Budget Action Plan:
Restructuring Options to the State Legislature for Transforming Michigan's Budget

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Executive Summary

When Michigan's fiscal year (FY) 2007 and 2008 budgets were finally resolved last year, measures that provided substantial government reform were largely absent. Although some taxes were raised, some spending cuts enacted, and some modest changes to public employee benefits were adopted, Michigan's structural deficit remains, and it will grow to a deficit of $9.6 billion by FY 2017—only ten years away—if current spending and tax policies continue.

Recognizing the significant budget proportion represented by corrections, Medicaid, and public employee compensation and benefits, this report builds upon the recommendations provided by a number of organizations and provides specific options for policymakers to consider. These options are *not* intended to provide relief for the state budget in the near term; rather, they will restore the state's fiscal health over the next decade and lay the foundation for future economic prosperity.

Corrections

- Simply put, (1) Michigan's prison population is larger than the average of Great Lakes states, (2) Michigan keeps prisoners locked up longer than the average of the Great Lakes states, and (3) Michigan spends more money confining them than other Great Lakes states.
- In order to achieve meaningful reform and cost savings, Michigan must adopt solutions that directly address these primary drivers of corrections costs and bring the state closer to the average of other Great Lakes states. Namely, (1) change incarceration policies to reduce the *number* of prisoners; (2) change incarceration policies to reduce prisoners' *average length of stay*; and (3) make operational changes to control departmental costs.

Medicaid

- Michigan has been a leader among the states over the past decade in maximizing federal Medicaid match dollars to fund services that would otherwise have been supported by the General Fund. Even so, cost increases in Michigan (as in other states) are placing increasing pressure on the state budget to narrow the groups of people eligible for Medicaid, cut back on covered benefits, and increase costs for beneficiaries who remain eligible as the most direct means of major cost savings.
- However, cuts to eligibility and benefits will only shift costs onto the private sector, and additional cuts to provider and health plan payments will push more and more providers out of the Medicaid program, jeopardizing access to care. In place of a series of legislative budget reductions, several options are for Michigan to better coordinate care, change the mix of services from institutional settings to community-based ones, promote healthy behaviors and preventive care, and improve efficiencies in the delivery of care. These options should be deliberated in the context of a statewide dialogue to set priorities for Medicaid benefits.

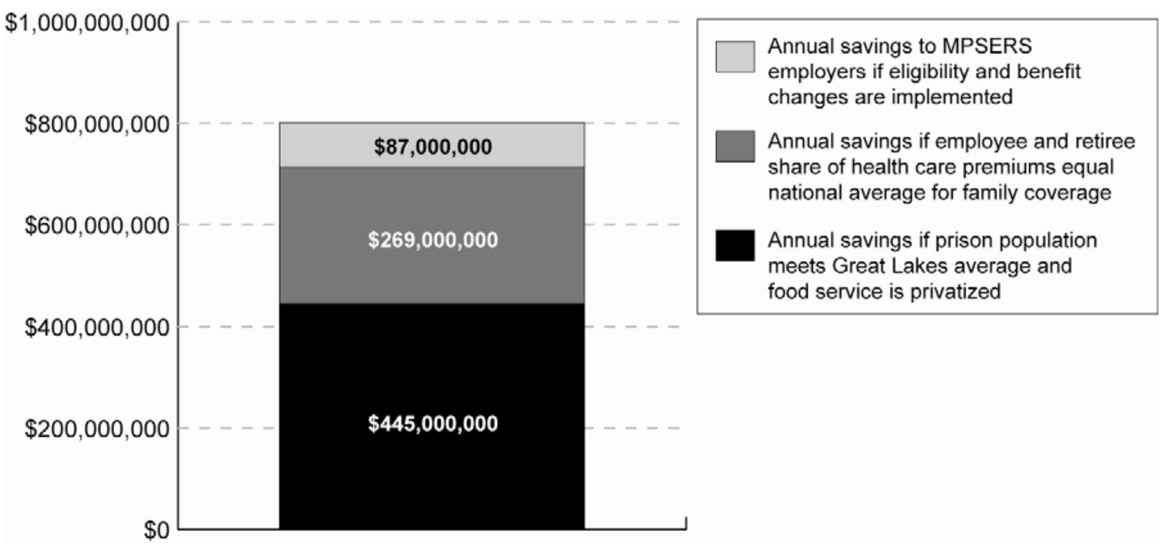
Teacher Retirement Benefits

- Michigan's teacher retirement system includes benefit provisions that are similar to those of other large public employer systems. However, the system also includes legacy costs that are unsustainable if the state wants to adequately fund the K–12 public school system in both the short and long term. To wit: a major portion (42 percent) of the increase in school aid appropriations over the last five years went to pay for the increased cost of public school retirees and beneficiaries.
- There are two main avenues to address the legacy costs: change eligibility and benefit policies for all newly hired teachers, and convert the retirement plan into a defined contribution–style plan.

State Government Employee Health Benefits

- State of Michigan employees have a health benefit package that is more expensive per employee than the national average for other state employee systems. In addition, State of Michigan employees pay a smaller share of the insurance premium than the national average for both other public sector and private sector employer systems.
- The two alternatives most likely to significantly reduce health care costs are reducing the benefit package and increasing the employee's or retiree's share of the premium cost, so that Michigan's state employee health benefits are brought into line with other public and private sector employers.

Estimated Annual Savings in Ten Years
if Recommended Changes Are Implemented



NOTE: Amounts are presented in current year dollars and have not been updated for inflation.

Introduction

Governor Jennifer Granholm appointed the bipartisan Emergency Fiscal Advisory Panel (EFAP) early in 2007 to assess the state's fiscal crisis and provide direction on how best to avoid similar crises in the future. Noting the persistent structural deficit plaguing the state, the panel's *Michigan's Defining Moment*[1] report emphasized the need for fundamental reform of state government and the delivery of public services.

Calling upon state government to become more efficient and productive, the report noted how the private sector in Michigan has been forced to respond to structural changes in the economy: "Government cannot insulate itself from the forces that are challenging the private sector. Who in the private sector can afford to carry excess capacity, not consolidate where appropriate, fail to add value at every state of production, not subject major expenses to competitive bidding, not measure benefits against costs?"[2]

When the fiscal year (FY) 2007 and 2008 budgets were finally resolved last year, the report's recommendations for substantial government reform were largely unaddressed. For FY 2007, the state budget was once again balanced through a series of short-term fixes that included borrowing against future revenues, accounting changes, delayed payments, and other one-time adjustments. Although by FY 2008 some taxes were raised, some spending cuts enacted, and some modest changes to public employee benefits were adopted,[3] Michigan's structural deficit remains, and it will grow to a deficit of $9.6 billion by FY 2017—only ten years away—if current spending and tax policies continue.

