

A man with glasses and a mustache, wearing a light-colored striped shirt and a patterned tie, stands with his hands on his hips in front of a whiteboard. The whiteboard contains the title and three brief descriptions.

MPSERS and MSERS: Three Pension Policy Briefs

2010

Michigan's Public-Employee
Retirement Benefits: Benchmarking
and Managing Benefits and Costs

By Richard C. Dreyfuss

2011

Estimated Savings From
Michigan's 1997 State Employees
Pension Plan Reform

By Richard C. Dreyfuss

2012

Five Options for Addressing
'Transition Costs' When Closing
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Five Options for Addressing 'Transition Costs' When Closing the MPSERS Pension Plan

By James M. Hohman

Available at www.mackinac.org/S2012-01

Nearly every state in the union operates pension funds for its public employees. Michigan is no exception.

The trouble begins when a state doesn't adequately prefinance the employee pensions that have already been earned. As of Sept. 30, 2010, the most recent date for which data are available, Michigan state government had a \$21.7 billion total unfunded liability in the pensions in its two largest pension systems, the Michigan Public School Employees' Retirement System and the Michigan State Employees' Retirement System. The three Policy Briefs published in this volume summarize this fiscal predicament, discuss the potential benefits of reform and address the so-called "transition costs" of closing the MPSERS pension plan to new public school employees.

The first Policy Brief, "Michigan's Public-Employee Retirement Benefits: Benchmarking and Managing Benefits and Costs," is by actuary and Mackinac Center Adjunct Scholar Richard C. Dreyfuss. His report examines the underfunding of the MPSERS and MSERS pension systems, the rapid growth of their unfunded liabilities and the frequent but insufficient attempts at reform. The brief also highlights how profoundly out of touch these pension and post-employment medical insurance benefits are with benefits offered in Michigan's private sector. Dreyfuss concludes with specific proposals for establishing predictability, reliability and affordability in MPSERS and MSERS. He recommends particularly that MPSERS' traditional pension arrangement be closed to new public school hires and that they instead receive individual 401(k)-style retirement accounts.

Such "defined-contribution" retirement accounts already exist for MSERS members hired on or after March 31, 1997. In his second Policy Brief, "Estimated Savings From Michigan's 1997 State Employees Pension Plan Reform," Dreyfuss quantifies the advantages of having closed the traditional MSERS pension plan. In fact, Michigan is one of the few states that manage a defined-contribution retirement system for their state workers. This offers the rare opportunity to assess the fiscal impacts of adopting a defined-contribution plan.

Dreyfuss calculates that transitioning new MSERS members to defined-contribution retirement accounts in 1997 saved the state from developing an additional

\$2.3 billion to \$4.3 billion in unfunded pension liabilities. He also estimates that the state saved \$167 million in pension "normal costs." Dreyfuss observes that switching to a defined-contribution pension plan has made it easier for state officials to honor their pension obligations to MSERS members.

State policymakers appear resistant to switching to a similar defined-contribution plan for new MPSERS members. Their express concern involves the alleged upfront "transition costs." Several state reports have pegged these costs at hundreds of millions of dollars.

This issue is examined in the volume's third Policy Brief, "Five Options for Addressing 'Transition Costs' When Closing the MPSERS Pension Plan." In this study, which I authored, I find the "transition costs" of closing the MPSERS plan to be nonbinding — that is, the state would face them only if policymakers chose to. I describe a series of approaches to closing the system that would avoid such costs, but I also consider the long-term consequences of assuming and paying the costs, noting that this approach would nevertheless save money in the long run.

Indeed, there is a general consensus that switching future MPSERS members to a defined-contribution retirement plan would result in long-term savings. There is also a recognition that the financing of MPSERS' and MSERS' post-employment medical benefits has been, at the very least, poorly managed.

Policymakers have it within their power to begin providing retirement benefits that advance the interests of public employees, taxpayers and the state as a whole. The studies in this anthology can guide lawmakers toward the satisfaction of keeping faith with public employees by placing the state's pension obligations on a secure financial foundation.

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April 18, 2012

Michigan's Public-Employee Retirement Benefits: Benchmarking and Managing Benefits and Costs

By Richard C. Dreyfuss

Michigan's Public-Employee Retirement Benefits: Benchmarking and Managing Benefits and Costs

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Executive Summary*

The state manages two major statewide retirement systems for public employees. The Michigan Public School Employees' Retirement System, known as "MPERS," provides both pension and retiree health care benefits to eligible public school employees. The Michigan State Employees' Retirement System, known as "MSERS," provides similar post-employment benefits to eligible state employees, though MSERS is distinguished from MPERS by the Michigan Legislature's major pension reform to MSERS in 1997. There are more than 300,000 active employees in the two retirement systems. With the inclusion of retirees and beneficiaries, the systems cover more than half a million people.

As of Sept. 30, 2009, the most recent date for which data are available, MPERS and MSERS pensions had unfunded liabilities of \$15.1 billion, while MPERS and MSERS retiree health care plans had unfunded liabilities of between \$24.6 billion and \$40.2 billion, depending on how the liabilities are calculated.

The combined \$15.1 billion unfunded liability for MPERS and MSERS pensions results specifically from the two systems' "defined-benefit" pension plans. In these defined-benefit plans, the members' government employer assumes the responsibility of annually investing employer and employee pension contributions in amounts sufficient to finance a projected annual retirement income. These plans place all of the investment risk on the government employer — in this case, on the taxpayer.

* Citations provided in the study's main text.

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MPERS provides defined-benefit pensions to both new and existing public school employees, while MSERS provides defined-benefit pensions only to state employees hired before April 1997. State employees hired after March 1997 are members of MSERS' "defined-contribution" pension plan, established by the Michigan Legislature in 1997. In this plan, the state makes ongoing contributions to a tax-favored account, with the employee able to contribute as well. The employee directs investment of the monies, and the accumulated capital is available to the individual at retirement. State government and state taxpayers do not assume investment risk, and the plan incurs no unfunded liability; the amount of money at retirement largely depends on investment returns over time.

State government and school districts are attempting to prefund MPERS and MSERS defined-benefit plans by accumulating sufficient assets to finance current and future benefits. In contrast, MPERS and MSERS retiree health care plans are being financed on a "pay-as-you-go" basis.

As recently as 2001, following the stock market gains of the 1990s, the MPERS defined-benefit pension plan was 96.5 percent (or almost fully) funded, while MSERS defined-benefit pension plan was 98.7 percent funded in 2002. Unfortunately, the economic and public policy realities in Michigan — an increasing outflow of residents, a declining private sector and the uncertainties caused by federal tax and health care policies — compound the problems now faced by the MPERS and MSERS systems. As of Sept. 30, 2009, MPERS' and MSERS' defined-benefit pension plans were 78.9 percent and 78.0 percent funded, respectively.

Another potential roadblock facing MPERS and MSERS defined-benefit pension plans involves actuarial

assumptions and accounting methodologies. Both plans assume an 8 percent annual investment return on assets; however, public pension plans nationwide may begin lowering this key rate assumption due to the prospect of changes in national government accounting standards together with less optimistic financial forecasts. If MPSERS' and MSERS' assumed investment rate is lowered, the unfunded liabilities calculated for MPSERS and MSERS defined-benefit pension plans could be significantly larger.

In recent years, MPSERS and MSERS pension and retiree health care plans have been modified by the Michigan Legislature, most recently in Michigan Public Acts 75 and 185 of 2010. While these revisions have generally been positive, they have not significantly altered the fundamental challenges facing the two systems.

Benchmarking MPSERS and MSERS benefit plans to the entire Michigan marketplace should be a priority in redesigning them to be affordable to Michigan taxpayers. Given the number of employees involved in MPSERS and MSERS, the public sector will struggle to sustain any benefits systems that have proven to be unaffordable in the private sector, especially since the public sector is dependent upon the private sector for funding the benefits.

Benchmarking with Michigan's private sector is possible given data from a proprietary survey conducted in 2010 by Aon Hewitt, an international human resources firm. Twenty-four major Michigan businesses, including very well-known, publicly traded companies, participated in the survey, providing data for a median of 10,122 salaried employees per company.

The pension plans offered to new hires by these 24 Michigan companies stand in contrast to the two defined-benefit pension plans offered by MPSERS and MSERS. These public plans provide traditional defined benefits based on final pay (or highest pay), a design that often results in underfunded plans. The MPSERS and MSERS defined-benefit plans also include cost-of-living adjustments.

None of the 24 companies offered new employees traditional final-pay defined-benefit pension plans. Some companies still maintained defined-benefit pension plans, but placed new employees in defined-contribution plans, which by definition have no unfunded liabilities. Other plans were "cash-balance" pensions, which are not based on final years of pay and are generally less expensive. Also of note, none of the 24 companies offered plans with cost-of-living adjustments.

Significantly, all 24 companies offered defined-contribution pension plans. Notably, MSERS compares well to the companies in the Aon Hewitt survey, since it offers new hires defined-contribution pension plans only. In addition, by design, the state's cost for this plan varies between 4 percent and 7 percent of employee compensation, a figure similar to the average employer contributions made by the 24 private companies. The benchmarking also shows that through the enactment of Public Act 75 of 2010, the Legislature moved closer to private-sector norms in Michigan by ending pension cost-of-living adjustments for new MPSERS employees.

The large Michigan companies in the Aon Hewitt survey generally differed from MPSERS and MSERS on retiree health care provisions. MPSERS and MSERS retirees currently receive employer subsidies of up to 100 percent and 90 percent, respectively, of their retiree health insurance premiums; retirees receive lower subsidies for dental and vision insurance, but these are similarly above market norms. Only three of the 24 Michigan companies offered new hires employer-subsidized retiree medical coverage in 2010; 17 provided no retiree medical subsidies to new hires, though some were also transitioning away from retiree medical plans that covered existing employees.

Legislative changes in 2007 slightly reduced the retiree health care benefits offered to new MPSERS employees, and the recently passed Public Act 185 of 2010 would make minor reductions to retiree health care benefits for new MSERS members as well. The requirement in Public Act 75 of 2010 that public school employees begin contributing 3 percent of their income toward an irrevocable trust for MPSERS retiree health care benefits should reduce the cost of these benefits to taxpayers. Nevertheless, MPSERS' retiree health care provisions remain above private-sector norms, and with the 3 percent payments currently being challenged in court, it is unclear how much relief these employee contributions will ultimately provide. It is even less clear how effective a Public Act 185 provision requiring MSERS active members to make a similar 3 percent contribution toward retiree health care will be. The contribution may be open to similar legal challenges, and in any event, the legislation requires the 3 percent payment only through fiscal 2013, limiting the overall impact.

Michigan policymakers should redesign public-employee pension and other retiree benefit plans by considering market trends and the best-demonstrated practices in both the private and public sectors in Michigan and the rest of the country. With MPSERS, the Michigan

Legislature should mirror its 1997 shift for MSERS and place all new public school employees in a defined-contribution plan to achieve affordable, predictable and fully funded costs. The state should also begin to better manage MPSERS and MSERS retiree health costs through a combination of plan design and eligibility reforms. A 2005 Michigan Supreme Court ruling even suggests that the Michigan Legislature is able to modify retiree medical liabilities for current MPSERS and MSERS retirees.

In addition, public understanding of the projected costs of MPSERS and MSERS pension and retiree medical benefits would be significantly enhanced if the Legislature required the Office of Retirement Services annually to publish a 20-year forecast of expected liabilities and expected taxpayer contributions. Such a projection would likely affirm the belief that these programs are unsustainable, that they defer significant costs to the next generation, and that they need substantial reform.

Introduction

The state of Michigan manages two major statewide defined-benefit pension plans.* The largest plan provides benefits for public school employees through the Michigan Public School Employees' Retirement System, known as "MPSERS." The second defined-benefit plan is provided through the Michigan State Employees' Retirement System, which covers employees of state government and is known as "MSERS." The MSERS defined-benefit plan was closed to state employees hired after March 1997; these employees were enrolled in MSERS' new defined-contribution plan.†

Separate and distinct plans also exist providing other post-employment benefits, commonly known as "OPEB," to MPSERS and MSERS participants. These benefits include employer-subsidized retiree medical, dental, vision and hearing insurance. In general, MPSERS and

* In defined-benefit plans, the employer assumes the responsibility of annually investing employer and employee pension contributions in amounts sufficient to finance a projected annual retirement income or projected insurance premiums for such items as retiree medical, dental and vision insurance. The projected benefits are generally set by a formula.

† In a defined-contribution plan, the employee and/or employer make ongoing contributions to a tax-favored account. These are invested, and they accumulate for the benefit of the individual at retirement. Generally, the investment decisions and the associated investment risks are the responsibility of the individual. Upon retirement, the employee can withdraw the account balance as either a lump sum or an annuity, according to the provisions of the plan. Michigan state employees who began work after March 31, 1997, are part of a defined-contribution pension program; see Public Act 487 of 1996, effective March 31, 1997. These employees are still part of MSERS and receive differing degrees of retiree health care benefits.

MSERS pensions are payable to eligible members and their beneficiaries, while OPEB provide coverage to qualifying plan members and their dependents.

This paper reviews MPSERS and MSERS pension and retiree medical benefits and confirms many of the published concerns¹ related to the level of benefits provided and the associated fiscal challenges facing Michigan taxpayers in both the short and long term. The paper does not discuss retiree benefits for state employees not enrolled in MSERS or for employees of Michigan's local governments, though these retirement benefits may raise similar concerns.[‡]

Similar to pensions, these MPSERS and MSERS OPEB plans have significant unfunded liabilities, which will be described in this paper.[§] (In the context of retirement plans, "liabilities" represent money owed to employees under current law upon their retirement, and "unfunded liabilities" are the amount by which the MPSERS or MSERS liabilities incurred to date exceed MPSERS or MSERS assets — i.e., the money the plans have set aside to meet current and future liabilities.)

As of Sept. 30, 2009 (the most recent data available), the unfunded liability of MPSERS and MSERS pensions combined was \$15.1 billion, while the OPEB unfunded liability combined was in the range of \$24.6 billion to \$40.2 billion, depending upon the methodology used to compute the liability.[¶]

‡ There are also three smaller plans managed by the state: the State Police Retirement System, the Judges Retirement System and the Legislative Retirement System. Local governments may adopt their own retirement plans, but the Municipal Employees' Retirement System, which is managed by an independent board, offers pension benefits to local governments and governmental organizations, and 692 of these governmental units participate in the system voluntarily. See "The Report of the Sixty-Third Annual Actuarial Valuation as of December 31, 2008 and 50-Year Actuarial Projection Covering Participating Municipalities in the Municipal Employees' Retirement System of Michigan" (Municipal Employees' Retirement System of Michigan, 2009), 3, http://www.mersofmich.com/formfiles/annual_actuarial_report2008.pdf (accessed Sept. 5, 2010); "About MERS" (Municipal Employees' Retirement System, 2010), http://www.mersofmich.com/index.php?option=com_content&task=view&id=42&Itemid=176 (accessed Sept. 5, 2010).

