House Legislative Analysis Section
Romney Building, 10th Floor
Lansing, Michigan 48909
Phone: 517/373-6466

SERS; CHOOSE DEFINED BENEFIT OPTION

House Bill 5807 (Substitute H-1)
First Analysis (5-20-98)

Sponsor: Rep. Eileen DeHart
Committee: Public Retirement

THE APPARENT PROBLEM:

Public Act 487 of 1996 amended the State Employees Retirement Act to create a new defined contribution retirement program. Entry into the new program was mandatory for new employees hired on or after March 31, 1997, and was optional for those who were members of the retirement system at the time the new program was adopted. (Pre-1997 employees could remain in the existing defined benefit program; they were required to make an irrevocable election, by April 30, 1998, choosing whether to enter the new defined contribution program.)

The traditional defined benefit pension system guarantees a lifetime pension benefit for those employees who are "vested" in the system (those who have at least 10 years of service with the state), and the amount is based on a formula that multiplies the employee's years of service times his or her final average compensation times 1.5 percent. The state funds the system with annual contributions, which are actuarially calculated to ensure that the system has enough assets to pay benefits to current retirees. The state's annual contribution rate varies, depending on investment assumptions, the number and ages of retirees and current employees, and so forth.

By contrast, in the new defined contribution system, the state contributes a fixed amount for each employee -- four percent of his or her salary, plus a matching contribution of up to three percent, if the employee contributes an equal amount. Thus, the state's contribution rate remains steady at (at most) seven percent of payroll. The employee, on the other hand, takes responsibility for investing his or her own account in a 401(k) plan, and bears the risk of whether the amount invested will grow enough to provide an adequate retirement income.

The 1996 legislation was part of a package of bills that converted the major state retirement systems to defined contribution systems for all new state employees, legislators, and judges. As part of the package, one bill would have also converted the Public School Employees Retirement System to the new system; that bill, however, was amended to make the new plan optional for school employees (and later the defined contribution provisions were repealed). In addition to converting state retirement systems to defined contribution plans, the package included a generous early retirement plan for senior state employees. The result, say critics, is a three-tier system that treats groups of employees in a disparate manner: older, more senior state employees who were able to take advantage of generous early retirement provisions; a second group of state employees who are vested in the defined benefit program and who will be able to retain those benefits as they retire; and a third, lesser retirement system for employees hired after March 31, 1997, consisting only of a 401(k) plan that puts all the risk on the employees. This disparate treatment of similar employees has been criticized on the number of grounds, and many believe it should be reversed.

THE CONTENT OF THE BILL:

House Bill 5807 would amend the State Employees Retirement Act to provide a choice between the two retirement plans for those state employees hired on or after March 31, 1997. Employees hired on or after the effective date of the bill would have 30 days after beginning employment to choose between "Tier 1" (the traditional defined benefit retirement program) and "Tier 2" (the new defined contribution plan). The choice would be an irrevocable election, and if a person did not file the election during the 30-day period, he or she would be considered to have elected Tier 2.

Further, all state employees would have 60 days after the effective date of the bill to terminate participation in Tier 2 and elect to become a member of Tier 1. The choice would be irrevocable, and anyone enrolled in Tier 2 who did not make an election within the 60-day period would continue to be a member of Tier 2.

An election made under the bill would require the signature of the spouse of the member, if married, though the retirement board could waive this requirement if the spouse's signature could not be obtained because of extenuating circumstances.

The bill specifies that if the bill or any portion of the bill would cause the retirement system to be disqualified for tax purposes by the Internal Revenue Service, then the portion that would cause the disqualification would not apply.

House Bill 5807 is tie-barred to House Bill 5857, which would amend the Judges Retirement Act to provide a choice of a defined benefit program or a defined contribution program for new members of that retirement system, as well as to make technical corrections to the act.

MCL 38.1i et al.

FISCAL IMPLICATIONS:

According to the House Fiscal Agency, in the short term, the bill has no fiscal implications for the state. In the long term, state costs would likely increase under the bill. (5-19-98)

ARGUMENTS:

For:

The bill would provide the same choice to new state employees (hired on or after March 31, 1997) that was given to more senior employees: whether to choose the new defined contribution retirement plan, or whether to opt into the traditional defined benefit plan. The decision to make the new plan mandatory for all new employees has been criticized on a number of grounds.