In a year-end review of the budget resolutions, the Citizens Research Council of Michigan (CRC) observed that the paths of revenue growth and spending pressures remained unaltered—in other words, the structural deficit remains.[4] In its May 2008 report, *Michigan's Fiscal Future*, the CRC cited corrections, Medicaid, public employee compensation (including retirement), and public employee health care coverage generally as the primary reasons for projecting a combined General Fund and School Aid Fund deficit of $9.6 billion by FY 2017 if current spending and tax policies continue.[5]

The need for fundamental change in the delivery of public services is even greater now than when the EFAP issued its recommendations in February 2007. Lawmakers are uniquely poised to implement one of the strategies arising out of the *Michigan's Defining Moment* public engagement campaign: Establish a new "public purse"—a tightly

[1] Governor's Emergency Financial Advisory Panel, *Michigan's Defining Moment: Report of the Emergency Financial Advisory Panel* (Lansing, Mich.: Governor's Emergency Financial Advisory Panel, February 2, 2007). [Online, accessed 7/30/08.] Available: *http://www.publicsectorconsultants .com/Documents/EFAP/EFAP_Final_Report.pdf*.
[2] Ibid., 16.
[3] Teacher health insurance pooling, graded premiums for teacher retiree health benefits, and increasing the percentage teachers must pay into the defined benefit pension system were enacted.
[4] Citizen's Research Council of Michigan (CRC), *Michigan's Fiscal Future: Long-term Analysis of Michigan's Economy and State Budget* (Livonia, Mich.: presentation dated December 14, 2007). [Online, accessed 7/30/08.] Available: *http://www.crcmich.org/PUBLICAT/budgetcrisis.html*.
[5] CRC, *Michigan's Fiscal Future, Report 349* (Livonia, Mich.: CRC, May 2008). [Online, accessed 7/30/08.] Available: *http://crcmich.org/PUBLICAT/2000s/2008/rpt349.pdf*.

focused, long-term, sustained taxing and spending strategy.[6] Recognizing the significant budget proportion represented by corrections, Medicaid, and public employee compensation and benefits, this report builds upon the recommendations of the EFAP and provides specific options for policymakers to consider—not for balancing next year's budget, but for changing Michigan's fiscal course toward sustainable prosperity for generations to come.

[6] The Center for Michigan, *Michigan's Defining Moment: A Common Ground Agenda for Michigan's Transformation* (Ann Arbor, Mich.: Center for Michigan, May 2008), 12. [Online, accessed 7/30/08.] Available: *http://www.thecenterformichigan.net/blog/wp-content/uploads/2008/05/common-ground-agenda-for-michigans-transformation.pdf*.

CORRECTIONS

According to the Michigan Department of Corrections (MDOC), Michigan's prison population will reach roughly 51,000 by the end of 2008 and 56,000 by 2012. The sheer size of our prison population places a weighty burden on the state budget, accounting for more than 20 percent ($2 billion) of Michigan's General Fund dollars. If population growth continues at the expected rate, annual spending for the MDOC will increase to $2.6 billion by 2012.[7] As the Citizens Research Council of Michigan (CRC) notes in its recent report, "The growth of correctional expenditures has been dramatic over the last 35 years and, second only to the increase in Medicaid expenditures, this growth has been the largest contributor to the ongoing State structural deficit. Given the magnitude of Corrections expenditures, it will be extremely difficult to bring long-term balance to the State General Fund budget without significant alteration of Corrections policy."[8]

Understanding the growth in the prison population is paramount to tackling the budget crisis issue. Simply put, (1) Michigan's prison population is larger than the average of Great Lakes states;[9] (2) Michigan keeps prisoners locked up for longer periods of time than the average of the Great Lakes states; and (3) Michigan spends more money confining them than other Great Lakes states (see Exhibit 1).

EXHIBIT 1
Michigan Corrections Compared to Great Lakes Average, 2005

Characteristic	Michigan	Great Lakes average
Average prison population	49,337	35,752
Average length of stay (months)	44.4	30.0
Incarceration rate per 100,000 residents	489	338
Annual cost per inmate	$28,743	$28,227
Average cost per inmate per stay	$106,349	$70,567
Annual cost of prison population to state budget	$1,417,945,380	$1,009,171,704

SOURCE: Citizens Research Council of Michigan; calculations by Public Sector Consultants.

In order to achieve meaningful reform and long-term cost savings Michigan must:

- Change incarceration policies to reduce both the *number* of prisoners in the correction system and prisoners' *average length of stay*
- Make operational changes to control departmental costs

[7] CRC, *Growth in Michigan's Corrections System: Historical and Comparative Perspectives, Report 350* (Lansing, Mich.: CRC, June 2008), vi. [Online, accessed 7/30/08.] Available: *http://www.crcmich.org/PUBLICAT/2000s/2008/rpt350.pdf*.

[8] Ibid., 1.

[9] Lindsay Hollander, *Incarceration and Its Costs in Michigan* (Lansing, Mich.: Senate Fiscal Agency, May 2007). [Online, accessed 7/30/08.] Available: *http://www.senate.michigan.gov/sfa/Publications/Issues/IncarcerationCosts/IncarcerationCosts.pdf*. The Great Lakes states are Illinois, Indiana, Michigan, Minnesota, New York, Ohio, Pennsylvania, andWisconsin.

Restructuring Option: Change Incarceration Policies to Reduce Prison Population to the Great Lakes Average

Changes to criminal statutes and sentencing guidelines are difficult political pills to swallow. Legislators tend to be wary of proposals that would reduce sentences and make them look "soft on crime"—a stance that is typically reinforced by the law enforcement community and victim's rights groups. However, Michigan's prison incarceration **rate** is 45 percent higher than the average of the Great Lakes states. In order to reduce spending now, as well as for the long term, changes must be made to the state's approach to dealing with criminal behavior. By resolving to reduce the prison population to meet the Great Lakes average, Michigan's legislators will demonstrate their commitment to appropriate fiscal practices and recognize cost avoidance annually, up to roughly $400 million per year.[10]

An important consideration when cost savings are achieved by lowering the prison population or reducing the time that a prisoner stays in prison is the reinvestment cost of releasing prisoners back into society. Initiatives to reduce the prison population and control spending must be balanced with reinvestment dollars (such as the Michigan Prisoner Reentry Initiative), which will improve the likelihood that prisoners who are released are not returned to the custody of the state system.