§ As noted later in the text, however, the liabilities for MPSERS and MSERS retiree health benefits may be subject to unilateral modification by the Michigan Legislature in ways that MPSERS and MSERS pension liabilities are not.

¶ The computed liability depends on the percentage growth rate assumed in the calculation; the higher liability estimates are based on a 4 percent annual investment return assumption, while the lower liability estimates are based on an 8 percent annual rate. Computations based on "Michigan Public School Employees' Retirement System 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), B-1; "Michigan State Employees' Retirement System 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), B-1; "Michigan Public School Employees' Retiree Health Benefits 2009 Annual Actuarial

Despite recent legislative revisions, such as state Public Act 75 of 2010 and Public Act 185 of 2010, which affect MPERS and MSERS pension and retiree medical benefits, it remains highly unlikely these programs will achieve a reasonable long-term cost structure. Specifically, it is highly unlikely that the plans will be “current,” so that school districts and the state* will be able to set aside sufficient money at regular intervals to ensure that employees’ benefits are funded as they are earned and in the aggregate are “paid up” by the time employees retire. It is also unlikely the plans will be affordable, so that the annual pension costs are between 5 percent and 7 percent of employee compensation — a common percentage among private-sector plans, and a cost achieved by MSERS’ defined-contribution plan, which has an employer contribution ranging from 4 percent to 7 percent of employee salary.² And finally, it is also unlikely that the plans’ costs will be predictable, so that the state and school districts are able to project with reasonable accuracy what the annual payments to MSERS and MPERS will be during the coming years.

Public Act 75 created a slightly reduced defined-benefit plan for new public school hires while establishing a new defined-contribution plan. Under the defined-contribution plan, an employee can contribute up to 2 percent of his or her salary to a personal retirement account. The employer then adds up to 1 percent of the employee’s salary to the employee’s account, so that the employer matches exactly half of the employee’s contribution.[†]

A prominent feature of Public Act 75 created an early-retirement incentive, which was accepted by 17,063, or

Valuation Report” (Gabriel Roeder Smith & Company, 2010), A-2; “Michigan State Employees’ Retiree Health Benefits 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), A-2.

* For MPERS, the state Legislature and the MPERS board, which is composed of state appointees, effectively design the plan and instruct the districts how much to deposit each year. The districts are legally bound to disburse the amount. Since public schools are funded primarily by state and local taxes, both state and local taxpayers bear most of the cost, though some of the MPERS pension cost is covered by mandatory pension contributions from MPERS members.

† Under Public Act 75, public school employees hired after July 1, 2010, are still part of a defined-benefit MPERS pension plan, but they will receive annual pension payments determined by a 5-year final average compensation level (as opposed to the final three years), will get no scheduled cost-of-living adjustments, and will face greater retirement age restrictions. In addition, employees may apply to school district officials to increase their defined-contribution employer match to 3 percent of the employee’s salary if the employee contributes a total of 6 percent. See Public Act 75 of 2010; see also Bethany Wicksall, “Legislative Analysis: Public School Retirement Revisions, Senate Bill 1227 as Enacted” (Michigan House Fiscal Agency, 2010), <http://www.legislature.mi.gov/documents/2009-2010/billanalysis/House/pdf/2009-HLA-1227-7.pdf> (accessed Aug. 3, 2010).

approximately 31 percent, of the eligible employees.[‡] The most significant provision involved requiring public school employees to make a contribution of 3 percent of their pay to a health care trust fund to help defray employer costs for MPERS retiree health care benefits. This particular provision is currently being challenged in court by several public school employees.³ A court order has temporarily placed collection of these funds into an escrow account pending resolution of this lawsuit.⁴

Based upon a June 28, 2010, legislative analysis developed by the House Fiscal Agency, this new 3 percent employee contribution would represent a \$3.5 billion savings over a 10-year period.⁵

Of note, the Legislature recently passed Public Act 185 of 2010, a set of MSERS revisions similar to the MPERS revisions in Public Act 75. The act offers an early-retirement incentive to 12,450 state employees, according to House Fiscal Agency estimates.[§] The act also reduces by up to 11 percent the state subsidies for retiree health care benefits for MSERS members hired after April 1, 2010.[¶]

A third provision of Public Act 185 requires MSERS active members to contribute 3 percent of their compensation to a trust fund to help reduce employer costs for MSERS retiree health care benefits, but unlike Public Act 75, Public Act 185 requires these payments only through fiscal 2013 — a total of approximately three years.^{¶¶}

‡ Bethany Wicksall, “Legislative Analysis: Public School Retirement Revisions, Senate Bill 1227 as Enacted” (Michigan House Fiscal Agency, 2010), 3, <http://www.legislature.mi.gov/documents/2009-2010/billanalysis/House/pdf/2009-HLA-1227-7.pdf> (accessed Aug. 3, 2010). This incentive increased the multiplier on the members’ pension payout from 1.5 percent to 1.6 percent if they were already eligible for retirement and they retired by Sept. 1, 2010. Employees who were not otherwise eligible to retire could still retire by Sept. 1, 2010, with a 1.55 percent multiplier if they had a combined age and years of service totaling 80 or more. See MCL 38.1381b(2).

§ Bethany Wicksall, “Legislative Analysis: State Employees’ Retirement Revisions, Senate Bill 1226 (H-38 as amended)” (Michigan House Fiscal Agency, 2010), 5, <http://www.legislature.mi.gov/documents/2009-2010/billanalysis/House/pdf/2009-HLA-1226-5.pdf> (accessed September 29, 2010). The incentive increases the multiplier on the members’ pension payout from 1.5 percent to 1.6 percent if they are already eligible to retire and they retire by Jan. 1, 2011. Employees who are not otherwise eligible to retire can still retire by Jan. 1, 2011, with a 1.55 percent multiplier if they have either 30 or more years of service or a combined age and years of service totaling 80 or more. See Public Act 185 of 2010 (State of Michigan, 2010), Sec. 19j(5), <http://www.legislature.mi.gov/documents/2009-2010/publicact/pdf/2010-PA-0185.pdf> (accessed October 6, 2010); see also Wicksall, “Legislative Analysis: State Employees’ Retirement Revisions, Senate Bill 1226 (H-38 as amended),” 1.

¶¶ Public Act 185 of 2010, Sec. 35(1)-(2); Wicksall, “Legislative Analysis: State Employees’ Retirement Revisions, Senate Bill 1226 (H-38 as amended),” 2. According to Public Act 185, MSERS active members make the 3 percent payments toward retiree health care “beginning with the first pay date after November 1, 2010 and ending September 30, 2013. ...”

The House Fiscal Agency estimates the state will save \$239.2 million during the three years of these contributions.⁷ As of this writing, no legal challenge has been made against this provision.

Public Policy Realities

The fiscal challenges facing future taxpayers involve effectively managing MPERS' and MSERS' unfunded liabilities, where the benefits have been overpromised and underfunded. Granted, as recently as 2001, following the stock market gains of the 1990s, MPERS defined-benefit pension plan was 96.5 percent (or almost fully) funded, while MSERS defined-benefit pension plan was 98.7 percent funded in 2002.*

But these benefit plans, including the “pay-as-you-go” health plans, now operate within a state experiencing a significant net outflow of population, where the prospects for economic growth are already uncertain due to the decline of the private sector. Mounting federal deficits and the likelihood of higher federal taxes on personal income, investments and business income will only compound the problems at the state and local levels.† Interwoven into all this are federal health care reforms and unfunded liabilities associated with federal entitlement plans like Social Security and Medicare. Cumulatively, funding any deficits for these federal programs will reduce available investment capital and disposable income for many years to come.

The fundamental problem is that MPERS and MSERS involve major long-term commitments, and state officials have historically chosen through public policy, both directly and indirectly, not to pay the necessary costs to keep the programs current with their liabilities. Rather than amend the programs' benefits to make the costs affordable, the reaction has been to further defer paying these costs.

* “Michigan State Employees' Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), B-5; “Michigan Public School Employees' Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), B-5. MPERS and MSERS retiree health plans, which are financed on a “pay-as-you-go” basis, are not prefunded and have almost no assets. See “Michigan Public School Employees' Retiree Health Benefits 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), A-2; “Michigan State Employees' Retiree Health Benefits 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), A-2.

† Prospective federal tax increases include the sunset of tax cuts in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003. See “The Budget and Economic Outlook: An Update” (Congressional Budget Office, 2010), <http://www.cbo.gov/ftpdocs/117xx/doc11705/08-18-Update.pdf> (accessed Sept. 6, 2010).

Part of this is prompted by pension and retiree medical plan provisions that are, as illustrated later, generous by Michigan marketplace standards. The problem has been further exacerbated by the economic downturns in 2001-2003 and 2007-2008, which have adversely impacted asset values within the major pension systems, where investment growth is relied on to fund future benefit obligations. As of Sept. 30, 2009, MPERS' and MSERS' defined-benefit pension plans were 78.9 percent and 78.0 percent funded, respectively.

The actuarial calculations involved in financing these two major pension systems are based upon an annual 8 percent asset return assumption. Achieving and sustaining this 8 percent standard is all the more likely to prove a significant challenge due to the mounting federal, state and local deficits, which will consume private-sector investment capital and disposable income and thereby reduce business growth and gains in the stock market and other classes of assets.

Major statewide public pension systems, such as those in California and New York, are considering revising their investment assumptions to levels as low as 6 percent.⁸ The federal Pension Protection Act of 2006 requires private-sector defined-benefit plans to use a lower funding assumption based upon an index that is currently at or about the 6 percent level.⁹ Reducing MPERS and MSERS assumptions to a similar 6 percent rate would increase the projected liabilities of their defined-benefit pension plans by billions of dollars.

The Pension Protection Act also requires private-sector plans to fully amortize (or “pay off”) any unfunded pension liabilities over shorter periods than those currently being used in MPERS and MSERS. Combined with an assumption of a 6 percent investment return, this shorter amortization period would cause MPERS and MSERS pension liabilities and required employer contributions — and therefore taxpayer contributions — to rise even further than they would under a 6 percent assumption alone.

In contrast, MPERS and MSERS have shifted significant costs beyond the expected retirement age of the average active employee, meaning that in the aggregate, benefits are not fully “paid-up” when the employees retire. For example, in the 2009 actuarial reports, the unfunded liabilities for MPERS and MSERS defined-benefit pension plans were scheduled to be paid off during the next 27 years, even as the average age of MPERS and MSERS members in the plans was 45.4 and 52.1, respectively — far less than 27 years from retirement age.¹⁰

While all this is invisible to the retiree, funding deficits will result in significant deferred costs for the next generation of employees and taxpayers. Since prefunding the costs so they are paid up as they are earned is deemed not affordable (given the actions taken by policymakers), it is hard to imagine how it will be considered affordable in the future.

2007 Revisions

Provisions in state Public Act 15 of 2007, which restated MPSERS asset values and lowered the permissible state contributions, served only to reduce current costs, while deferring other costs, presumably in the name of affordability.* Deferring contributions and liabilities should not be considered as savings just because school districts are able to pay less toward retirement benefits in the current year; rather, it should be considered unpaid amounts left for future taxpayers to finance.

Pension and retiree health care reform provisions contained in Public Acts 110 and 111 of 2007 did raise the thresholds for receiving MPSERS retiree health benefits and increase member contributions for MPSERS pension benefits.¹¹ While directionally correct, such provisions only applied to new hires and will prove to be of minor significance. New hires are a small percentage of MPSERS members, and the increase in what they pay is small given the enormity of the long-term costs facing the state.

OPEB and GASB 45

From an accounting point of view, the MPSERS and MSERS retiree medical benefits described in Michigan law¹² represent accounting liabilities that must be calculated and included in annually disclosed financial reports as long as the Legislature continues to keep the laws on the books. The development and calculation of OPEB liabilities are conceptually similar to those of pensions from an actuarial and accounting perspective.

However, given a 2005 Michigan Supreme Court ruling, there are grounds to believe OPEB accounting liabilities

* The bill revalued MPSERS assets at their market value, rather than the five-year rolling average of their market value (the method used previously). Though the five-year rolling average was retained moving forward, this restatement to market values had the effect of raising the stated asset value of the plan to a market peak. The bill also required the Legislature to pay a smaller amount to the pension fund than needed to stay on pace to prefund the earned pension benefits. For the year, the payment would be equal to "4.5% of the unfunded actuarial accrued liability." *Public Act 15 of 2007*, <http://www.legislature.mi.gov/documents/2007-2008/publicact/pdf/2007-PA-0015.pdf> (accessed Aug. 31, 2010).

for Michigan public employees may be unilaterally modified even for current retirees, meaning that they do not represent binding legal liabilities that cannot be altered.[†] For this reason, OPEB accounting liabilities may be considered to represent a significantly different type of liability from those of MPSERS and MSERS pension benefits. In contrast, modifying pension benefits that employees have already earned would likely present considerable constitutional difficulties.[‡] Hence, the law may treat the two liabilities differently, allowing the Legislature to modify commitments on OPEB[§] and not on pensions.

Effective Sept. 15, 2006, important accounting changes were made to large government retiree medical plans under Government Accounting Standards Board Statement 45 (known as "GASB 45"), which now requires accounting recognition of OPEB liabilities. This transition of OPEB accounting from a pay-as-you-go accounting to a more pension-type accounting system serves to better quantify the amount of current and future costs within the retiree medical benefit program. The effect is to make the liabilities of the MPSERS and MSERS retiree health plans more like pension liabilities and more transparent to the public.

Of important note, unlike pension plans, GASB 45 does not require OPEB liabilities to be prefunded, or paid up, by the time employees retire. While the state has adopted the GASB 45 accounting standard, the funding remains on a "pay-as-you-go" basis. In other words, the money placed in MPSERS and MSERS health plans each year is used only to pay health insurance benefits for current MPSERS and

[†] *Studier v Michigan Public School Employees' Retirement Board*, 472 Mich 642 (2005). Public Act 75 of 2010, however, may have created an unalterable, though limited, OPEB legal liability. As noted earlier, the act requires MPSERS employees to contribute 3 percent of their compensation to an irrevocable trust for MPSERS retiree health care, and the money in this trust may have to be spent on those health care benefits (see, for instance, Patrick J. Wright, "MEA Lawsuit on Retiree Health Benefits Misguided" (Mackinac Center for Public Policy, 2010), <http://www.mackinac.org/archives/2010/v2010-22.pdf> (accessed Aug. 31, 2010)). Also as noted earlier, the money is temporarily being placed in an escrow account pending an MEA lawsuit against the 3 percent requirement. (Public Act 185 may have created a similar legal liability.)

[‡] See Patrick J. Wright, "MEA Lawsuit on Retiree Health Benefits Misguided" (Mackinac Center for Public Policy, 2010), <http://www.mackinac.org/archives/2010/v2010-22.pdf> (accessed Aug. 31, 2010). Wright concludes that modifying pension liabilities would be unconstitutional under a 2005 Michigan Supreme Court decision (see previous footnote).