• The current law sets up a disparate, even discriminatory, system that treats one group of employees far differently than another group, even though they may be working right alongside each other, performing the same duties, earning the same salary. This creates resentment among employees and undermines morale. When one also considers the groups that were able to take early retirement with an even more generous pension, the situation seems even more unfair.

• One of the benefits of the new system for employees is that it is more "portable"; in other words, a person doesn't have to be a career state employee (with 10 years of credited service) to earn a pension; under the defined contribution system, a person is fully vested in his or her account, including employer contributions, after four years of employment. However, many are concerned that this feature will create an incentive for people to come into state employment for only short periods of time and then leave with their pension benefits. State managers worry that the state will become a "training ground" for other industries, and that training and recruitment costs will increase. Others are concerned that the new pension plan is not attractive enough to enable the state to recruit the best and brightest employees.

• The state has recently completed a comprehensive education program for current state employees to assist them in deciding whether to switch into the new defined contribution system (some feel the program was "sold" to employees, and at great expense). In the end, most state employees (about 85 percent) chose to stay in the traditional retirement program. Many found that it was a decision that depended on a number of factors: one's age and proximity to retirement, whether one plans to be a career state employee or a short-term employee, whether one's spouse had a retirement plan and what kind, and so forth. Many state employees do not wish to take on the responsibility of investing their own funds, but prefer to leave those decisions to the professionals who manage the state's pension funds. Moreover, many chose the stability of a fixed, lifetime benefit over the risk of the stock market. To deny future state employees those same choices is discriminatory. The mandatory transition from a defined benefit program to a defined contribution system is clearly more in the interest of the employer, the state, than in the employee's best interests.

• One of the less discussed, but significant, features of the 1996 legislation was to change the level of health benefits available to retirees. Under current law, people hired on or after March 31, 1997 will receive a greatly scaled down health benefits package at retirement. Where pre-1997 members will receive 100 percent payment of health insurance premiums at retirement, those in the newer group will receive only 30 percent of health premiums after 10 years of service, and at most, 90 percent after 30 years of service. The bill, by allowing newer employees to opt into the defined benefit program, would presumably also allow them to get into the more generous health care benefits plan as well.

• The current law treats state employees very differently than public school employees, whose retirement system has not been converted. Traditionally, those two groups of employees have been treated equally in terms of pension benefits. It has been pointed out that the legislature recently enacted legislation that changed the investment assumptions of both of these large state pension systems. By taking advantage of the soaring stock market, the state was able to reduce its contribution to the retirement systems and use the savings in other areas of the budget. In exchange, the defined contribution provisions were removed from the Public School Employees Retirement System Act. State employees, however, were given nothing in exchange for the greater risk assumed by their retirement system.

Against:

The administration opposes the bill, citing the advantages to employees of the new defined contribution plan. Providing a "portable" pension plan is the best way to meet the needs of an increasingly mobile workforce. Further, the new plan meets the needs of all new employees, not just those with 10 or more years of service. Many would benefit from a plan that allows them to take their fund with them to each new employer and have it continue to grow with each subsequent job. The defined contribution plan allows employees to earn at least a partial pension benefit after just two years of employment; this benefits far more employees than the traditional system.

Many public employers (and most private sector employers) offer only a defined contribution plan. It is unfair to the state taxpayers to perpetuate an expensive system that places the risk on the state budget. Further, to open a window period to allow those who have recently converted to the defined contribution plan to revert back to the defined benefit program would create confusion, uncertainty, and unnecessary administrative costs.

POSITIONS:

The Retirement Coordinating Council supports the bill. (5-19-98)

The Michigan State Employees Association supports the bill. (5-19-98)

The UAW Michigan Community Action Program supports the bill. (5-19-98)

Representatives of the following testified in support of the bill (5-19-98):

• The Michigan State Employees Association (MAGE)

• UAW Local 6000

• The Michigan Professional Employee Society

The Department of Management and Budget opposes the bill. (5-19-98)

Analyst: D. Martens

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.