Change Sentencing Guidelines to Reduce the Length of Stay for Michigan Prisoners

Michigan's statutory sentencing guidelines categorize felony offenses by crime class and severity of crime, and assign a sentencing range for the offense. The average length of stay for a prisoner in the Michigan Department of Corrections is 44 months, or 14 months more than the Great Lakes average of 30 months.[11] In addition, Michigan's truth-in-sentencing laws require that full minimum sentences be served before prisoners are eligible for parole.

Sentencing guidelines and truth-in-sentencing laws are not concepts unique to Michigan; however, Michigan's strict adherence to the 100 percent minimum sentence for all prisoners is stronger than federal guidelines, which allow for less than the full term (85 percent) to be served. In addition, Michigan does not allow for "good time" credits (which many states and the federal government do) and applies mandatory minimums for *all* crimes, as opposed to violent offenses only.[12]

Significant cost savings can be achieved by reducing mandatory minimums. When Michigan reaches the average length of stay for the Great Lakes region, the state will save approximately $34,500 per prisoner stay. This decrease alone would bring Michigan down from an average of approximately $106,000 to $71,000 per stay, which is roughly

[10] Calculated as follows: 13,585 fewer prisoners (the difference between Michigan's and the Great Lakes' average prison population) multiplied by $28,743 (Michigan's annual cost per prisoner) equals $390,473,655 in avoided costs. Prison population reduction of this proportion would happen over a period of years; costs could be avoided each year, increasing until they reach nearly $400 million in the year Michigan meets the Great Lakes average.
[11] CRC, *Growth in Michigan's Corrections System*, 25.
[12] Ibid., 5.

the Great Lakes average. According to the CRC, had Michigan reduced the average length of stay for Michigan prisoners by one year from 1990 to 2005, the prison population would be reduced by 14,000, the incarceration rate would be 351 per 100,000 (rather than 489/100,000), and corrections expenditures would have decreased by $403 million for each year the population was sustained at the lower level.[13]

Reduce Number of Prisoners Serving Past Earliest Release Date

Exacerbating the relatively high average length of prison stay for Michigan prisoners is a relatively high number of prisoners who serve beyond their Earliest Release Date of Parole (ERD). In 2006 approximately 16,000, or 31 percent, of Michigan prisoners were serving beyond their ERD.[14] If all 16,000 serving beyond their ERD were released, the state would save $459 million annually. However, some of these prisoners (such as violent criminals and/or sex offenders) are not good candidates for release at their ERD; therefore the savings would likely be less than $459 million.

Preclude Prison for Some Crimes

In 2007, 23 percent of the state's prison population (or 11,822 prisoners) were incarcerated for "nonviolent crimes"[15] at a cost of approximately $340 million annually. Policies that reduce this population (for example by eliminating prison sentences for *nonviolent* crimes) should be considered.

Restructuring Option: Operational Changes to Improve Efficiency

The major cost savings in corrections reforms are in reducing the number of prisoners and their average length of stay, and in making operational changes to the department. These operational areas include prisoner transportation, delivery of mental health services, and food service. For most of these, precise cost savings are very difficult to estimate. Further auditing and investigation into the specifics of these cost savings are highly recommended.

One area where good data does exist is the cost of the prison food service system. A recent report by the Michigan Senate Subcommittee on Prison Reform and Public Safety (as well as a June 2008 Michigan Auditor General's report) cited several potential areas of significant cost savings within the MDOC food service delivery system. The average daily cost of feeding a Michigan prisoner is $4.68. According to the Auditor General's report, both Kansas and Florida use private contractors to provide prisoner meals at average daily costs of $4.14 and $2.65, respectively. Based on these costs, the Auditor General estimates possible cost savings of $10.2 million to $38 million annually.[16]

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[13] CRC, *Growth in Michigan's Corrections System*, 12.
[14] Ibid., 13.
[15] Ibid., 7.
[16] Michigan Office of the Auditor General Audit Report, *Performance Audit of Prisoner Food Services, Department of Corrections* (Lansing, Mich.: Office of the Auditor General, June 2008). [Online, accessed 7/30/08.] Available: *http://audgen.michigan.gov/comprpt/docs/r471062107L.pdf*.

MEDICAID

Michigan Medicaid provides a vast range of medical and health services to 1.8 million residents, at a cost of roughly $8.3 billion.[17] Each dollar of Michigan's General Fund that is spent on Medicaid brings in $1.40 from the federal government—so reducing Michigan's Medicaid expenditures would also bring the loss of federal dollars that are used to care for the state's vulnerable populations. Michigan has one of the most cost-effective Medicaid programs in the nation—ranked 41st in per enrollee expenditures and lowest of the Great Lakes states in 2005[18]—and it has been especially accomplished in maximizing federal matching dollars. Michigan has done much to contain General Fund costs in Medicaid. In the recently enacted FY 2009 budget, Medicaid represents 25 percent of the General Fund, the same proportion as in FY 2002 when it covered 500,000 *fewer* people.

There are a limited number of ways to contain Medicaid General Fund costs:

- Cut people from the rolls by restricting eligibility for optional populations. For example, eliminating eligibility for parents and caretaker relatives would save $55.5 million General Fund. This would cost the program $72.8 million in matching federal funds.[19] Such cuts will increase the ranks of the uninsured, whose health care costs will be borne by providers and private businesses offering coverage to their employees.

- Cut payments to health care providers (physicians, hospitals, nursing homes, and others) and health plans. Michigan has made such cuts in recent years and partially restored them because they drive providers from the program, curtailing access to necessary care for those on Medicaid.

- Cut services that Medicaid covers. In recent years, Michigan has cut costs for prescription drugs and related services (saving $50.8 million General Fund) and adult dental, podiatric, and chiropractic care, as well as hearing aids—saving $12 million General Fund. The latter cuts were restored.

- Shift Medicaid costs onto payers outside state government, most prominently the federal government. Michigan has been a leader in maximizing federal Medicaid match dollars to fund services that had previously been supported by the General Fund. Over the last ten years, state General Fund increases for the four community health networks[20] have fallen well below the 32 percent increase in the Detroit Consumer Price Index. While General Fund support has not kept pace with inflation, overall funding has *increased* primarily as a result of increased reliance on federal

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[17] The Henry J. Kaiser Family Foundation, *FY 2006 Medicaid Fact Sheet*, June 26, 2008. [Online, accessed 8/1/08.] Available: *http://www.statehealthfacts.org/mfs.jsp?rgn=24&rgn=1&x=12&y=6*.

[18] The Henry J. Kaiser Family Foundation, *Medicaid Payments per Enrollee, FY 2005.* [Online, accessed 8/7/08.] Available: *http://www.statehealthfacts.org/comparetable.jsp?ind=183&cat=4&sub=47&yr=28&typ=4&sort=218&o=d*.