[§] Gov. Jennifer Granholm, for instance, proposed eliminating retiree dental and vision insurance subsidies for all MPSERS members retiring after Sept. 30, 2010. See "Executive Budget Fiscal Year 2011" (Michigan Office of the Budget, 2010), A-6, http://mi.gov/documents/budget/2_310743_7.pdf (accessed Sept. 3, 2010); "Overview of Governor Granholm's FY 2010-11 Budget" (Michigan Senate Fiscal Agency, 2010), 36-37, 39-40, <http://www.senate.michigan.gov/sfa/Publications/BudUpdates/OverviewGovsRecFY11.pdf> (accessed Sept. 3, 2010).

MSERS retirees, rather than prefunding benefits for active members who have not yet retired.

This pay-as-you-go approach does produce a lower annual cost at present; to prefund these liabilities would involve a significantly higher budgeted annual contribution level. But pay-as-you-go financing also means that no assets are set aside, and therefore that there is no asset growth to help pay for future benefits. At some point in the future, as the number of retirees climbs, the relationship between annual pay-as-you-go and prefunding payments will be reversed, and pay-as-you-go will become more expensive than prefunding.

Under GASB 45, the state's decision to use a pay-as-you-go policy for retiree health benefits means that the state must discount these future liabilities using a lower investment return assumption than the 8 percent basis used in pensions. As a result, the state has selected a 4 percent interest rate assumption that results in significantly higher liabilities than under a prefunded approach, such as the one used in MPSERS and MSERS pension plans.

While a pay-as-you go policy creates near-term cash flow relief compared to a prefunded arrangement, GASB rules also require that the difference between the contribution required each year for prefunding (known as the "annual required contribution") and the pay-as-you-go cost be reflected annually on the balance sheet as a liability. Another assumption that affects the retiree health care liabilities involves the future rate of health care cost increases. While MPSERS and MSERS assumed a 9.0 percent growth in health care costs in fiscal 2010, they also assumed progressively lower annual medical cost growth in subsequent years, reaching an assumed annual rate of increase of 3.5 percent in fiscal 2021 and subsequent years.¹³

It is also difficult to predict the extent to which projected Medicare benefits will offset future retiree health care liabilities, especially given a further and most significant variable: the potential impact of federal health care legislation passed in 2010¹⁴ on GASB 45 liabilities for MPSERS and MSERS retiree health plans. Such considerations are relevant at all levels of state and local government where OPEB liabilities may exist.

Financial engineering of pension and GASB liabilities will prove to be of limited short-term value. The proper balance between short- and long-term costs can be debated, but the need to establish affordable short- and long-term costs is fundamental. While superior MPSERS and MSERS asset growth — in other words, achieving or surpassing the 8 percent assumed annual rate of return — will help

pay future pension costs to an extent, such gains will prove insignificant in retiree medical benefits, given that almost no assets have been set aside to grow and help finance future benefits.

While the pay-as-you-go cost approach provides some short-term budgetary relief, it fails to account for future costs implicit in increased longevity, rising annual health care costs and a growing number of retirees and their eligible dependents. The combined impact of these factors on future retiree medical costs should be better disclosed by policymakers and better understood by legislators and taxpayers as a whole.

As funding requirements increase, the resulting impact on taxpayers will become evident unless legislators decide to borrow or otherwise further defer these costs. This is significant given the funding requirements that already exist for current taxpayers. Without successfully managing these costs, the resulting increases in taxes will create disincentives for individuals and businesses to live, work or invest in Michigan.

The following summary, reported by the Office of Retirement Services, shows MPSERS' and MSERS' unfunded liabilities as of Sept. 30, 2009, the date calculated in the most recent annual actuarial valuation reports, which were released in May and June of this year. Of significant note is that the pensions' unfunded liabilities are not scheduled to be paid off for another 27 years.¹⁵ The pattern of increasing future costs, the likelihood of actuarial losses (which will increase the unfunded liability) and the prospects of a lower assumed rate of return on assets will make it likely that even the current unfunded liability will not be fully amortized over this period.

Graphic 1: Unfunded Liabilities of MPSERS and MSERS Pension and Retiree Medical Benefits (Billions of Dollars)

	Defined-Benefit Pension	Other Post-Employment Benefits (OPEB)	Total
Michigan Public School Employees' Retirement System (MPSERS)	\$11.98	\$16.78 to \$27.58	\$28.76 to \$39.56
Michigan State Employees' Retirement System (MSERS)	\$3.13	\$7.81 to \$12.62	\$10.94 to \$15.75
Total	\$15.11	\$24.59 to \$40.20	\$39.70 to \$55.31

Source: Computations based on "Michigan Public School Employees' Retirement System 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), B-1; "Michigan State Employees' Retirement System 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), B-1; "Michigan Public School Employees' Retiree Health Benefits 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), A-2; "Michigan State Employees' Retiree Health Benefits 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), A-2. As noted elsewhere in the text, the unfunded liabilities for MPSERS and MSERS retiree medical care (or OPEB) may be subject to modification by the state Legislature. The range of figures reported for OPEB liabilities is based on whether a 4 percent or 8 percent interest rate is assumed.

Benchmarking to Michigan's Private Sector

Benchmarking public employee benefit plans to the entire Michigan marketplace should be a priority given the changes reported with increased frequency in the private sector. As a reference, this paper presents a summary review of salaried benefit programs for 24 major Michigan employers in 2010. Such data should be used as a guide in designing sound and competitive benefit plans affordable to Michigan taxpayers. Based upon a review of the retiree benefit provisions of major salaried employers in Michigan, the comparison to MPSERS and MSERS reveals a significantly higher value in the MPSERS and MSERS retiree benefit provisions.

These problems of predictability and affordability in retiree benefits have become apparent in the private sector over the past 10 years, and companies have typically taken the steps necessary to develop costs that are affordable and predictable. An example is the widespread conversion from defined-benefit plans to defined-contribution plans and the significant scarcity of defined-benefit retiree medical plans.

Given the number of employees involved in MPSERS and MSERS (see Graphic 2), the public sector seems unlikely to sustain benefits systems that the private sector has

considered unaffordable, especially since the public sector is dependent upon the private sector for funding these benefits. The public sector's means of reconciling this is frequently seen in funding policies that defer such costs to the next generation.

To benchmark the MPSERS and MSERS pension and retiree medical plans, the author used data that was reported by large Michigan companies in the 2010 national employee benefit survey of major employers conducted annually by Aon Hewitt, an international human resources firm. The proprietary survey, known as Aon Hewitt Benefit SpecSelect™, reports benefits for the companies' salaried employees.

This year, 24 major Michigan companies participated in the survey. The survey, while not comprehensive, included many well-known, publicly traded companies. The companies provided data for an average of 26,045 employees per company, though this skews high due to one particularly large participant; the median was around 10,122. Because of the frequent changes made to private-sector employee benefit plans, the most recent plan modifications may not be reflected in the current survey results.

Graphic 2: MPSERS and MSERS Members by Type as of Sept. 30, 2009

	MPSERS Defined-Benefit Pension Plan	MSERS Defined-Benefit Pension Plan	MPSERS Retiree Health Care	MSERS Retiree Health Care
Active Members (Currently Working)	268,208	27,455	268,208	52,995
Retirees and Beneficiaries	171,922	49,029	171,922	48,850
Inactive Vested	14,454	6,613	1,578	7,021
Total	454,584	83,097	441,708	108,866

Source: "Michigan Public School Employees' Retirement System 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), D-1; "Michigan State Employees' Retirement System 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), D-1; "Michigan Public School Employees' Retiree Health Benefits 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), D-1; "Michigan State Employees' Retiree Health Benefits 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), D-1. "Inactive Vested" are not in the MPSERS and MSERS workforce, but have earned benefits that are payable at a future date.

Comparing Michigan Private-Sector Pensions to MPSERS' and MSERS' Pensions

Aon Hewitt survey data on pension plans are summarized, along with MPSERS and MSERS pension plans, in the series of bullet points in Graphic 3 on Page 12. The comparison is made to MPSERS and MSERS pensions based upon their Sept. 30, 2009, actuarial

valuation reports, which were released in May and June 2010.¹⁶ Some provisions of Public Act 75 and Public Act 185 are also included in the descriptions below. These descriptions are not meant to provide explanations of every detail of these benefit plans.

Notably, none of the 24 companies offered new employees traditional defined-benefit plans in which annual retiree pension benefits are based on the last few years of final pay, when an employee's income is usually highest. In contrast, most MSERS and MPSERS retirees receive a traditional defined-benefit pension based on final years of pay (or strictly speaking, the highest years of pay, which are usually the final years).*

The formulas for these pension benefits generally mean that MPSERS or MSERS members who have 30 years' service receive an annual pension of 45 percent of the average of their final years of compensation[†] (MPSERS members do make financial contributions toward their pension benefits, as described below). The pension benefits are in addition to payments from Social Security.

Some companies in the Aon Hewitt Survey maintained defined-benefit pension plans, but most of these were closed to new employees, while the remainder were "cash-balance" pensions, which are not based on final years of

* MPSERS employees hired after July 1, 2010, receive an annual benefit based on the average of their final five years of pay. Bethany Wicksall, "Legislative Analysis: Public School Retirement Revisions, Senate Bill 1227 as Enacted" (Michigan House Fiscal Agency, 2010), 2, <http://www.legislature.mi.gov/documents/2009-2010/billanalysis/House/pdf/2009-HLA-1227-7.pdf> (accessed Aug. 3, 2010).

MPSERS' defined-benefit plan for Member Investment Plan members, who were hired before July 1, 2010, and represent about 85 percent of current active participants, is based on the average of the employee's final three years of pay. Calculations based on "Michigan Public School Employees' Retirement System 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), D-4. "The Basic Plan and the Member Investment Plan" (Michigan Office of Retirement Services, 2009), http://www.michigan.gov/orsschools/0,1607,7-206-36450_36452--,00.html (accessed Dec. 2, 2009).

There is a MPSERS Tier 1 defined-benefit pension plan for MPSERS "Basic Members" who were hired before Jan. 1, 1987; the benefit involves the highest five consecutive years of compensation (see "The Basic Plan and the Member Investment Plan" (Michigan Office of Retirement Services, 2009), http://www.michigan.gov/orsschools/0,1607,7-206-36450_36452--,00.html (accessed Dec. 2, 2009); "Michigan Public School Employees' Retirement System 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), F-1).

MSERS' formula in most cases is based on the final three years of pay. "Michigan State Employees' Retirement System 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), F-1.

† The formula is generally (average pay over the final years of service) x (years of service) x (1.5 percent). See, for instance, "Michigan Public School Employees' Retirement System 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), F-1, F-2.

pay and are generally considered to have more-predictable costs and liabilities.[‡] In an important regard, the MSERS system compares favorably, since it likewise closed its defined-benefit plan to new hires and provided employees instead with a defined-contribution plan. Of note, all 24 of the companies in the survey offered defined-contribution pension plans.

The preference in retirement plan design among Michigan employers is apparent in the number of defined-contribution plans. It is common for employers to express the cost of retirement and other benefits as a percentage of employee pay, and data from the Aon Hewitt survey suggests that the overall maximum employer average contribution from the 24 Michigan companies was a little over 6 percent of employee pay. A recent survey of Fortune 100 companies found that a majority (58 percent) had a defined-contribution plan only. Typical Fortune 100 workers covered by only a defined-contribution plan received company contributions of 5.77 percent of pay.¹⁷ Also of note, between 1985 and 2010, the percentage of Fortune 100 companies that offered traditional defined-benefit pension plans to new hires fell from 89 percent to 17 percent.¹⁸

This is consistent with the author's experience that private employers are attempting to achieve an overall annual employer cost profile of 5 percent to 7 percent of pay in retirement costs. Private-sector employers that could not achieve this desired level of employer contribution in defined-benefit plans have generally transitioned into defined-contribution plans.

Predictability is another important aspect of effectively managing annual benefit costs. A defined-contribution plan provides a predictable expense each year, while the employer liability of a defined-benefit plan in the long-term can fluctuate in ways difficult to predict, with the annual funding proving easy to manipulate and often involving political considerations.

Of significant note, Michigan state government has already achieved predictability in its MSERS Tier 2 plan, a defined-contribution plan effective for members hired on or after April 1, 1997.[§] In the MSERS Tier 2 plan, the state provides a contribution of up to 7 percent of an employee's pay. Similarly, the state of Alaska, effective July 1, 2006, implemented a mandatory defined-

‡ A cash-balance type of defined-benefit plan expresses the accrued benefit as an account balance that grows with pay-based credits and a formula-based "interest rate." See also first footnote on Page 12.

§ People hired before April 1, 1997, could opt into MSERS Tier 2.

contribution plan for new state employees and for public education employees eligible for the teachers' retirement system. The employer match ranges from 5 percent of pay for state employees to 7 percent of pay for members of the teachers' plan.¹⁹

In contrast, the MPERS defined-contribution plan established under Public Act 75 of 2010 did not significantly alter the basic challenges of MPERS' defined-benefit pension system. While the modifications introduced by Public Act 75 were generally positive, new MPERS members continue to enter a relatively generous defined-benefit pension plan that has considerable unfunded liabilities.

None of the Michigan companies in the Aon Hewitt survey reported defined-benefit pension plans with an automatic "cost-of-living adjustment," which is a periodic — sometimes annual — increase to pension payments in order to account for inflation or increases in overall costs. The presence of an automatic annual cost-of-living adjustment can easily add over 25 percent to the ongoing cost of a pension plan. Public Act 75 of 2010 therefore represents a step in the right direction in eliminating the 3 percent pension cost-of-living adjustment for new public school employees. The \$300 annual cap on the cost-of-living adjustment to MSERS' defined-benefit pension also mitigates the financial impact of MSERS' cost-of-living benefit.²⁰

Still, MPERS Member Investment Plan members hired before July 1, 2010, represent most of the current employees, and the 3 percent cost-of-living adjustment in their pension plan stands in contrast to the companies in the Aon Hewitt Survey. It can be argued that the cost of MPERS cost-of-living benefit is generally offset by the required employee contribution to the plan, a place where MPERS exceeded private-sector norms, since none of the companies required employee contributions. Nevertheless, offsetting the cost-of-living benefit with the employee contribution would lead roughly to an annual "net" benefit provided exclusively by state taxpayers of 1.5 percent of final average three (or five) years' pay times years of service. Such a benefit level is generous by marketplace standards, especially given the trend to defined-contribution plans. As noted, MSERS defined-benefit plan (MSERS Tier 1), which was closed to new members on March 30, 1997, does not require an employee pension contribution.

