacement decisions made by the employer. Once the costs of the enhanced multiplier and early out have been paid for (by FY 2016-17), the MPSERS contribution rate should be around three percentage points lower than what otherwise would have occurred (without these changes in law), but only if the employee contributions are allowed. This is because of the increased employee contributions to the system, and the introduction of the hybrid plan for new employees, both of which lower the cost to employers, via the MPSERS contribution rate.

School Employee Pension Reforms: 10-Year Estimated Savings Analysis of Public Act 75 of 2010
(Dollars in Millions)

	FY 2010-11	FY 2011-12	FY 2012-13	FY 2013-14	FY 2014-15	FY 2015-16	FY 2016-17	FY 2017-18	FY 2018-19	FY 2019-20	Cumulative Savings Total
3.0% Employee Contributions[1)]	$300.0	$310.6	$321.4	$332.6	$344.2	$356.4	$368.7	$381.6	$395.1	$409.1	$3,519.7
Revised Hybrid Plan for New Employees	1.2	4.0	6.5	8.9	11.3	13.8	16.5	19.4	22.4	25.4	129.4
Retirement Incentive – Pension Cost	0.0	(158.3)	(158.3)	(158.3)	(158.3)	(158.3)	0.0	0.0	0.0	0.0	(791.3)
Increased Retiree Health Care Costs	(176.4)	(176.4)	(176.4)	(32.9)	0.0	0.0	0.0	0.0	0.0	0.0	(562.1)
Wage Savings	427.7	334.4	224.0	50.7	0.0	0.0	0.0	0.0	0.0	0.0	1,036.8
Estimated Gross Savings	**$552.5**	**$314.3**	**$217.3**	**$201.1**	**$197.2**	**$211.9**	**$385.2**	**$401.0**	**$417.5**	**$434.5**	**$3,332.5**

[1)] Currently held in escrow pending resolution of lawsuit.

Note: See assumptions detailed above.

Source: Senate Fiscal Agency