[19] Michigan House of Representatives, House Fiscal Agency, *Managing Medicaid Costs in Michigan: A Legislative Briefing* (Lansing, MI: House Fiscal Agency, January 2007)

[20] Area agencies on aging, community mental health services programs and authorities, local public health, and substance abuse coordinating agencies.

Medicaid funding; for example, Medicaid program expenditures represent 77 percent of the 2008 community mental health service program appropriation, compared to 52 percent in 1998. Moreover, new waivers (family planning and Adult Benefit) have saved General Fund dollars and expanded benefits, and provider taxes have leveraged additional federal dollars.

- Require that those on Medicaid pay a portion of the cost of services that they receive (copayments) For several years, Michigan has required copayments for certain Medicaid services and products: physician office visits, dentist visits, outpatient hospitalization, inpatient hospitalization, emergency room visits for non-emergency care, brand-name and generic drugs, and others. These copayments are intended to encourage modest enrollee financial responsibility and discourage unnecessary use of care. Research from other states, however, suggests different results. An extensive study of Arizona Medicaid found that high administrative costs associated with collecting copayments and the requirement that states return to the federal government its share of the collected copayments significantly limited cost savings to the state. Even more counterproductively, the study shows that copayments "result in across-the-board reductions in all service usage, not just less important services or products."[21] Discouraging use of necessary services among Medicaid enrollees will only drive up program costs when they need more expensive care down the road.

Nevertheless, there are opportunities to deliver care more efficiently in Medicaid without jeopardizing access to and quality of care. As noted in the House Fiscal Agency's January 2007 report, "Managing Medicaid Costs in Michigan," the state can, in addition to the options mentioned in the bullets above, do the following[22]:

- Better coordinate care, particularly for persons with high-cost, chronic conditions
- Change the mix of services utilized from higher-cost care in institutional settings to lower-cost care in the community
- Promote healthy behaviors and preventive care to reduce the demand for future health and medical services
- Curtail payment for tests and procedures that clinical research has shown to be ineffective
- Improve efficiencies in the delivery of care by preventing unnecessary utilization, reducing medical errors, and facilitating the exchange of health information through improved technology

While very difficult to quantify, these options offer true possibilities to contain Medicaid costs. In fact, Michigan's Medicaid program has made some progress on these fronts already. Even so, more can be done through a concerted effort by all stakeholders to reach agreement about the future of the program.

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[21] J. Gruber, *The Role of Consumer Copayments for Health Care: Lessons from the RAND Health Insurance Experiment and Beyond* (Menlo Park, Cal. and Washington, D.C.: Kaiser Family Foundation, 2006), 4. [Online, accessed 8/7/08.] Available: *http://www.kff.org/insurance/upload/7566.pdf*.
[22] House Fiscal Agency, *Managing Medicaid Costs.*

Restructuring Option: Statewide Dialogue on Medicaid's Future

Medicaid offers a particularly acute example of the challenges of managing a state budget in an era of limited resources. In this atmosphere, the best option is for the state to hold a statewide dialogue to set priorities for Medicaid benefits. A small commission with representatives from the Michigan Department of Community Health, consumers, providers, health plans, and businesses should carry out informed deliberations across Michigan about how care could be delivered more effectively to Medicaid enrollees. The latest, best research and knowledge about high-quality, cost-effective health care—that is, what has proven to be effective and what has not—should inform these discussions. Only in this way will consensus be reached on the direction of Medicaid and the proportion of the state budget it should occupy.

TEACHER RETIREMENT BENEFITS

The Michigan Public School Employees' Retirement System (MPSERS) provides pension benefits and other post-employment benefits (OPEB) to 714 participating employers and over 162,000 retirees and beneficiaries.[23] The MPSERS' benefit provisions are quite similar to other large public employer systems. The legacy costs of the MPSERS, however, are unsustainable if the state wants to adequately fund the K–12 public school system in both the short and long term. This section briefly describes MPSERS benefits, compares the MPSERS to other public employers, and offers potential cost saving alternatives to this defined benefit pension system.

A comparison of the increases in pension costs for K–12 districts to their increases in state appropriations demonstrates the ongoing structural budget problems facing school districts and the State of Michigan. In FY 2008 Michigan's K–12 system will contribute an estimated $1.5 billion[24] to fund the MPSERS pension system and provide health, dental, and vision benefits to retirees and beneficiaries. Compared to FY 2003, when the K–12 system contributed $1.27 billion,[25] this is a $230 million increase. Over that same five-year period School Aid Fund appropriations increased from $12.35 billion to $12.90 billion—a $552 million increase.[26] In other words, 42 percent of the increase in school aid appropriations over the last five years went to pay for the increased cost of public school retirees and beneficiaries. The remainder of this section will focus on the pension system, while OPEBs will be examined in the section on state employee and retiree health care costs.

[23] Michigan Department of Management & Budget, Office of Retirement Services, *Michigan Public School Employees' Retirement System 2007 Comprehensive Annual Financial Report* (Lansing, Mich.: OMB/ORS, January 17, 2008), 26.

[24] (1) Ibid., 25. (2) Gabriel Roeder Smith & Company, *Michigan Public School Employees' Retirement System Annual Actuarial Valuation Report, September 30, 2007* (Detroit, Mich.: GRS, April 7, 2008), A–1. Calculations by Public Sector Consultants.

[25] Michigan Office of Management & Budget, Office of Retirement Services, *MPSERS 2004 Comprehensive Annual Financial Report*, 21.

[26] (1) Michigan House of Representatives, House Fiscal Agency, *Summary for Public Act 112 of 2008* (Lansing, Mich.: House Fiscal Agency, April 17, 2008). (2) Michigan Office of the State Budget, *State of Michigan 2003 Annual Comprehensive Financial Report* (Lansing, Mich.: Office of the State Budget, December 23, 2003), 20.

The benefit provisions for this defined benefit (DB) plan are established in Public Act 300 of 1980, as amended. The statute defines two different types of members—those in the original Basic Plan and the Member Investment Plan (MIP). MIP members are further defined by their date: (1) members enrolled prior to January 1, 1990, (2) members enrolled between 1990 through June 2008, and (3) members hired after July 1, 2008. Members contribute to the system according to a formula set in statute that is based on date of hire and salary. Pensions are paid on a monthly basis for the lifetime of a retiree and are computed on an annual basis at 1.5 percent of a member's final average compensation multiplied by the total number of years of credited service.