While the Aon Hewitt survey did not review the conditions under which employees could begin receiving

an unreduced pension benefit, traditionally such salaried plans have included requirements such as reaching ages 60 to 62 with 25 to 30 years of service. In comparison, MPERS and MSERS requirements are more generous.²¹

Graphic 3: Comparison of Pension Benefits for 24 Major Michigan Employers and MPERS and MSERS

24 Major Michigan Employers' Salaried Employees' Pension Benefits

Defined-Benefit Plans

- 0 (0%) had a final pay defined-benefit plan for new employees
- 6 (25%) had a cash-balance defined-benefit plan*
- 10 (42%) had frozen or discontinued their defined-benefit plans
- 8 (33%) did not sponsor a defined-benefit plan of any kind
- No plan reported automatic pension cost-of-living adjustments
- No plan required employee contributions

Defined-Contribution Plans

- All 24 companies (100%) had at least one defined-contribution plan, typically a 401(k) plan
- 6 companies (25%) have currently suspended their 401(k) employer match
- 8 companies (33%) had additional defined-contribution plans, such as a profit-sharing and Employee Stock Ownership Plans;† most of these supplemental plans did not require an employee contribution
- Overall, employers' potential contributions to their various defined-contribution plans averaged 6.16% of total employee salary‡

Source: 2010 Aon Hewitt Benefit SpecSelect™.

* A cash-balance type of defined-benefit plan expresses the accrued benefit as an account balance that grows with pay-based credits and a formula-based "interest rate." However, the investment risk is the responsibility of the plan itself and not the participant. In many plans, the entire account balance may be withdrawn as a lump sum or converted into an annuity. Cash-balance plans tend to be more predictable than traditional pension plans.

† Employee Stock Ownership Plans provide retirement benefits to employees through such mechanisms as selling or providing company stock to employees.

‡ An employer's exact contribution to such plans depends on more than company policy; it usually also depends on the amount of money employees are contributing, how many employees elect to participate in voluntary plans, and, in the case of profit-sharing plans, the company's recent financial results.

MPSERS Defined-Benefit Pension Provisions (MPSERS Tier 1) for Member Investment Plan

The benefits described below apply to “Member Investment Plan” individuals joining the MPSERS pension plan on or after Jan. 1, 1990 — approximately 85 percent of current active participants.*

- Annual pension benefit formula (in general):
Hires before July 1, 2010:
Final average 3 years’ compensation[†] x 1.5 percent x years of service
Hires on or after July 1, 2010:
Final average 5 years’[‡] compensation x 1.5 percent x years of service
- Unreduced retirement with 30 years’ service; age 60 with 10 years’ service, or age 60 with 5 years’ service just completed²²
- Cost-of-living adjustments:
Hires before July 1, 2010:
Annual pension cost-of-living adjustment of 3 percent (MIP member who retired on or after Jan. 1, 1987)²³
Hires on or after July 1, 2010:
No annual pension cost-of-living adjustment
- Required employee contribution of 3 percent for first \$5,000 of pay, 3.6 percent of the next \$10,000 of pay and 4.3 percent of pay in excess of \$15,000 (4.3 percent increased to 6.4 percent effective for new entrants on July 1, 2008 or later; MIP members hired before Jan. 1, 1990, contribute 3.9 percent of pay)²⁴

Source: Michigan Public School Employees’ Retirement System 2009 Annual Actuarial Valuation Report; Public Act 75 of 2010.

MSERS Defined-Benefit Provisions (MSERS Tier 1)

The description below applies to most MSERS members; there are exceptions for corrections officers, conservation officers and some other classifications.

- Closed to new entrants after March 31, 1997. (New entrants joined a defined-contribution plan with an employer match varying from 4 percent to 7 percent of pay, depending on employee contribution)[§]
- Annual pension benefit formula (in general):
Final average 3 years’ compensation[¶] x 1.5 percent x years of service
- Unreduced retirement benefits (in general): Age 55 with 30 years’ service, or age 60 with 10 years’ service²⁵
- A cost-of-living adjustment of 3 percent annually for members retiring on or after Oct. 1, 1987, though a retiree’s annual upward adjustment is capped at \$300²⁶
- No employee contributions²⁷

Source: Michigan State Employees’ Retirement System 2009 Annual Actuarial Valuation Report.

Comparing Michigan Private-Sector Retiree Medical Benefits to MPSERS’ and MSERS’ Plans

Separate yet related to the pension issue is the challenge of predictability and affordability of future retiree medical costs.

The existence of employer-provided retiree medical coverage in 2010 is significant unto itself, given national trends and the Michigan private-employers’ data from the Aon Hewitt Survey (see Graphics 4 and 5).

Graphic 4 reflects a national survey of large employers conducted by Mercer, an international human resources consulting firm, indicating the decline in employer-sponsored retiree health care nationwide. Although companies are somewhat more likely to offer health

§ In MSERS’ defined-contribution plan, the state employer contributes an amount equal to 4 percent of the employee’s pay to a personal defined-contribution account. The state also matches any additional employee contribution up to 3 percent of the employee’s pay, making a maximum employer contribution of 7 percent of the employee’s pay. See “State of Michigan 401(K) and 457 Plans” (State of Michigan), 1-2, https://stateofmi.ingplans.com/einfo/pdfs/forms/michigan/plans_guide.pdf.

¶ The annual actuarial valuation report states that the pension benefit depends on the highest three consecutive years of compensation for most MSERS members (see “Michigan State Employees’ Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), F-1). These will typically be the final three years.

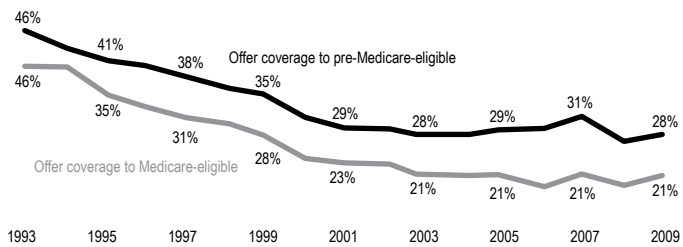
* Calculations based on “Michigan Public School Employees’ Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), D-4. “The Basic Plan and the Member Investment Plan” (Michigan Office of Retirement Services, 2009), http://www.michigan.gov/orsschools/0,1607,7-206-36450_36452--,00.html (accessed Dec. 2, 2009). There is a MPSERS Tier 1 defined-benefit pension plan for MPSERS “Basic Members” who were hired before Jan. 1, 1987 (see “The Basic Plan and the Member Investment Plan” (Michigan Office of Retirement Services, 2009), http://www.michigan.gov/orsschools/0,1607,7-206-36450_36452--,00.html (accessed Dec. 2, 2009).)

† The annual actuarial valuation report states that the pension benefit depends on the highest three consecutive years of compensation for MIP members (see “Michigan Public School Employees’ Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), F-1). These will typically be the final three years.

‡ Public Act 75 of 2010 actually sets this as the highest five years of compensation (see “Public Act 75 of 2010,” Sec. 4 (12), <http://www.legislature.mi.gov/documents/2009-2010/publicact/pdf/2010-PA-0075.pdf> (accessed Aug. 3, 2010)). These will typically be the final five years.

care coverage to retirees who are not yet eligible for Medicare,* the number who offer either kind of coverage are clearly in the minority.

Graphic 4: Percentage of Large U.S. Employers Offering Retiree Medical Plans to New Hires, 1993-2009



Source: Mercer's National Survey of Employer-Sponsored Health Plans. See "In a Tough Year, Employers Hold the Line on Health Benefit Cost Increases" (Mercer, Nov. 18, 2009), <http://www.mercer.com/summary.htm?siteLanguage=100&idContent=1364345> (accessed Sept. 6, 2010).

The recent changes affecting the entire auto industry underscore this point. The norm where coverage continues to exist is in an environment of plans closed to new hires, reduced benefits, increased premiums — 100 percent employee-paid, in several cases in the Aon Hewitt survey — or liability caps defining an employer's future cost. Moreover, continuation of other insurances, such as dental and vision coverage, adds to the value of MPSERS and MSERS benefit packages.

Graphic 5 once again draws upon the 2010 Aon Hewitt survey for 24 large Michigan companies. The descriptions of the MPSERS and MSERS benefits are based upon their Sept. 30, 2009, actuarial valuation reports, as well as Public Act 75 and Public Act 185. As in Graphic 3, these descriptions are not meant to provide detailed explanations of these benefit plans.

Graphic 5: Comparison of Retiree Health Care Benefits for 24 Major Michigan Employers and MPSERS and MSERS

24 Major Michigan Employers' Salaried Employees Retiree Medical Benefits

- 17 (71%) provided no coverage, ceased offering coverage to new employees or created transition arrangements reducing coverage for existing employees
- 4 (17%) offered coverage with a 100 percent retiree contribution
- 3 (12.5%) offered employer-subsidized coverage

Source: 2010 Aon Hewitt Benefit SpecSelect™.

* Companies more frequently offer pre-Medicare health coverage than Medicare supplementary insurance because the pre-Medicare benefit is generally more attractive to employees. From the employer's perspective, pre-Medicare insurance has the advantage of ending predictably when the retiree turns 65, limiting the employer's liability.

MPSERS Retiree Medical Benefits

MPSERS pension recipients, including both MIP and non-MIP members, are generally eligible for the following benefits.[†]

- Pension recipients are eligible for up to a 100 percent employer-paid health plan[‡] and a 90 percent employer-paid dental, vision and hearing coverage
- *Hires before July 1, 2008:*
Receive between 10 percent and 100 percent of the maximum employer contribution for between 21 and 30 or more years' service
- *Hires after July 1, 2008:*
If retiree is less than age 60, employer pays 90 percent of the maximum amount if the employee has 25 years or more of service; if the retiree is age 60 or older, the employer pays between 30 percent and 90 percent of the maximum employer contribution for between 10 and 25 or more years' service[§]
- Retirees pre-Medicare pay an amount equal to the Medicare Part B Premium[§]
- As of July 1, 2010, MPSERS active members are required to contribute 3 percent of their compensation toward payment of MPSERS retiree health care benefits[§]

Source: Michigan Public School Employees' Retiree Health Benefits 2009 Annual Actuarial Valuation Report and Public Act 75 of 2010.

MSERS Retiree Medical Benefits

As in Graphic 3, the description below applies to most MSERS members (exceptions occur for corrections officers and some others).

- As of Nov. 1, 2010, and until Sept. 30, 2013, MSERS active members are required to contribute 3 percent of their compensation toward payment of retiree health care benefits.[§]

Defined-Benefit Participants (MSERS Tier 1)

- All MSERS Tier 1 retirees are eligible for benefits[§]
- MSERS Tier 1 retirees receive 90 percent employer-paid health insurance premiums and 90 percent employer-paid dental and vision insurance premiums[§]

[†] "Michigan Public School Employees' Retiree Health Benefits 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), C-1. There are some exceptions for members who have retired from deferred vested status.

[‡] The health plan is referred to as the "Master Health Plan" and is authorized by the MPSERS board and the Department of Management and Budget. MCL 38.1391; MCL 38.1304(4).

[§] Bethany Wicksall, "Legislative Analysis: Public School Retirement Revisions, Senate Bill 1227 as Enacted" (Michigan House Fiscal Agency, 2010), 1, <http://www.legislature.mi.gov/documents/2009-2010/billanalysis/House/pdf/2009-HLA-1227-7.pdf> (accessed Aug. 3, 2010). As noted earlier, several public school employees have filed a lawsuit claiming this provision to be unconstitutional, and a court order has temporarily placed collection of the 3 percent contribution into an escrow account, rather than the MPSERS retiree health care trust fund established by the Legislature.

Defined-Contribution Participants (MSERS Tier 2 in general)*

- Eligible after 10 years' service and may receive benefits at age 60 or at age 55 with 30 years' service³³

- *Hires before April 1, 2010:*

Receive between 30 percent and 90 percent of medical, dental and vision insurance premiums for between 10 years' and 30 years' service (essentially 3 percent x years of service)[†]

- *Hires after April 1, 2010*

Receive between 30 percent and 80 percent of medical, dental and vision insurance premiums for 10 or more years' service (essentially 3 percent x years of service with a cap at 80 percent)[‡]

Source: Michigan State Employees' Retiree Health Benefits 2009 Annual Actuarial Valuation Report, Public Act 185 of 2010 and Wicksall, "Senate Bill 1226 (H-38 as Amended)."

Conclusion

If Michigan is ever to effectively manage public employee benefit costs, it must first engineer these plans around the taxpayers' ability to pay both now and in the future. This means having costs that are current, predictable and affordable. The research for this paper revealed little evidence of all three parameters in MPERS and MSERS pensions and retiree medical benefits. Moreover, the future portends greater fiscal challenges.

Given the precarious fiscal state of affairs in Michigan, one is reminded of the frequent experience that when taxes are increased, economic activity contracts. As evidenced in the tax increases associated with the

* There are exceptions. MSERS Tier 1 members who opted to join the MSERS Tier 2 defined-contribution pension plan have the same retiree health care eligibility and benefits as Tier 1 members. There are also "special retirement eligibility conditions for corrections officers, conservation officers, or retirees under early retirement window programs." See "Michigan State Employees' Retiree Health Benefits 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), C-1. See also the discussion of Public Act 185 on Page 6 and Page 7 of this study and the accompanying footnotes.

† Technically, Public Act 185 provides an additional cap on the share of the premium paid by MSERS, but at present, this cap does not generally affect the calculation described in the main text above. See Public Act 185 of 2010, Sec. 68(4); Bethany Wicksall, "Legislative Analysis: State Employees' Retirement Revisions, Senate Bill 1226 (H-38 as Amended)," (Michigan House Fiscal Agency, 2010), 2; and "Michigan State Employees' Retiree Health Benefits 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), C-1.

‡ Technically, as in the previous footnote, the arrangement is more complex. See Public Act 185, Sec. 68(4); see also Bethany Wicksall, "Legislative Analysis: State Employees' Retirement Revisions, Senate Bill 1226 (H-38 as Amended)," (Michigan House Fiscal Agency, 2010), 2.

prior state budgets, tax increases to address MPERS and MSERS would undoubtedly have a corresponding impact in the marketplace. Expected future increases in employee benefit costs will further test the system and lead to a difficult economic environment.

This situation is particularly ironic, given that the state was visionary in converting to a defined-contribution plan for MSERS members in 1997. This is a case study for the state. Such a conversion reaffirms the notion seen in the private and public sectors that annual pension costs need to be in the range of 5 percent to 7 percent of payroll.

Despite the MSERS Tier 2 defined-contribution plan, which carries no unfunded liabilities, MSERS on the whole continues to carry an unfunded deficit from Tier 1 participants who were members of MSERS prior to 1997. This liability is scheduled to be paid off over the next 27 years.

Michigan policymakers should mirror the 1997 action and place all new public school employees in a defined-contribution plan to achieve affordable, predictable and fully funded costs. The state should also begin to better manage its GASB 45 OPEB liability through a combination of plan design and eligibility reforms.

Public understanding of MPERS and MSERS pension and retiree medical benefits would be significantly enhanced if the Legislature required the Office of Retirement Services annually to publish a 20-year forecast of expected liabilities and expected taxpayer contributions. Such a projection provided now would affirm the belief that these programs are unsustainable and highlight the limited impact current reforms are likely to play in the long run.

The idea of switching new MPERS employees into a program similar to that of MSERS Tier 2 was recently analyzed in a publication of the Michigan Senate Fiscal Agency.³⁴ The paper confirmed that in the long term, a defined-contribution plan for new employees would save money and provide predictable costs, but also concluded that the savings would not be realized for a number of years.

The savings, however, would probably be even greater than estimated by the SFA. The paper implies that the normal cost of the MPERS program represents the actual annual cost of the program. In fact, the normal cost of the program is only part of the annual cost; another portion is the annual payment on the unfunded liability. Hence, the normal cost does not represent the full cost of the plan. Indeed, if the normal cost were considered an

absolute measure of the true cost of the MPERS defined-benefit pension plan, the plan would not have an accrued unfunded liability of nearly \$12 billion.

Following this, all pension and retiree costs should be fully recognized during the working career of the workforce; in other words, amortization of an employee's costs should not extend into the worker's retirement years. The compound impact of these existing pension and retiree medical programs will likely create unaffordable costs. The only mitigating factor could be in the pension area, where market gains in excess of the benchmark of 8 percent could help offset future cost increases.

However, the reality is that the investment assumption will likely be lowered to less than 8 percent and amortization periods will likely be shortened due to economic realities and potential GASB reforms.* Equally important is the risk that any future MPERS and MSERS funding progress and higher-than-expected asset growth could be an incentive for additional benefit enhancements to be enacted.

Poor benchmarking is a problem plaguing the public sector. Frequently, a given benefit provision or financial approach is justified as being common practice in other public plans — plans that often have even larger funding deficits. As an example, pension cost-of-living adjustments are virtually nonexistent in the private sector while defined-benefit plans are in decline, yet the common justification for such benefits is to simply reference another state that has them.

Instead, Michigan policymakers should design employee-benefit plans considering market trends and the best-demonstrated practices in both the private and public sectors in Michigan and the rest of the country.

These basic problems of poor benchmarking, deferred costs, and the lack of predictability and affordability in retiree costs will continue as long as they are ignored. These issues are highly interrelated. Without significant reforms, state taxpayers are facing costs that will exceed

* For instance, the Governmental Accounting Standards Board is currently considering a new standard that would require public-sector pension funds to amortize debt over fewer years and to assume a lower rate of annual asset growth for accounting purposes. See, for example, Dunstan McNichol, "States Face Pension Stress as GASB Rules Widen Gap" (Bloomberg Businessweek, July 9 2010), <http://www.businessweek.com/news/2010-07-09/states-face-pension-stress-as-gasb-rules-widen-gap.html> (accessed Sept. 6, 2010); "Pension Accounting and Financial Reporting by Employers: Plain Language Supplement," (Governmental Accounting Standards Board, 2010), http://www.gasb.org/cs/ContentServer?c=Document_C&pagename=GASB/Document_C/GASBDocumentPage&id=1176156938146 (accessed Sept. 8, 2010).

their ability to pay and will likely become significant burdens to the next generations of taxpayers.

It is hoped this paper will provide a basis to promote an increased awareness and discussion on these needed reforms. ❧

Endnotes

- 1 For examples from the major Detroit newspapers, see Ron French, "Michigan's Education Time Bomb: Costly, Loophole-Ridden Retirement System Threatens Public Schools," *The Detroit News*, May 10, 2007, <http://detnews.com/article/20070510/SCHOOLS/705100442&template=printart>; Dawson Bell, "State Public Retirement Funds \$50 Billion Short," *Detroit Free Press*, Feb. 18, 2010, <http://www.freep.com/article/20100218/NEWS06/2180470/State-public-retirement-funds--50-billion-short> (accessed March 8, 2010).
- 2 "State of Michigan 401(K) and 457 Plans" (State of Michigan), 1-2, https://stateofmi.ingplans.com/einfo/pdfs/forms/michigan/plans_guide.pdf.
- 3 *McMillan v Michigan Public School Employees Retirement System*, Michigan Court of Claims, No 10-45-MM.
- 4 Karen Bouffard, "Judge: Michigan Can't Tap School Pension Contributions until Suit Is Resolved," *The Detroit News*, 2010.
- 5 Bethany Wicksall, "Legislative Analysis: Public School Retirement Revisions, Senate Bill 1227 as Enacted" (Michigan House Fiscal Agency, 2010), <http://www.legislature.mi.gov/documents/2009-2010/billanalysis/House/pdf/2009-HLA-1227-7.pdf> (accessed Aug. 3, 2010).
- 6 Calculations based on Wicksall, "Legislative Analysis: State Employees' Retirement Revisions, Senate Bill 1226 (H-38 as amended)," 2.
- 7 Wicksall, "Legislative Analysis: State Employees' Retirement Revisions, Senate Bill 1226 (H-38 as amended)," 5.
- 8 Michael Quint, "New York May Cut Assumed Rate of Return on Pension Investments," *Bloomberg*, Aug. 20, 2010, <http://www.bloomberg.com/news/2010-08-20/new-york-may-cut-assumed-8-rate-of-return-on-retiree-pension-investments.html>; Gina Chon, "Calpers Confronts Cuts to Return Rate," *The Wall Street Journal*, March 1, 2010, <http://online.wsj.com/article/SB10001424052748703316904575092362999067810.html> (accessed April 23, 2010).
- 9 "Update for Weighted Average Interest Rates, Yield Curves, and Segment Rates: Notice 2010-57" (The Internal Revenue Service, 2010), <http://www.irs.gov/pub/irs-drop/n-10-57.pdf> (accessed Sept. 5, 2010).
- 10 "Michigan Public School Employees' Retirement System 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), D-4; "Michigan State Employees' Retirement System 2009 Annual Actuarial Valuation Report" (Gabriel Roeder Smith & Company, 2010), D-4.
- 11 "Public Acts 110 and 111 of 2007 At-A-Glance" (Michigan Department of Management & Budget, 2009), http://www.state.mi.us/dmb/ors/emp/psru/docs/R0763C_RetirementLawAtAGlance.pdf (accessed Sept. 17, 2009).

12 MCL 38.1301-1467 and MCL 38.1-69.

13 See “Michigan State Employees’ Retiree Health Benefits 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), E-7; “Michigan Public School Employees’ Retiree Health Benefits 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), E-7.

14 Specifically, the Patient Protection and Affordable Care Act of 2010, as well as additional provisions in the federal Health Care and Education Reconciliation Act of 2010.

15 “Michigan Public School Employees’ Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), A-1; “Michigan State Employees’ Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), A-1.

16 “Michigan State Employees’ Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010); “Michigan Public School Employees’ Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010).

17 Brendan McFarland, “Prevalence of Retirement Plans by Type in the Fortune 100” (Towers Watson, 2010), Figure 1, Figure 7, <http://www.towerswatson.com/united-states/research/2106> (accessed Sept. 3, 2010).

18 Ibid., Figure 1.

19 “PERS and TRS Defined Contribution Retirement Plan: General Plan Information” (State of Alaska Division of Retirement and Benefits, 2010), http://doa.alaska.gov/drbdcrp/pdf/AK_DCR_PlanInfo_030410.pdf (accessed Aug. 15, 2010).

20 “Michigan State Employees’ Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), F-3.

21 Ibid., F-1; “Michigan Public School Employees’ Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), F-1.

22 “Michigan Public School Employees’ Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), F-3.

23 Ibid.

24 “Public Acts 110 and 111 of 2007 at-a-Glance” (Michigan Department of Management & Budget, 2009), http://www.state.mi.us/dmb/ors/emp/psru/docs/R0763C_RetirementLawAtAGlance.pdf (accessed Sept. 17, 2009); “Michigan Public School Employees’ Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), F-2.

25 “Michigan State Employees’ Retirement System 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), F-1.

26 Ibid., F-3.

27 Ibid.

28 “Michigan Public School Employees’ Retiree Health Benefits 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), C-1.

29 Ibid.

30 Public Act 185 of 2010 (State of Michigan, 2010), Sec. 35(1)-(2), <http://www.legislature.mi.gov/documents/2009-2010/publicact/pdf/2010-PA-0185.pdf> (accessed October 6, 2010).

31 “Michigan State Employees’ Retiree Health Benefits 2009 Annual Actuarial Valuation Report” (Gabriel Roeder Smith & Company, 2010), C-1.

32 Ibid.

33 Ibid.

34 Kathryn Summers-Coty, “Examining a Change from Defined Benefit to Defined Contribution for the Michigan Public School Employees’ Retirement System,” (Michigan Senate Fiscal Agency, 2009), <http://www.senate.michigan.gov/sfa/Publications/Notes/2009Notes/NotesMarApr09ks2.pdf> (accessed Aug. 24, 2010).

Estimated Savings From Michigan's 1997 State Employees Pension Plan Reform

By Richard C. Dreyfuss

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Executive Summary*

In 1997, as a result of state legislation, the pension plan for the Michigan State Employees' Retirement System underwent a significant change. State employees who qualified for MSERS and who were hired on or after March 31, 1997, were placed in a "defined-contribution" retirement plan. Under this system, they were provided with individual retirement savings accounts to which the state government makes mandatory contributions and the employees make voluntary contributions.

This retirement savings plan, which defines the state's deposits to the retirement account but not the level of future retirement benefits, stands in contrast to MSERS' ongoing "defined-benefit" pension plan for state employees who were hired before March 31, 1997. Under that traditional plan, state government promises an employee a defined annual retirement income. To finance these future pension benefits, state government sets aside money and invests it annually, using the assets accrued over time to pay employees' retirement benefits as they come due. Under this traditional plan, the investment risk lies with the state — ultimately, with the taxpayers.

In this Policy Brief, the author analyzes state pension data to determine whether state taxpayers have saved money because of the decision to close the MSERS defined-benefit plan to new members and to place them in the MSERS defined-contribution plan instead. The author reviews three areas of potential cost-savings: annual "normal costs"; unfunded liability; and "political incentives."

* Citations provided in the study's main text.

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The "normal cost" of a defined-benefit plan is the annual cost to state government of prefunding the future retirement benefits that working members earned in that particular year. The average normal cost of the MSERS defined-benefit plan from fiscal 1997 through fiscal 2010 — i.e., from the first year of the MSERS transition through the most recent year for which complete data is available — was 8.1 percent of the previous year's payroll (the previous year's payroll is typically employed by the state when measuring this cost).

The state's annual cost of benefits earned under the MSERS defined-contribution plan cannot exceed 7 percent of the current year's payroll, due to the plan's design. Using data from the Michigan Office of Retirement Services, the Michigan Senate Fiscal Agency and the MSERS defined-benefit plan's comprehensive annual financial reports, the author estimates that from fiscal 1997 through fiscal 2010, state government saved a total of \$167 million in MSERS defined-benefit plan normal costs by switching new employees to the defined-contribution plan. This estimate includes an adjustment for the increased normal costs that can result from the closing of a defined-benefit plan.

A second potential area of savings involves the defined-benefit plan's unfunded liability. This liability occurs whenever contributing the normal costs proves insufficient to ensure that a defined-benefit plan remains on track to meet its future pension obligations. As of September 30, 2010, the MSERS defined-benefit plan had an unfunded liability of approximately \$4.1 billion. This shortfall has developed for several reasons, including the fact that the plan's assets have not been growing at the actuarially assumed rate of 8 percent annually and the fact that the Legislature did not make the annual required contributions needed to finance the unfunded liability once it arose. If new employees had continued to enter the MSERS defined-benefit plan, the plan's unfunded liability

would almost certainly have been higher — an estimated \$2.3 billion to \$4.3 billion higher, given a proration based on state data.

Some argue that any savings from switching new employees from a defined-benefit to a defined-contribution plan is mitigated by the fact that closing the defined-benefit plan requires future amortization payments to be made on a “level-dollar basis,” which is initially more expensive than the level-percent-of-payroll basis used for an open plan. This “transition-cost” argument is dubious, however. The switch to a level-dollar amortization pattern does not alter the benefits ultimately paid, and in MSERS’ case, the state has generally failed to make the level-dollar amortization payments.

A final area of cost analysis involves the change in political incentives that occurs with the creation of a defined-contribution plan. A defined-benefit plan can carry considerable unfunded liabilities, while retroactive benefit increases can be enacted and necessary funding significantly deferred. Indeed, since proper funding of a defined-benefit plan requires taxing current voters to provide pension benefits that may not be paid out for years, sound funding policy can be unappealing to legislators seeking re-election and hoping to provide visible benefits now.

In contrast, a defined-contribution plan cannot be legally underfunded, and any increase in the plan’s benefits must essentially be paid for when the change is made. A defined-contribution plan thus reduces the political opportunities to defer funding of pension benefits to a future generation of taxpayers and avoids placing a questionable burden on taxpayers who may have been too young to vote when benefits were granted and funding was postponed. While it is difficult to quantify the savings from improved political incentives — the author offers no estimate — this category may be the single largest area of savings over time.

Thus, from fiscal 1997 through fiscal 2010, the MSERS defined-benefit plan is estimated to have saved state taxpayers \$167 million in pension normal costs, \$2.3 billion to \$4.3 billion in lower unfunded liabilities, and important but unquantifiable sums by improving the political incentives of pension funding. These considerable savings and the fact that the plan is predictable, affordable and current in its obligations make it a model for reform of other state government pension plans.

Introduction

On March 31, 1997, Michigan took what is still considered a dramatic step towards reforming the state’s public-sector “defined-benefit” pension system. This change required state hires who qualified for the Michigan State Employees’ Retirement System from that day forward to enroll in a “defined-contribution” pension plan, rather than the existing defined-benefit pension plan.¹ This new policy was effected by legislation passed in December 1996 by Gov. John Engler and the Michigan Legislature. The same legislation provided continuing MSERS defined-benefit members a one-time chance to voluntarily switch to the new defined-contribution plan.²

The author describes the difference between the two types of retirement plans in a Mackinac Center Policy Brief published in October 2010:

In ... defined-benefit plans, the members’ government employer assumes the responsibility of annually investing employer and employee pension contributions in amounts sufficient to finance a projected annual retirement income. These plans place all of the investment risk on the government employer — in this case, on the taxpayer.

... In [a defined-contribution] plan, the state makes ongoing contributions to a tax-favored account, with the employee able to contribute as well. The employee directs investment of the monies, and the accumulated capital is available to the individual at retirement. State government and state taxpayers do not assume investment risk, and the plan incurs no unfunded liability; the amount of money at retirement largely depends on investment returns over time.³

Informally, a defined-benefit plan is the kind common 20 years ago, where an employer promised to pay a “guaranteed” pension, while a defined-contribution plan is an individual account — often a 401(k) — in which an employer helps an employee save for retirement.