The current MPSERS provisions for normal retirement age, early retirement options, employee contribution rates, vesting requirements, and retirement benefit calculator are quite similar to those of other large public employer pension systems. In December 2007, the Wisconsin Legislative Council published a study of major employee retirement systems. The study looked at 85 different systems across all 50 states for fiscal year 2006. Included in the survey were the MPSERS, the Michigan's State Employees Retirement System, and Michigan's Municipal Employees Retirement System. The study findings are summarized below:

- **Normal retirement age—**28 plans required 30 years of service at age 55 or older; seven plans required more than 30 years of service; and 21 required fewer than 30 years of service. Fourteen of the plans adopted "Rule of Y" provisions under which a person can retire with normal retirement benefits when that person's number of years of service, plus his or her age, equals a specified number. The "Rule of Y" numbers ranged from 80 to 90. *In the MPSERS, a MIP member may retire at any age with 30 years of service or age 60 with 10 or more years. A basic plan member may retire at age 55 with 30 or more years or age 60 with 10 or more years.*
- **Early retirement—**75 of the 85 plans permitted early retirement before the normal age and service requirements of the plans have been met. In FY 2006, 47 of the 85 plans allowed early retirement at a minimum age of 55 or more; 16 plans allowed early retirement at a minimum age of less than 55. Most of the plans had an annuity reduction for early retirement. *The MPSERS early retirement age is 55 with 15 or more years of credited service and the annuity reduction is 6 percent a year*.
- **Employee contribution rates—**28 plans had employee contribution rates (as a percentage of payroll) of 5 percent or less; 45 plans had more than 5 percent; in six plans the rates varied; and six plans were noncontributory. *In MPSERS the contribution rates vary with date of hire. An MIP member hired before January 1990 contributes 3.9 percent.*
- **Retirement benefit calculator—**68 of the 85 plans studied were coordinated with the Social Security system, meaning that employees earn Social Security benefits for their employment. The formula multipliers (the percentage set by the legislature and used in the retirement benefit formula to determine the member's monthly retirement annuity) for these 68 plans vary in terms of number of years of service, date of

employment, or age at retirement. The average formula multiplier for the coordinated plans is 1.97 percent.[27] *The MPSERS formula multiplier is 1.5 percent.*

While the MPSERS benefits are quite similar to other large public sector pension systems, the private sector is clearly moving in another direction. The March 2007 annual survey of private sector employee benefits, published by the U.S. Bureau of Labor Statistics, reports that 61 percent of private sector employees have access to retirement benefits and 51 percent choose to participate. Those numbers increase to 78 percent access and 66 percent participation for large employers (i.e., 100+ employees). Fifty five percent of private sector employees have access to a defined contribution benefits plan and 43 percent participate. For large employers the access rate is 70 percent and the participation rate is 53 percent. On the other hand, only 21 percent of private sector employees have access to defined *benefit* plans and 20 percent participate.[28] In contrast, 90 percent of public sector employees participate in a defined benefit plan.[29]

Restructuring Option: Changes in Eligibility and Benefits

There are a number of alternatives available to reduce the cost of MPSERS pension benefits. Please note, however, that implementation of these alternatives would have to be for *new hires only*, in order to comply with Article IX, Section 24, of the Michigan Constitution.[30] Reforms might include the following, either singly or in combination:

- Increase the new member contributions. Public Act 111 of 2007 already increased the new member contributions effective July 1, 2008. The bill increased new member contributions from 4.3 percent to 6.4 percent for income over $15,000. The savings were estimated at $5 million for the first year, growing to $29 million in six years.[31] Extrapolating the savings up to ten years would yield $48 million or $23 million for each one percent increase in the contribution rate.
- Modify the retirement eligibility restrictions for new hires from "30 and out" to 57 years of age with 30 years of service; and increase the number of years of service needed to retire at age 60 from 5 to 10. After ten years this could save anywhere from $24 to $60 million per year depending on the rate of new hires into the system.[32]
- Increase new member contributions on annual pay exceeding $30,000 or $40,000 instead of $15,000. The savings after ten years would more than likely be very small because so few of the new hires would have reached this higher threshold.

[27] William Ford, *2006 Comparative Study of Major Public Employee Retirement Systems* (Madison, Wisc.: Wisconsin Legislative Council, December 2007), 10–22. [Online, accessed 7/30/08.] Available: *http://www.legis.state.wi.us/lc/publications/crs/2006_retirement.pdf*.
[28] U.S Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry in the United States*, (Washington, D.C.: U.S. Department of Labor, BLS, March 2007), 7–8. [Online, accessed 8/12/08.] Available: *http://www.bls.gov/ncs/ebs/sp/ebsm0006.pdf*.
[29] PEW Center on the States, *Promises with a Price: Public Sector Retirement Benefits* (Washington, D.C.: PEW Center on the States, December 17, 2007), 11.
[30] "The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby."
[31] Senate Fiscal Agency Bill Analysis for Public Acts 110 and 111 of 2007, October 5, 2007, 7.
[32] Gabriel Roeder Smith and Company, *MPSERS-SERS Retirement Benefit Reform Report, August 21, 2007, Draft* (Detroit, Mich.: GRS, n.d.), B-2, B-3, and C-3. Calculations by Public Sector Consultants.

- Implement a defined contribution system for all new hires and allow current members a window to transfer into the new system. This option would not begin to save money until 14 years after it is implemented—over those years this option would actually cost money—but there would be significant long-term savings.
- Implement a hybrid plan for new hires that combines elements of both DB and DC plans. The DB would promise recipients a set level of reduced benefits, while the employee's contribution would be deposited in a DC investment account.
- Allow new hires to choose to belong to either the defined benefit system or a new defined contribution (DC) system. The cost or savings would depend on the employer matching rate and the number of new hires that chose to enter into the system. One way to limit any potential increase in employer's cost is to limit the employer-matching rate to the DB contribution rate for new hires. After ten years each 1 percent of a projected DC payroll savings (i.e., the difference in payroll contributions from DB to DC) would save $40 to $50 million.

Restructuring Option: Defined Contribution Plans

Absent any changes in the eligibility and benefits noted above, the long-term legacy costs of the present system will continue, and will be subject to future swings in the market. Many private sector employers have moved away from this type of traditional DB plan to a defined contribution (DC) plan. The DC plan allows employees to set aside money into a pretax plan, such as a 401(k) or 403(b), with a portion of that contribution being matched by their employer. Beginning in April 1997, all new State of Michigan employees were enrolled in this type of DC retirement plan. The state contributes 4 percent of gross pay and matches the employee's contribution up to 7 percent (i.e., maximum employer contribution of 7 percent and employee contribution of 3 percent).

One way to save costs over the long term would be to enroll all *new* public school employees into a DC program similar to the one offered by the State of Michigan. A major concern associated with the switch to a DC plan that has been raised by the Office of Retirement Services, Governor Granholm, legislators, other public officials, and school employees is that it would result in a rather substantial increase in short-term costs.