Michigan continues to maintain the MSERS defined-benefit plan for members hired prior to March 31, 1997.* A separate statewide defined-benefit plan covering public school employees (“MPERS”) was unaffected by this 1997 change and remains in effect today.† As of September 30, 2010 (the most recent date for which full

* The MSERS defined-benefit plan is also referred to as the “MSERS Tier 1” plan, while the MSERS defined-contribution plan is referred to as “MSERS Tier 2.”

† MPERS stands for Michigan Public School Employees’ Retirement System.

data are available), the significant unfunded liabilities of the MSERS and MPSERS defined-benefit plans — approximately \$4.1 billion and \$17.6 billion, respectively⁴ — raise significant questions regarding sustainability and exactly how this can be viewed as a favorable incentive to live, work and invest in Michigan.

Given that approximately 14 years have passed since the adoption of the MSERS defined-contribution plan, it is possible to review the plan's current status to determine the financial impact of the 1997 change. Such a topic is difficult to analyze precisely, given that it effectively requires certain assumptions regarding the current status of the MSERS pension plan had this change not occurred. Nevertheless, because the MSERS defined-benefit plan still exists, one can develop reasonable estimates and general conclusions, presenting the results in terms of ranges where appropriate. This Policy Brief is intended to produce such estimates for policymakers to consider.

Estimating the Financial Impact of Adopting the MSERS Defined-Contribution Plan

In the MSERS defined-contribution plan, the state employer contributes an amount equal to 4 percent of each employee's pay to the employee's retirement account. The employee also receives an additional 100 percent employer match on the next 3 percent of pay that he or she voluntarily contributes.*

To address the question of whether this plan has saved taxpayers money, the brief analysis below falls into three categories:

- (1) Measuring the annual employer contributions to the MSERS defined-contribution plan vs. the defined-benefit "normal cost"
- (2) The potential impact on state government's unfunded liability
- (3) Potentially counterproductive political incentives in pension plans.

Each of these categories is examined in turn below. The analyses are based upon certain simplifying assumptions. Different assumptions could yield materially different results.

* "State of Michigan 401(K) & 457 Plans Key Features" (Michigan Office of Retirement Services), https://stateofmi.ingplans.com/csinfo/pdfs/forms/michigan/640002/key_features.pdf (accessed September 23, 2009). An employee's maximum annual contribution is "[t]he lesser of \$16,500 or 100% of compensation." Ibid.

(1) Annual "Normal Costs"

The "normal cost" of a defined-benefit plan is the annual employer cost of the future liability associated with the benefits earned in that particular year.[†] State government's normal cost for the MSERS defined-benefit plan in fiscal years 1997 through 2010 has averaged 8.1 percent of the previous year's payroll.[‡] This actuarially determined normal cost is based on a number of assumptions, including a projection of 8 percent annual returns on the plan's invested assets.[§] The defined-contribution plan has an annual employer cost of between 4 percent and 7 percent of the current year's payroll.[§]

To estimate the normal cost savings from placing new MSERS employees in a defined-contribution plan, the author compared the cost of pension benefits for employees under the MSERS defined-contribution plan to the normal cost of the benefits for employees remaining in the MSERS defined-benefits plan. To perform this calculation, the author used several sources of data.

Data for the MSERS defined-benefit system for fiscal years 1996 through 2010 was taken from a series of MSERS comprehensive annual financial reports.[¶] The reports provided both the MSERS defined-benefit payroll figures and the MSERS defined-benefit normal costs.

Payroll data for MSERS defined-contribution employees for fiscal years 2000 through 2009 were provided by the Michigan Office of Retirement Services.[¶] The ORS did not have this data for fiscal year 2010 at the time of this writing,[¶] and the office is unable to provide the data for fiscal years 1997 through 1999.[¶] The 2010 payroll figure was obtained from the Michigan State Employees' Retiree Health Benefits 2010 Annual Actuarial Valuation Report.[¶] The defined-contribution payroll figures for fiscal years 1997 through 1999 were estimated as a linear increase

[†] This normal cost is distinct from payments made to address "unfunded liabilities" carried over from previous years. These liabilities are discussed in the next section.

[‡] Author's calculations based on figures from the comprehensive annual financial reports for the Michigan State Employees' Retirement System in fiscal years 1998, 2000, 2002, 2004, 2006, 2008 and 2010. See "State Employees Defined Benefit Plan: Comprehensive Annual Financial Reports (CAFRs)," (Department of Technology, Management & Budget, Office of Retirement Services, 2011), <http://goo.gl/AE6zU> (accessed May 10, 2011). Normal costs were calculated as a percentage of the previous year's payroll, as opposed to the current year's payroll, because this approach has been adopted in the comprehensive annual financial reports for the MSERS defined-benefit plan.

[§] The exact employer cost depends on how much personal money each employee chooses to contribute to the plan (see earlier discussion in main text). "State of Michigan 401(K) & 457 Plans Key Features," (Michigan Office of Retirement Services), https://stateofmi.ingplans.com/csinfo/pdfs/forms/michigan/640002/key_features.pdf (accessed September 23, 2009).

from an MSERS defined-benefit payroll of \$0 in fiscal 1996 (before the MSERS reform) to the known value of \$531 million in fiscal 2000.

State government is unable to provide data for the state's defined-contribution payments for MSERS members for the fiscal years 1997 through 2010.¹¹ The Michigan Senate Fiscal Agency, however, was able to provide the state's defined-contribution payments and payroll for all employees in state-managed defined-contribution systems: MSERS, the Michigan Legislative Retirement System and the Michigan Judges' Retirement System.¹² In order to develop the estimate below, the author assumes that the MSERS defined-contribution payments as a percentage of MSERS defined-contribution payroll will be approximately the same as this same percentage for

the three state systems combined. Given that MSERS employees comprise the vast majority of employees in the three systems, this assumption seems reasonable.

It could be questionable, however, to compare this estimated percentage for the MSERS defined-contribution plan to the percentage obtained when the state's normal cost for the MSERS defined-benefit plan is expressed as a percent of the MSERS defined-benefit payroll. The author recognizes that closing the MSERS defined-benefit plan to new entrants in 1997 probably raised the plan's normal costs, since these costs tend to trend upward with an aging plan population.*

* With a defined-benefit plan using the "entry-age normal" cost method (the method used by MSERS defined-benefit plan), it is possible to argue that the

Graphic 1: Estimated Total Normal Cost Savings From Shifting New MSERS Employees to a Defined-Contribution Pension Plan, 1997-2010

Fiscal Year Ending 9/30	Payroll for MSERS Defined-Contribution Employees ^a	State's Defined-Contribution Payments as Percent of Current Payroll (Estimated) ^b	Payroll for MSERS Defined-Benefit Employees	State's Defined-Benefit Normal Cost for MSERS	State's Defined-Benefit Normal Cost as Percent of Previous Year's Payroll	Adjusted Normal Cost as Percent of Previous Year's Payroll	Estimated Financial Savings From Lower Normal Cost of Defined-Benefit Plan
	(A)	(B)	(C)	(D)	(E) = (D)/(C) [†]	(F) = (E)-0.5%	(G) = ((F)-(B))•(A)
1996	\$0		\$2,515,000,000				
1997	\$133,000,000	5.1%	\$2,273,000,000	\$230,000,000	9.1%	8.6%	\$5,000,000
1998	\$265,000,000	6.0%	\$2,108,000,000	\$186,000,000	8.2%	7.7%	\$4,000,000
1999	\$398,000,000	6.2%	\$2,214,000,000	\$161,000,000	7.6%	7.1%	\$4,000,000
2000	\$531,000,000	6.1%	\$2,254,000,000	\$172,000,000	7.8%	7.3%	\$6,000,000
2001	\$641,000,000	6.1%	\$2,231,000,000	\$174,000,000	7.7%	7.2%	\$7,000,000
2002	\$682,000,000	6.1%	\$2,133,000,000	\$174,000,000	7.8%	7.3%	\$8,000,000
2003	\$798,000,000	6.0%	\$1,860,000,000	\$173,000,000	8.1%	7.6%	\$13,000,000
2004	\$909,000,000	6.1%	\$1,889,000,000	\$152,000,000	8.2%	7.7%	\$15,000,000
2005	\$991,000,000	6.2%	\$1,880,000,000	\$152,000,000	8.1%	7.6%	\$13,000,000
2006	\$1,053,000,000	6.3%	\$1,848,000,000	\$154,000,000	8.2%	7.7%	\$15,000,000
2007	\$1,147,000,000	6.1%	\$1,826,000,000	\$153,000,000	8.3%	7.8%	\$20,000,000
2008	\$1,235,000,000	6.4%	\$1,764,000,000	\$151,000,000	8.3%	7.8%	\$17,000,000
2009	\$1,380,000,000	6.3%	\$1,734,000,000	\$146,000,000	8.3%	7.8%	\$21,000,000
2010	\$1,316,000,000	6.3%	\$1,611,000,000 ^b	\$143,000,000	8.3%	7.8%	\$20,000,000
							Total: \$167,000,000[‡]

Sources: Michigan Office of Retirement Services, Michigan Senate Fiscal Agency, MSERS comprehensive annual financial reports and Michigan State Employees' Retiree Health Benefits 2010 Annual Actuarial Valuation Report. All dollar figures were rounded to the nearest million, though precise figures were used in the calculations wherever state government has provided them for a particular data series.

^aThe figures for fiscal years 1997 through 1999 are not available. The figures provided for these years are linearly interpolated between the \$0 figure for fiscal 1996 and the \$531 million figure for fiscal 2000. The figure for fiscal 2010 was not available from the Office of Retirement Services at the time of this writing, so the figure provided was drawn from the Michigan State Employees' Retiree Health Benefits 2010 Annual Actuarial Valuation Report.

^bThe figures for the MSERS defined-contribution payments as a percentage of payroll are not available. The figures provided are based on the calendar-year defined-contribution payments and defined-contribution payroll for three combined state retirement systems: MSERS, the Michigan Legislative Retirement System and the Michigan Judges' Retirement System. The figure for 2010 was not available from the state at the time of this writing, so the value for 2010 was assumed to be the same as it was in 2009.

[†] Percentage calculated with normal cost for current year and payroll cost for previous year.

^b This value was taken from the Michigan State Employees' Retirement System 2010 Annual Actuarial Valuation Report, since 2010 payroll data was not available from the most recent MSERS comprehensive annual financial reports at the time of this writing.

[‡] Total may not reflect sum of figures above due to rounding.

To attempt to account for this fact and to help ensure that the normal costs savings of switching employees to a defined-contribution plan was not overstated, the author subtracted 0.5 percent from the state's defined-benefit normal cost as percentage of payroll before comparing that percentage to the annual payroll percentage cost of the MSERS defined-contribution plan. This reduction is simply meant as a general estimate, based on the author's experience, of the increase in the normal cost that may have occurred after closing the MSERS defined-benefit plan. This downward adjustment, together with the other data, produced a cumulative estimated savings of about \$167 million from fiscal 1997 through fiscal 2010 (see Graphic 1).

(2) Unfunded Liability

By definition, defined-contribution plans have no unfunded liability. In a defined-contribution plan, the annual employer contribution is a final cost. In a defined-benefit plan, the annual employer cost is simply a deposit towards an ultimate liability at a future date.

In a perfect world, contributing the normal cost to a defined-benefit plan should be sufficient (when invested with the plan's accumulated assets) to cover the future pension liability. In practice, however, contributing the normal cost alone can fall short of the plan's needs for a variety of reasons, including lower-than-expected investment returns, unanticipated changes in members' retirement patterns, modified actuarial assumptions and funding methods, and plan amendments, such as retroactive increases in benefits.* If the normal cost payments prove insufficient, then the annual employer contribution to a defined-benefit plan will require additional funding to reduce the unfunded liability.†

The MSERS defined-benefit plan currently carries a substantial unfunded liability. Had MSERS defined-

normal costs would not materially increase when the plan is closed to new entrants. The author has chosen, however, to assume higher normal costs in part because of his own knowledge of these plans and in part to ensure that his estimate of any possible savings remains conservative.

* Similarly, of course, normal cost contributions could ultimately exceed the funding requirements, perhaps because of higher-than-expected investment returns, plan-design amendments or favorable experience compared to the original assumptions. In such cases, the plan may show a surplus. This surplus may result in a future employer contribution that is less than the calculated normal cost.

† It should be noted that under the Michigan Constitution, these liabilities, which have already accrued, cannot be renounced. Michigan Constitution of 1963, Article 9, Section 24; see also, for instance, Patrick J. Wright, "MEA Lawsuit on Retiree Health Benefits Misguided," (Mackinac Center for Public Policy, Aug. 9, 2010), <http://www.mackinac.org/13341> (accessed May 8, 2011).

contribution members remained in the MSERS defined-benefit plan following 1997, it is reasonable to assume that they would have added to the unfunded liability as a result of the same unfavorable asset returns, adverse plan experience, failure to make the annual required contributions to the plan,‡ and other funding policies that have led to the unfunded liabilities for those members currently in the MSERS defined-benefit plan.§

Defined-benefit asset performance from 1997 to 2010 has lagged the actuarially assumed rate of 8 percent annual growth. The author estimates the actual annual performance has averaged about 5.5 percent.¶,13 Therefore, had MSERS defined-contribution plan members remained in the MSERS defined-benefit plan, a contribution of the normal cost alone would not have been sufficient to cover the cost of the benefits.

To estimate the change in liability had the defined-benefit plan remained open to new hires, the author conducted a simplified analysis that prorated the unfunded liability in proportion to the hypothetically higher defined-benefit payroll.** The author acknowledges that this method could possibly overstate the additional liability that might have

‡ The Michigan Legislature has frequently failed to make the actuarially calculated annual required contribution to MSERS' and MPSERS' defined-benefit plans. From fiscal 2001 through fiscal 2010, the state exceeded the annual required contribution twice, met it once, and failed to meet it seven times.

§ It is possible that the directors of the MSERS defined-benefit plan would have made substantially different investment decisions if the plan had continued to receive new members. Such changes might have made the unfunded liability smaller, or they might have made it larger. Ultimately, any estimate of the change in liability produced by closing the defined-benefit plan depends on assumptions regarding the investment decisions or funding policies and actuarial methods that would have been in effect had the plan remained open. Here, the author assumes that the investment decisions would have produced roughly the same rates of return. This assumption seems reasonable, given that the MSERS defined-benefit plan appears to have been investing much like the MPSERS defined-benefit plan, which remains open to new hires.

¶ The rates of return can be, and have been, higher over different time periods. The most recent MSERS comprehensive annual financial report states, for instance: "For the fiscal year ended September 30, 2010, the total System's rate of return was 8.5% as compiled by State Street Investment Analytics. Annualized rates of return for the three, five, seven, and ten year periods ending September 30, 2010 were: (3.8)%, 3.3%, 5.9%, and 3.1% respectively." "Michigan State Employees' Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2010," (Michigan Office of Retirement Services, 2010), http://www.michigan.gov/documents/orsstatedb/SERS_2010_Published_1-10-11_342741_7.pdf (accessed March 17, 2011).

** Providing a more sophisticated analysis would require, to begin with, complete demographics for the active members and retirees who belong to the plan. This data is not publicly available. Moreover, debatable assumptions would have to be made in an attempt to reconstruct a hypothetical past. In the end, a more precise and sophisticated analysis might prove no more persuasive or accurate than the simplified approach used above.

Graphic 2: Estimated Additional Unfunded Liability of Leaving New MSERS Hires in the Defined-Benefit Pension Plan, Annual Estimates, 1997-2010

Fiscal Year Ending 9/30	Defined-Contribution Payroll [□]	Defined-Benefit Pension Payroll	Combined Payroll	Defined-Benefit Plan Actuarial Value of Assets	Defined-Benefit Plan Accrued Liabilities	Defined-Benefit Plan Unfunded Liability (Actual) (Annual Snapshot)	Estimated Additional Unfunded Liability (Annual Snapshot)
	(A)	(B)	(C) = (A)+(B)	(D)	(E)	(F) = (E)-(D)	(G) = ((C)/(B)-1)*(F)
1997	\$133,000,000	\$2,273,000,000	\$2,406,000,000	\$8,834,000,000	\$8,100,000,000	(\$734,000,000)	(\$43,000,000)
1998	\$265,000,000	\$2,108,000,000	\$2,373,000,000	\$9,109,000,000	\$8,497,000,000	(\$612,000,000)	(\$77,000,000)
1999	\$398,000,000	\$2,214,000,000	\$2,612,000,000	\$9,648,000,000	\$9,029,000,000	(\$619,000,000)	(\$111,000,000)
2000	\$531,000,000	\$2,254,000,000	\$2,785,000,000	\$10,337,000,000	\$9,474,000,000	(\$863,000,000)	(\$203,000,000)
2001	\$641,000,000	\$2,231,000,000	\$2,872,000,000	\$10,633,000,000	\$9,878,000,000	(\$755,000,000)	(\$217,000,000)
2002	\$682,000,000	\$2,133,000,000	\$2,815,000,000	\$10,616,000,000	\$10,753,000,000	\$137,000,000	\$44,000,000
2003	\$798,000,000	\$1,860,000,000	\$2,658,000,000	\$10,441,000,000	\$11,761,000,000	\$1,320,000,000	\$566,000,000
2004	\$909,000,000	\$1,889,000,000	\$2,798,000,000	\$10,149,000,000	\$12,004,000,000	\$1,855,000,000	\$893,000,000
2005	\$991,000,000	\$1,880,000,000	\$2,871,000,000	\$9,897,000,000	\$12,400,000,000	\$2,503,000,000	\$1,320,000,000
2006	\$1,053,000,000	\$1,848,000,000	\$2,901,000,000	\$10,890,000,000	\$12,799,000,000	\$1,909,000,000	\$1,088,000,000
2007	\$1,147,000,000	\$1,826,000,000	\$2,973,000,000	\$11,344,000,000	\$13,162,000,000	\$1,818,000,000	\$1,142,000,000
2008	\$1,235,000,000	\$1,764,000,000	\$2,999,000,000	\$11,403,000,000	\$13,766,000,000	\$2,363,000,000	\$1,654,000,000
2009	\$1,380,000,000	\$1,734,000,000	\$3,114,000,000	\$11,107,000,000	\$14,234,000,000	\$3,127,000,000	\$2,489,000,000
2010	\$1,316,000,000	\$1,611,000,000	\$2,927,000,000	\$10,782,000,000	\$14,860,000,000	\$4,078,000,000	\$3,332,000,000†

Sources: Michigan Office of Retirement Services, MSERS comprehensive annual financial reports and Michigan State Employees' Retiree Health Benefits 2010 Annual Actuarial Valuation Report. All dollar figures were rounded to the nearest million, though precise figures were used in the calculations wherever state government has provided them for a particular data series. Negative unfunded liabilities occur in years in which there were fund surpluses.

□ The figures for fiscal years 1997 through 1999 are not available. The figures provided for these years are linearly interpolated between the \$0 figure for fiscal 1996 and the \$531 million figure for fiscal 2000. The figure for fiscal 2010 was not available from the Office of Retirement Services at the time of this writing, so the figure provided was drawn from the Michigan State Employees' Retiree Health Benefits 2010 Annual Actuarial Valuation Report.

† This calculation does not represent the author's final estimate; rather, it is used to produce an estimated range of savings of between \$2.3 billion and \$4.3 billion in unfunded liability.

accrued, but he also acknowledges that this method could understate the additional liability that might have accrued. As a result, the estimate of any savings in unfunded liability will ultimately be presented here as a range of values, rather than a specific dollar figure.*

Using the prorated approach described, a policy decision to keep new MSERS members in a defined-benefit plan could have generated an additional unfunded liability of about \$3.3 billion in 2010 (see Graphic 2). Given the simplifying assumptions in such a calculation, however, the author believes it is more appropriate to place the estimated additional unfunded liability in 2010 in a range from \$2.3 billion to \$4.3 billion. Developing a more precise figure is beyond the scope of this Policy Brief.

* As discussed under "(1) Annual 'Normal Costs'" above, the defined-contribution payroll data used in the calculations in Graphic 2 were available from state government only for fiscal years 2000 through 2009. The 2010 figure was taken from the Michigan State Employees' Retiree Health Benefits 2010 Annual Actuarial Valuation Report, while the data for fiscal years 1997 through 1999 were interpolated between the known data for fiscal years 1996 and 2000.

The Question of "Transition Costs"

Some contend that there is one other cost consideration related to MSERS' unfunded liability. Generally speaking, when a defined-benefit plan is closed to new entrants, as MSERS was in 1997, the Government Accounting Standards Board requires that contributions toward reducing the plan's unfunded liability be made on a level-dollar basis rather than a level percent of payroll. This results in higher initial contributions, which some have described as a "transition cost."

Arguably, these higher contribution levels are appropriate. Public-sector pension amortization periods are frequently too long, in addition to the contributions being backloaded. Higher initial contributions on the unfunded liabilities reduce the amount of intergenerational cost transfers — that is, current liabilities inappropriately being shifted to the next generation of taxpayers. To consider these funding reforms as "undesirable costs" — or incorrectly, as "new costs" — mistakenly implies that more-timely contribution schedules are fiscally inappropriate.

It is also difficult to argue that the shift to level-dollar payments constitutes an extra “cost” from the closing of the MSERS defined-benefit plan during the years being studied. The MSERS defined-benefit plan did not have an unfunded liability when it closed in 1997, and when an unfunded liability later developed, the state usually failed to make the required contributions on that liability. Also of note, the change from level-percent to level-dollar payments had no impact on the actual benefits ultimately to be paid.

(3) Political Incentives

Defined-benefit plans, by definition, permit retroactive increases in benefits, with the necessary funding often being deferred. For example, legislators may increase the benefit formula “multiplier” (the fraction of a worker’s salary) used to determine the pension benefit payments, or they may provide additional, ad hoc cost-of-living adjustments to the post-retirement annual pension payments. In the MSERS defined-benefit plan, the comprehensive annual financial report indicates that the following changes were made to the plan’s post-retirement cost-of-living adjustments:

One-time upward adjustments have been made in 1972, 1974, 1976, 1977 and 1987. Beginning in 1983, some benefit recipients share in a distribution of a portion of investment income earned in excess of 8% annually (supplemental payment). Beginning in 1988, all benefit recipients are eligible for automatic 3% annual (non-compounded) benefit increases, with a maximum \$300 annual increase.*

In many cases, the cost of these benefits will be borne by taxpayers years after the officeholders who approved the increase have left office. Some of these taxpayers may have been too young to vote at the time the benefit increase was approved. Moreover, there are inherent political pressures to maintain or increase benefit levels, even when they are extremely expensive. Similar pressures exist to underfund these plans. Properly funding the plans requires immediate spending whose benefits will not be realized for years. It may also mean contributing more money, perhaps in a tight budget year, by reprioritizing spending, cutting other

programs or reducing pension benefits prospectively — options that are often unappealing to legislators, especially when they are seeking re-election. In effect, properly funding these plans carries a low political rate-of-return.

In contrast, any improvements legislators make to the benefits of a defined-contribution plan, such as a larger employer match for any employee contribution, must, by their nature, be paid for in the same year they are made. Defined-contribution plans cannot be legally underfunded, as many defined-benefit plans are. Such factors reduce the uncertainty for taxpayers and the political pressure for unsustainable improvements in benefits. While this category of savings is the most subjective (no estimate is offered here), reducing politics in pension plans may be the most significant category of savings realized by switching employees from defined-benefit to defined-contribution plans.

Final Thoughts

Designing employee pensions involves more than a traditional debate between defined-benefit and defined-contribution plans. Both types of plans have inherent advantages and disadvantages. For the record, defined-contribution plans have suffered asset downturns over the period studied as well. Any such losses are the responsibility of the individual participant, however, rather than current and future taxpayers as a group.

A complete analysis of the advantages and disadvantages of defined-benefit and defined-contribution plans in the public sector is beyond the scope of this brief. Nevertheless, it is reasonably certain that the MSERS defined-contribution plan has cost taxpayers less over the period studied than retaining this same group in the MSERS defined-benefit plan. The Legislature failed to make the annual required contributions to the defined-benefit plan even after the plan was closed, so it seems unlikely the Legislature would have made the larger annual required contributions necessary if the plan had continued to receive new entrants. Thus, continuing only with the defined-benefit plan would have likely placed that plan in worse financial condition than it exists in today; the truly debatable question is the magnitude of the additional unfunded liability.†

* “Michigan State Employees’ Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2010,” (Michigan Office of Retirement Services, 2010), 77, http://www.michigan.gov/documents/orsstatedb/SERS_2010_Published_1-10-11_342741_7.pdf (accessed March 17, 2011). According to the comprehensive annual financial report, a member’s eligibility for these benefits depended on the date of retirement: “Retired before October 1, 1987[.] Greater of supplemental payment or the combination of the 1987 one-time adjustment and the automatic increases. Retired on or after October 1, 1987[.] Automatic increases only.” Ibid., 77.

† An analysis by the Michigan Senate Fiscal Agency, while recognizing the potential long-term financial benefit of transferring new public school employees to a defined-contribution plan, has nevertheless underestimated the total financial benefit that might be realized. Kathryn Summers-Coty, “Examining a Change from Defined Benefit to Defined Contribution for the Michigan Public School Employees’ Retirement System,” (Michigan Senate Fiscal Agency,

The calculations in this Policy Brief suggest that since the advent of the MSERS defined-contribution plan in 1997, Michigan taxpayers have saved approximately \$167 million in lower pension normal costs and between \$2.3 billion and \$4.3 billion in lower unfunded liabilities. An additional and important advantage, though difficult to quantify, is the reduced political temptation to provide benefits whose costs are largely deferred to future generations. In other words, a defined-contribution plan is less prone to potentially harmful political interventions.

Of significant note, MSERS' current and projected defined-benefit pension liabilities and related employer contributions are predicated on achieving an assumed 8 percent annual asset return over the long-term. The reasonableness of such an assumption could easily be debated and could well be the subject of a separate report. In fact, such an assumption was recently studied by Wilshire Associates, an independent international investment and consulting firm. The report, which studied 126 U.S. state pension plans (including MSERS, MPSERS and two other major Michigan government pension plans), concludes:

Using [our] return forecasts, none of the 126 state retirement systems are expected to earn long-term asset returns that equal or exceed their actuarial interest rate assumption.¹⁴

Wilshire further concludes that the median long-term asset return for the 126 state pension plans would be approximately 6.5 percent — 1.5 percentage points less than Michigan's 8 percent return assumption.

The key point is this: If MSERS' current actuarial valuations were to be recalculated using lower investment return assumptions, then the unfunded liability and annual

2009), <http://www.senate.michigan.gov/sfa/Publications/Notes/2009Notes/NotesMarApr09ks2.pdf> (accessed Aug. 24, 2010). The study focuses exclusively on comparing the employer contribution for a hypothetical MPSERS defined-contribution plan to the normal cost of the existing MPSERS defined-benefit plan, noting that the difference between the two is not particularly large. But as the author noted in an earlier Mackinac Center Policy Brief:

In fact, the normal cost of the program is only part of the annual cost; another portion is the annual payment on the unfunded liability. Hence, the normal cost does not represent the full cost of the plan. Indeed, if the normal cost were considered an absolute measure of the true cost of the MPSERS defined-benefit pension plan, the plan would not have an accrued unfunded liability of nearly \$12 billion [now \$17.6 billion].

See Richard C. Dreyfuss, "Michigan's Public-Employee Retirement Benefits: Benchmarking and Managing Benefits and Costs," (Mackinac Center for Public Policy, Oct. 25, 2010), 13-14, <http://www.mackinac.org/archives/2010/S2010-05.pdf> (accessed April 16, 2011).

required contributions for the MSERS defined-benefit plan would be higher. Thus, the cost savings calculated in this Policy Brief for switching new employees to the MSERS defined-contribution plan could be materially higher. The magnitude of the increase, of course, would depend on the precise return assumption used.

The nature and amounts of any future savings will depend on actual investment experience and other factors, including funding policies. Regardless, common sense and the calculations in this Policy Brief suggest that Michigan government should follow the demonstrated best practices of the private sector with regard to employee pensions. In the private sector, pension costs are now designed to be current, with no unfunded liability; predictable, with easily computed expenditures for coming years; and affordable, with annual costs between 5 percent and 7 percent of payroll.* The MSERS defined-contribution plan achieves these objectives and can thus serve as a model for reforming other government pension systems. ☺

Endnotes

1 Public Act 487 of 1996.

2 Ibid.

3 Richard C. Dreyfuss, "Michigan's Public-Employee Retirement Benefits: Benchmarking and Managing Benefits and Costs," (Mackinac Center for Public Policy, Oct. 25, 2010), 1, <http://www.mackinac.org/archives/2010/S2010-05.pdf> (accessed March 28, 2011).

4 "Michigan State Employees' Retirement System 2010 Annual Actuarial Valuation Report," (Gabriel Roeder Smith & Company, 2011), A-1; "Michigan Public School Employees' Retirement System 2010 Annual Actuarial Valuation Report," (Gabriel Roeder Smith & Company, 2011), A-1.

5 "Michigan State Employees' Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2010," (Michigan Office of Retirement Services, 2010), 70, http://www.michigan.gov/documents/orsstatedb/SERS_2010_Published_1-10-11_342741_7.pdf (accessed March 17, 2011).

6 Specifically, data were taken from the comprehensive annual financial reports for the Michigan State Employees' Retirement System in fiscal years 1998, 2000, 2002, 2004, 2006, 2008 and 2010. See "State Employees Defined Benefit Plan: Comprehensive Annual Financial Reports (CAFRs)," (Department of Technology, Management & Budget, Office of Retirement Services, 2011), <http://goo.gl/AE6zU> (accessed May 10, 2011).