There are three reasons for the increase in costs. The first is that the employer contribution for a new DC employee may be about 2.1 percent higher than the current actuarially determined cost of a new DB hire. This assumes that the contribution rate for new public school hires would average around 6.35 percent of pay (i.e., the state's average contribution rate for DC members).[33]

The second reason for the initial increase in costs is that the present DB system would become a "closed system" with no more new employee contributions credited to it. This would lower annual member contributions without any real decrease in pension cost for those currently in the system.

[33] Phil Stoddard, Director, Michigan Office of Retirement Services, Memorandum to Craig Thiel, Citizens Research Council of Michigan (Lansing, Mich.: November 1, 2007).

The third and most costly reason also stems from the conversion of the present system to a closed system. If this were to happen, the Governmental Accounting Standards Board (GASB) requires that the unfunded accrued liability be paid off over a shorter period of time, thereby increasing the annual contribution rate to the employer. The first year increase in costs due to becoming a closed system is estimated at $156 million. This increase in costs would decline each year so that after 14 years the system would begin to save money.[34] It could take between 20–30 years to fully pay back the initial increase in costs. In recognition of the extended payback, perhaps the most reasonable alternative is a voluntary DC system for new hires as described below.

In order to pay for the cost increase of implementing a new DC plan, the State of Michigan could implement one of the following alternatives:

- Simply increase the annual pension contribution, thereby requiring the individual school districts to assume the costs out of their foundation allowance[35] increase. (This might prove difficult since the increase in school aid appropriations over the last five years has only averaged $110 million.)
- Set aside a portion of an increase in a particular funding source and earmark it to cover the increase. (Of course, if the funding source is one that is already earmarked for schools, this does nothing more than effectively decrease the foundation allowance.)
- Increase the share of health care premiums for MPSERS retirees, increase the co-pays, or reduce the benefits and use the savings to offset the increase in costs from the switch to DC.
- If the DC were approved for new hires in 2008 and effective July 1, 2009, the $156 million increase in pension costs would not hit until FY 2011. It could be offset by increasing the employer pension contribution immediately by one or two tenths of a percentage point; then adding one or two tenths of percentage point increase each year until the overall increase is sufficient to pay the increased costs of the switchover for the first ten or 15 years. (This might prove problematic in terms of compliance with GASB or with credit rating agencies but at least it represents a plan to adequately fund the switch over time.)
- As mentioned previously, perhaps the best option would be to allow new hires to join either the defined benefit *or* a defined contribution system. This would solve the short-term fiscal problem created by closing the DB system to new members. It is quite likely that most new members would join the DC system for portability reasons. There would also be a financial incentive because the DB system has increased the new member contributions for employees hired after July 1, 2008, from 4.3 percent to 6.4 percent for income over $15,000.

STATE GOVERNMENT EMPLOYEE HEALTH BENEFITS

This section of the report examines the costs of providing health care benefits to State of Michigan employees, retirees, and public school retirees. More specifically it describes

[34] Ibid.

[35] Foundation allowance is the number used to calculate state government's contribution to operating spending in conventional local school districts and charter schools.

the administrative and statutory requirements for each group's health care premium, compares Michigan's costs to those of other employers, and identifies potential cost saving reforms. In 2007, almost 213,000 employees and retirement beneficiaries in these three groups received health care benefits at a combined cost of $1.45 billion. Based on recent studies described later in this report, the health care costs associated with State of Michigan employees and retirees exceed the national average for other state employee systems. Not only do the costs exceed the average, but also the employee share of the premium is much lower than the employee share in other public sector and private sector employer systems.[36]

Long-Term Legacy Costs: Other Post-Employment Benefits

Both the State Employees' Retirement System (SERS) and the Michigan Public Schools Employees' Retirement System (MPSERS) provide OPEBs to their retirees and beneficiaries. These OPEBs include benefits such as health, dental, and vision care. While the state's pension systems are well funded (SERS at 86.2 percent[37] and MPSERS at 88.7 percent[38]), neither system has been pre-funding OPEBs. In fact, all of Michigan's pension systems operate on a pay-as-you-go system. The unfunded accrued liability (the excess of total liabilities, both present and prospective, over present and prospective assets) is currently estimated at $12.5 billion for SERS and $25.4 billion for MPSERS.[39]

Michigan is not unlike most units of government and most other states in its failure to pre-fund retirees' OPEBs. According to a recently released study by the Pew Center on the States, "…the total actuarial accrued liability for state employees (all states) is about $381 billion. About 97 percent—$370 billion—of the obligations for state employees over an amortization period that usually runs about 30 years was unfunded at the end of fiscal year 2006… The $381 billion figure is a conservative number that does not reflect the full extent of the long-term cost, as some states face large bills for teachers as well. Cities, counties, and school districts also are totaling up their own liabilities and will continue to do so over the next several years."[40]

Comparisons

Currently state employees who choose the state health plan, a Preferred Provider Organization (PPO), pay 5 percent of their premium. Employees who choose a health maintenance organization (HMO) have either no premium or a significantly reduced premium based on the total premium costs of their HMO. In 2007 the total bill for employees' health care was $545.4 million. The total bill includes coverage for 49,000

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[36] Our analysis updates the 2007 work of the Center for Michigan's John Bebow, using information that the Citizens Research Council of Michigan obtained from the Department of Civil Service. We thank them for first exploring this line of inquiry

[37] Gabriel Roeder Smith & Company, *Michigan State Employees' Retirement System Annual Actuarial Valuation Report, September 30, 2007* (GRS, Detroit, Mich.: April 14, 2008), A–3.

[38] Gabriel Roeder Smith & Company, *Michigan Public School Employees' Retirement System Annual Actuarial Valuation Report, September 30, 2007* (GRS, Detroit, Mich.: April 7, 2008), A–3.

[39] Michigan Office of Management & Budget, Office of Retirement Services, *MPSERS and SERS 2007 Comprehensive Annual Financial Report*, 8.

[40] Pew Center on the States, *Promises with a Price: Public Sector Retirement Benefits* (Washington, D.C.: Pew Center on the States, December 17, 2007), 41.

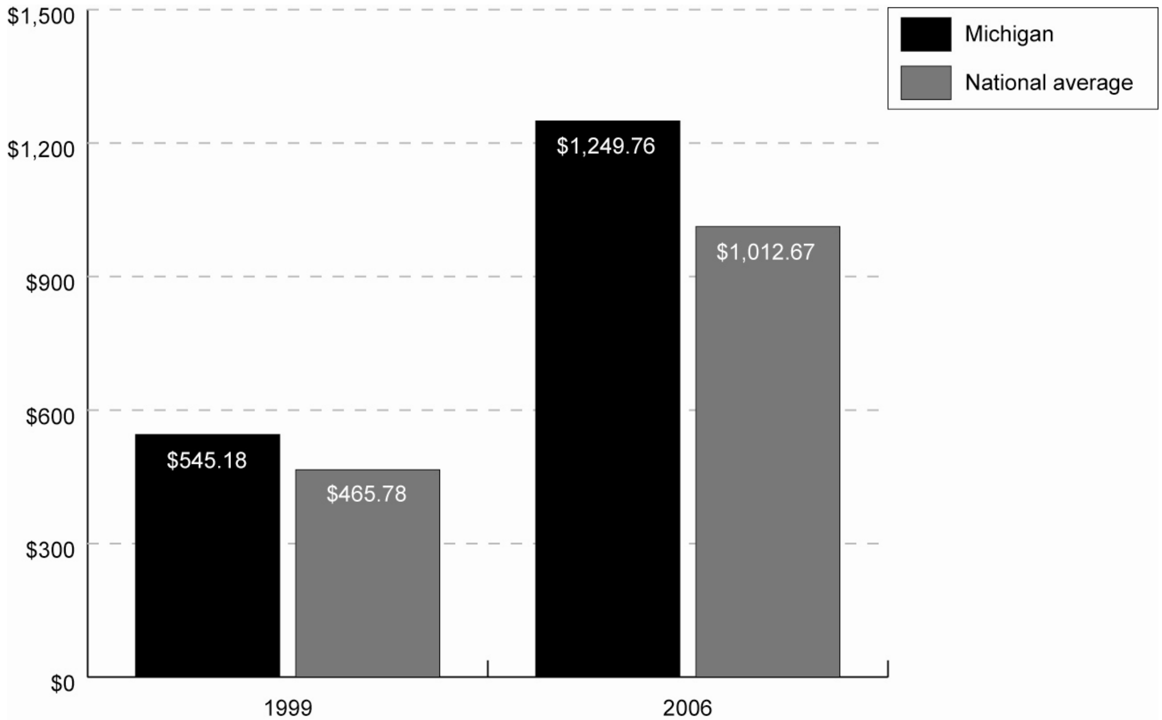
employees and, in many cases their spouses and dependents. The employees' overall premium share represented only 3 percent of the total.[41] The collective bargaining agreements that were approved by the Michigan Civil Service Commission last December increased the employee premiums to 10 percent for the state health plan and a minimum of 5 percent for an HMO, for the fiscal year beginning October 1, 2008.[42]

Tier 1 (i.e., defined benefit) retirees in the SERS system currently pay the same health care premium as the employees in the classified service. Tier 2 (i.e., defined contribution) retirees pay no more than 10 percent of the premium if they have at least 30 years of service. For those with less than 30 years the state pays 3 percent of the premium for each year of service. In 2007 the retirees paid $8.3 million of the $329.7 million spent on retiree health care, or 2.5 percent.[43] MSPERS retirees pay an amount equal to that paid by a Medicare Part B recipient before becoming eligible for Medicare. After a retiree obtains Medicare eligibility there is no retiree premium sharing. The beneficiary also pays 10 percent of the premium for spouses and dependents. In 2007 the retirees paid $69.8 million of the estimated $579.3 million spent on health care, or 12 percent.[44]

The National Council of State Legislators (NCSL) publishes a comparison of state employee health care costs on its website. In 1999 Michigan's total monthly premium costs for an employee's family health coverage was $545.18, compared to the average cost of the 49 states reporting of $465.78. State of Michigan employees paid 5 percent of this premium as compared to a 23 percent average across the 49 states. In 2006 Michigan's total monthly employee premium costs for family health coverage were $1,249.76, compared to the average cost of all 50 states of $1,012.67. State of Michigan employees paid 5 percent of their premiums, compared to a 19 percent average across all 50 states.[45] Exhibits 2 and 3 show how State of Michigan employees continue to have a health benefit package that is more expensive per employee than the national average, for which they pay a smaller share than the national average.

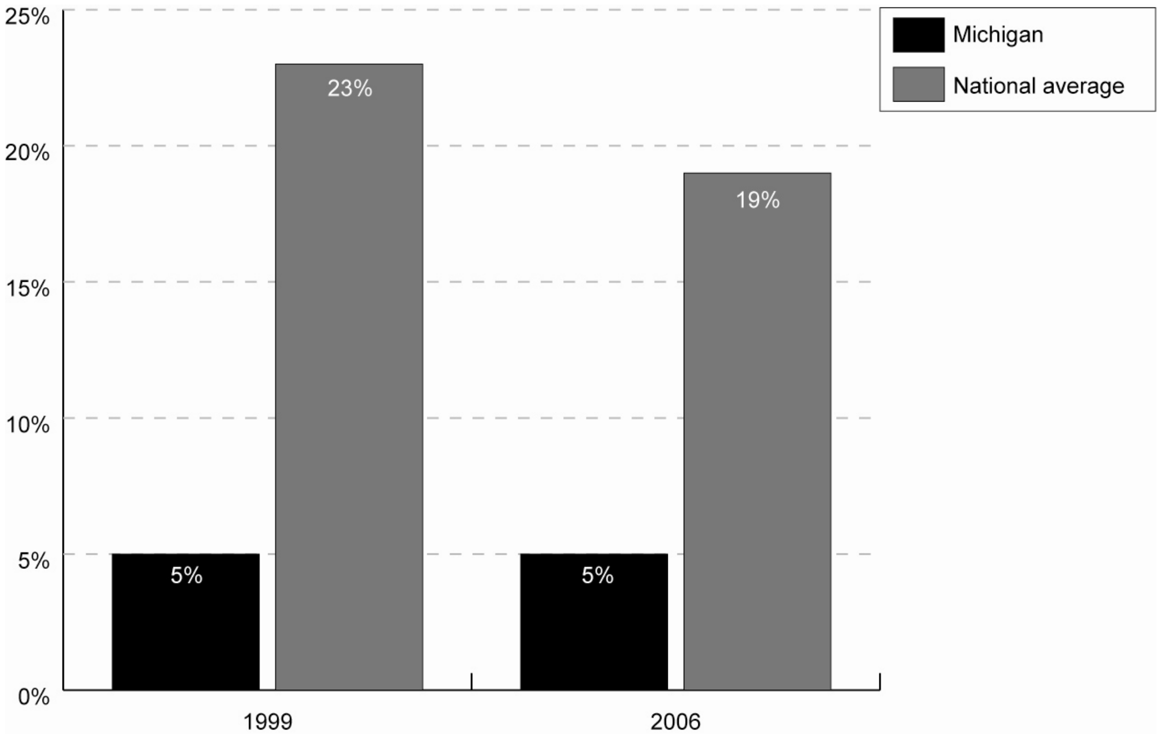
[41] Population and premium data from the Michigan Office of Civil Service; calculations by Public Sector Consultants.
[42] Office of the State Employer, Changes to Health Insurance Fiscal Year 2009 (Lansing, Mich.: Office of the State Employer, n.d.). [Online, accessed 7/30/08.] Available: *http://www.michigan.gov/ose/0,1607,7-143--184557--,00.html*.
[43] Michigan Office of Management & Budget, Office of Retirement Services, *Michigan State Employees' Retirement System 2007 Comprehensive Annual Financial Report* (Lansing, Mich.: OMB/ORS, December 14, 2007), 23.
[44] Michigan Office of Management & Budget, Office of Retirement Services, *MPSERS 2007 Comprehensive Annual Financial Report*, 24.
[45] National Council of State Legislators, *State Employee Health Benefits—Monthly premium costs (Family coverage)*, May 2006. [Online, accessed 7/30/08.] Available: *http://64.82.65.67/health/StateEmpl-healthpremiums.pdf*.

EXHIBIT 2
Monthly Premium (State *and* Employee Share), Family Health Coverage



SOURCE: National Council of State Legislators, May 2006.

EXHIBIT 3
State Employee-paid Premium Percentage



SOURCE: National Council of State Legislators, May 2006.

The Kaiser Family Foundation recently published the "Employer Health Benefits 2007 Annual Survey." According to the survey, state and local government workers in the United States pay an average of 13 percent of their health insurance premium if they have single coverage and 22 percent for family coverage. For employees of all public and private sector employers included in the survey, these proportions are 16 percent and 28 percent respectively. The average total monthly premium cost for family PPO health coverage was $1,037.[46]

Restructuring Option: Change Benefits and Premium Share

The two alternatives most likely to significantly reduce health care costs are reducing the benefit package and increasing the employee's or retiree's share of the premium cost. A logical argument could be made that an increase in the latter would eventually result in a reduced benefit package. The State of Michigan would recognize significant savings if Michigan's premiums share were brought into line with other public and private sector employers as identified in the Kaiser Family Foundation Survey mentioned above.

- Reduce the benefit package, thereby reducing the costs.

[46] The Kaiser Family Foundation and Health Research and Educational Trust, *Employer Health Benefits 2007 Annual Survey* (Menlo Park, Cal. and Chicago, Ill.: Henry J. Kaiser Family foundation and Health Research and Educational Trust, 2007), 68. [Online, accessed 7/30/08.] Available: *http://www.kff.org/insurance/7672/upload/76723.pdf*.

- Increase employee and retiree premiums based on the average of other public sector employers.
- Increase employee and retiree premiums based on the average of public and private sector employers.

The State of Michigan would have saved anywhere from $88.6 million to $219.8 million in FY 2007 if its employees and retirees had contributed to the costs of their health care in the same proportion as other public or private sector employers. The public school system would have saved anywhere from $5.5 million to $92.4 million. If you apply the FY 2009 premium shares as negotiated in the upcoming collective bargain agreements the state's savings would have declined to a range of $45.4 million to $176.6 million. Please note that these estimates represent savings that *would have* happened in FY 2007 *if* the increased employee and retiree premiums had been in place. In future years these savings would increase based on the overall cost increases in health care benefits.

There are a number of other alternatives to reduce the cost of health care benefits for these three groups that would yield savings, but not of the same magnitude as increasing the employee premium or reducing the benefit. These alternative reforms could be implemented either singly or in combination. They are not the preferred alternatives, however, because of their complexity, limited potential for significant savings, or potential constitutional triggers:

- Increase employee and retiree co-pays and deductibles. The Civil Service Commission approved changes for state employees effective October 1, 2008, that doubled the annual deductible, increased the co-pay for office visits from $10 to $15, and significantly increased the co-pays on prescription drugs.
- Require that active employees contribute a portion of their pay to cover the cost of their health insurance when they retire. While this option might generate a significant amount of money over time, the statutory change might constitutionally obligate the state to provide health insurance for all participating future retirees.
- Require early retirees to pay a much larger share of their premium (e.g., 50 percent for anyone under the age of 55 or 25 percent for anyone under the age of 60).
- Cap the employer's premium at FY 2007 levels and require the employee or retiree to cover the annual increase in overall costs.

An increase in health care premiums paid by state employees would have to be collectively bargained. Since the collective bargaining agreements are already in place through September 30, 2011, the state would have to wait for three years or try and reopen the recently approved agreements. Any new or renegotiated agreements would require the approval of the state Civil Service Commission. Moreover, any change to retiree health care premiums would require changes to the SERS and MSPERS statutes.

Conclusion

A white paper that calls for a reduction in the length of prison sentences, suggests the possibility of dramatically changing the Medicaid program, and raises even the idea of a change to state employee benefits will not be a popular publication. Indeed, discussions about the intricacies of Michigan's budget are not likely kitchen table fodder.

But Michigan is in an era when families are feeling pressure from sharp increases in the cost of gasoline on top of large job cuts in the manufacturing sector, business owners incur rising costs of raw materials and health insurance for their employees, and lawmakers are asked to choose each year how to spend a limited number of tax dollars on an unlimited number of important policy goals and programs.

In this budget crisis era—which began for our state in 2000–2001 and is likely to continue until the middle of the next decade—the state's policymakers, businesses, and residents **must be able to talk openly** about

- what programs and services are critical for the state government to provide,
- how Michigan's programs, services, and employee benefits compare to other Great Lakes states and private sector employers, and
- how to allocate Michigan's revenues—regardless of the absolute number of dollars collected—across education, health care, corrections, natural resources, and other statewide programs.

Michigan's previous choices in establishing policies on corrections, Medicaid, teacher retirement, and public employee health care are the primary reasons that the state's General Fund and School Aid Fund still reflect structural gaps in revenues and expenditures. Left unaddressed, this gap will grow and leave future policymakers with the annual task of attempting to hide from ever more obvious budget realities. Left unaddressed, the choices of the past will further constrain and limit future legislatures at a time when states—like businesses and nonprofits—are increasingly forced to apply more discipline and focus to a core set of activities.

The options presented in this policy paper from a variety of research sources and organizations provide a path for the long term: meaningful restructuring of Michigan's public commitments and policies. As a state, we can **choose** to have meaningful discussions now, or we can be **forced** into limited policy choices.