* See Dreyfuss, "Michigan's Public-Employee Retirement Benefits: Benchmarking and Managing Benefits and Costs," (Mackinac Center for Public Policy, Oct. 25, 2010), 8-11, <http://www.mackinac.org/archives/2010/S2010-05.pdf> (accessed March 28, 2011).

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- 7 James Hohman, Mackinac Center for Public Policy, e-mail from Kerrie Vanden Bosch, Michigan Office of Retirement Services, May 10, 2011.
- 8 James Hohman, Mackinac Center for Public Policy, e-mail from Kerrie Vanden Bosch, Michigan Office of Retirement Services, June 13, 2011.
- 9 James Hohman, Mackinac Center for Public Policy, e-mail from Kerrie Vanden Bosch, Michigan Office of Retirement Services, May 10, 2011.
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- 11 James Hohman, Mackinac Center for Public Policy, various communications by phone and by e-mail with officials with the Michigan Office of Retirement Services, the Michigan Senate Fiscal Agency, the Michigan Department of Civil Service, the Michigan State Office of the Auditor General and representatives of the state's third-party administrator of the defined-contribution programs, May 4-June 10, 2011.
- 12 James Hohman, Mackinac Center for Public Policy, e-mail from Kathryn Summers, Michigan Senate Fiscal Agency, March 7, 2011.
- 13 Author's estimate based on "Michigan State Employees' Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2010," (Michigan Office of Retirement Services, 2010), 53, http://www.michigan.gov/documents/orsstatedb/SERS_2010_Published_1-10-11_342741_7.pdf (accessed March 17, 2011); "Michigan State Employees' Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2000," (Michigan Office of Retirement Services, 2001), 38, http://www.michigan.gov/documents/sers2000cafr_115296_7.pdf (accessed April 20, 2011).
- 14 Julia K. Bonafede, Steven J. Foresti and Russell J. Walker, "2011 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation," (Wilshire Consulting, 2011), 14, <http://www.scribd.com/doc/50219014/2011-Wilshire-Report-on-State-Retirement-Systems-Funding-Levels-and-Asset-Allocation> (accessed May 8).

Five Options for Addressing 'Transition Costs' When Closing the MPERS Pension Plan

By James M. Hohman

Five Options for Addressing ‘Transition Costs’ When Closing the MPSERS Pension Plan

By James M. Hohman

Executive Summary*

As of Sept. 30, 2010, the defined-benefit pension plan in the Michigan Public School Employees’ Retirement System had an unfunded liability of \$17.6 billion. This unfunded liability and the large annual payments necessary to fund it suggest the plan’s liabilities should be contained by closing the plan to new entrants, much as the defined-benefit pension plan in the Michigan State Employees’ Retirement System was closed in 1997. Future public school employees would be offered participation in a 401(k)-style defined-contribution plan.

A concern repeatedly raised about closing the MPSERS plan, however, is the so-called “transition costs” involved. This paper discusses these “transition costs,” their validity and ways to minimize or eliminate them if they are considered barriers to the important and necessary reform of closing the MPSERS defined-benefit plan.

The Senate Fiscal Agency, the House Fiscal Agency and the Office of Retirement Services have each published estimates of the “transition costs” involved in closing the MPSERS defined-benefit plan. The two material items discussed in the papers are changes in the “normal cost” and the “amortization costs.”

Normal cost refers to the annual cost of paying for employee pension benefits earned during that particular year. According to the SFA, HFA and ORS analyses, these costs would increase if the defined-benefit plan were closed and new entrants were placed in a defined-contribution plan similar to MSERS’. This conclusion is questionable. The stated normal cost for the MPSERS defined-benefit plan has almost certainly been understated by a debatable

assumption of 7 percent to 8 percent annual pension asset growth. The failure of this assumption is clear from the plan’s asset growth over the past 14 years and the plan’s large and growing unfunded liabilities.

Even assuming the normal costs are as currently stated, the transition cost could be eliminated by simply tailoring a MPSERS defined-contribution plan differently than the MSERS defined-contribution plan. This same MPSERS normal cost structure could be maintained in a defined-contribution plan simply by requiring school districts and other MPSERS employers to contribute approximately 71 cents for each dollar of employee contributions up to 5.38 percent of employee salary — a total employee and employer contribution similar to that of the MSERS defined-contribution plan in fiscal 2010.

The larger “transition cost” discussed in the three papers is the immediate increase purportedly required in the size of MPSERS’ “amortization payments,” which are deposits made annually by MPSERS employers to pay down the defined-benefit plan’s unfunded liabilities. These amortization payments ensure the pension plan can meet its future pension obligations.

The rules of the Governmental Accounting Standards Board are frequently interpreted to mean that if the MPSERS defined-benefit plan were closed to new entrants, the MPSERS amortization payment schedule would need to change to a “level-dollar” treatment that would calculate larger upfront amortization payments than those projected if the plan were to remain open. The expected increase is large in the first year — the Office of Retirement Services places it at \$360 million — but would decline over the next seven years and ultimately produce lower projected payments than under MPSERS current “level-percentage” amortization schedule. In fact, if all went as expected, there would be a projected net savings in total amortization payments over time.

* Citations provided in the study’s main text.

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Three things should be noted about this immediate “transition cost.” First, GASB rules govern how MPSERS and other government entities *report* their expenditures; the rules do not tell policymakers what expenditures they should make, as GASB itself has confirmed. Thus, even if the state were to adopt a level-dollar amortization payment schedule in reporting on a closed MPSERS plan, it would make increased immediate payments only if it chose to.

Second, the phrase “transition cost” is misleading. MPSERS’ cost is the underlying pension liability, which would not change; the cost is not the amortization payments used to meet that liability. Hence, even if MPSERS employers paid more at first, the plan’s cost would not increase any more than a large first payment on a mortgage would affect the value of a home.

Third, the emphasis on normal and amortization “transition costs” ignores a considerable additional cost: the potential that unfunded liabilities in the MPSERS plan will become even more burdensome. In fiscal 2010 (excluding the cost of an early retirement incentive), the unfunded liability in the MPSERS defined-benefit plan increased by \$4.3 billion — nearly a tenth of the annual state budget. Since fiscal 2000, the unfunded liabilities of the plan have increased by 6,500 percent, and the state has failed to make GASB’s “required” annual payments eight times.

If policymakers nevertheless perceive “transition costs” for amortization payments as a problem, they have alternatives. Five are provided in the study, listed from most comprehensive to most limited.

First, since MPSERS pension liabilities must be met under the Michigan Constitution, policymakers could scale back MPSERS’ extensive retiree medical care coverage, which is not protected under the Michigan Constitution, and which cost MPSERS employers \$795 million in fiscal 2011. The retiree medical reduction need not be \$360 million, given that the “transition cost” would decrease in subsequent years, and given that the Legislature could tap \$133 million already slated for MPSERS reform.

Second, policymakers should consider making the most of MPSERS reform. If there are upfront “transition costs,” the Legislature could maximize the benefit of incurring those costs by not just closing MPSERS, but also freezing it — that is, providing current defined-benefit plan members with a defined-contribution plan in lieu of their current plan, so that they would earn no additional benefits under the defined-benefit plan. This step would

considerably decrease the potential future unfunded liabilities of the MPSERS pension plan. In addition, GASB appears to provide flexibility in choosing an accounting treatment for the amortization payments on a closed and frozen plan, making it even easier for the state to adopt a payment schedule that minimizes immediate costs.

The state’s third-best course is simply to pay the “transition costs.” MPSERS’ unfunded liabilities have built up over years, and they must be made good at some point. Making larger amortization payments sooner rather than later will not only ensure that retirement assets are available as employees retire, but reduce the projected total burden of amortization payments on taxpayers as well.

Policymakers have additional alternatives, however. Legislators have frequently failed to make the “required” amortization payments under GASB schedules, and they could continue this “business as usual” with a closed plan by reporting under a level-dollar schedule, but making level-percentage payments.

Alternatively, legislators could also choose to spread the amortization payments across the entire MPSERS payroll, including the payroll not just of members of the defined-benefit plan, but of the new defined-contribution plan as well — something the state is already doing with MSERS. The state could then maintain a level-percentage accounting treatment for MPSERS.

Each of these five approaches to amortization payments would make it easier for policymakers to honor their constitutional obligation to pay MPSERS pension benefits.

Introduction

Ensuring that state government offers sustainable retirement benefits will be a challenging task for Michigan policymakers. On Sept. 30, 2010, the state had a massive, unfunded \$21.7 billion constitutional obligation to provide retirement income that has already been earned by government employees under state government’s two largest pension plans: the Michigan Public School Employees’ Retirement System and the Michigan State Employees’ Retirement System.*

* Author’s calculations based on “Michigan Public School Employees’ Retirement System 2010 Annual Actuarial Valuation Report,” (Gabriel Roeder Smith & Company, 2011), A-1; “Michigan State Employees’ Retirement System 2010 Annual Actuarial Valuation Report,” (Gabriel Roeder Smith & Company, 2011), A-1. In addition to these costs for retirement income, both of these retirement systems incur costs for other significant retirement benefits, such as retiree medical insurance coverage; these benefits are not, however, constitutional obligations.

To contain these costs, policymakers have begun transitioning some of the state's various defined-benefit retirement systems to defined-contribution plans.* An exception to this reform, however, has been MPSERS, which is the state government's largest pension plan. As of Sept. 30, 2010, the MPSERS pension plan had total actuarial accrued liabilities of \$60.9 billion and an actuarial value of assets of \$43.3 billion, leaving an unfunded actuarial accrued liability of \$17.6 billion.¹

Reforming MPSERS by shifting new employees from a defined-benefit plan to a defined-contribution plan would further benchmark the state's retirement systems to private-sector norms. Yet the state has also been warned by several analysts that this reform would result in substantial "transition costs" the state cannot afford.²

It might seem that the state can neither keep its system nor reform it — or to paraphrase Jefferson, that the state has a wolf by the ear and can neither hold him nor safely let him go.³

This paper, however, explains how policymakers can honor the commitments made to MPSERS participants while controlling and even eliminating so-called "transition costs."

State statutes set parameters for the retirement benefits of all Michigan governments and government-owned entities, such as state universities and community colleges. The state requires public school districts to offer retirement benefits through MPSERS.^{†,4}

* The difference between defined-benefit plans and defined-contribution plans is described in Richard C. Dreyfuss, "Michigan's Public-Employee Retirement Benefits: Benchmarking and Managing Benefits and Costs," (Mackinac Center for Public Policy, Oct. 25, 2010), 1, <http://www.mackinac.org/archives/2010/S2010-05.pdf> (accessed March 28, 2011). Dreyfuss states:

"In ... defined-benefit plans, the members' government employer assumes the responsibility of annually investing employer and employee pension contributions in amounts sufficient to finance a projected annual retirement income. These plans place all of the investment risk on the government employer — in this case, on the taxpayer.

"... In [a defined-contribution] plan, the state makes ongoing contributions to a tax-favored account, with the employee able to contribute as well. The employee directs investment of the monies, and the accumulated capital is available to the individual at retirement. State government and state taxpayers do not assume investment risk, and the plan incurs no unfunded liability; the amount of money at retirement largely depends on investment returns over time."

† Employees at seven state universities were part of MPSERS until the plan was closed to them Jan. 1, 1996: Eastern Michigan, Central Michigan, Northern Michigan, Western Michigan, Ferris State, Michigan Technological and Lake Superior State. Employees of community colleges still belong to MPSERS. "Michigan Public School Employees' Retirement System: Comprehensive Annual

Most state employees, on the other hand, receive pension benefits through the Michigan State Employees' Retirement System.⁵ There are also separate plans for judges, state police and legislative employees.⁶ Local governments can offer pension benefits to employees at their own discretion.[‡]

In 1996, the state created a defined-contribution plan for all new hires who entered the MSERS retirement system. The MSERS defined-benefit plan was closed to new participants, though existing participants were free to remain in the defined-benefit plan and continue earning benefits there if they chose.⁷ The Legislature instituted a similar transition to defined-contribution plans for new hires in its retirement systems for judges and legislative employees.⁸

In the defined-contribution plans for the three systems, the state employer automatically deposits an amount equal to 4 percent of an employee's salary into an independent account and then matches an employee's personal contributions to the account up to 3 percent of the employee's salary.⁹ The individual employee is responsible for determining how much money is placed in his or her account, how this money is invested[§] and how this money is used upon his or her retirement. The state does not guarantee a particular retirement income or incur liabilities for future payments.

These defined-contribution systems offer three major benefits to employers. First, the plan is "current," meaning that the costs for retirement are paid in full on an annual basis and the employer does not risk having to contribute more money in the future for unfunded liabilities. Under a defined-contribution plan, costs are incurred immediately and payment of that cost retires the employer obligation completely. In contrast, under a defined-benefit plan, employer payments are only deposits set aside to pay a future liability. These deposits may prove insufficient, so that further deposits become necessary to cover the unfunded liabilities that develop. Unfunded liabilities in a defined-benefit plan may emerge for several reasons: investment returns that are lower than the initial predictions; demographic patterns, such as member

Financial Report for the Fiscal Year Ended Sept. 30, 2011," (Michigan Office of Retirement Services, 2011), 24, <http://goo.gl/hyUcr> (accessed Feb. 15, 2012).

‡ While there are myriad local government retirement systems, the Michigan Municipal Employees' Retirement System covers 750 local governments and local government entities, such as regional transit authorities. MERS was created by state law, and it is now an independent nonprofit entity. "About MERS," (Municipal Employees' Retirement System, 2012), <http://goo.gl/4yPnO> (accessed March 4, 2012).

§ Specifically, the employee is free to choose among investment options offered by an investment firm that has been approved by the state.

longevity, that diverge from initial expectations; or future pay and benefit changes.

Second, the plan is predictable, meaning that the employer's costs fluctuate only with payroll and with the program's design parameters, both of which are under the employer's control. The employer's contributions to the plan are not subject to factors like problematic investment returns or demographics — the less predictable elements that influence employer pension contributions in defined-benefit plans.

Third, benefits in a defined-contribution system are usually affordable. Private-sector employers' payments to defined-contribution plans are usually between 5 percent to 7 percent of payroll, as noted by actuary and Mackinac Center Adjunct Scholar Richard C. Dreyfuss.¹⁰ MSERS defined-contribution plan, which requires state government deposits of up to 7 percent of employee payroll, is consistent with this general private-sector range.

In contrast, current employer contributions to the MPSERS defined-benefit pension plan are 17.39 percent or 18.62 percent of payroll, depending on when the employee was hired.¹¹ This high percentage is largely because of unfunded liabilities, which in turn are largely due to experience that has not matched expectations and to the state's failure to make the actuaries' annual recommended contributions to the MPSERS pension fund. As noted earlier, at the end of fiscal 2010, MPSERS defined-benefit pension plan had a \$17.6 billion unfunded liability.¹²

This unfunded liability suggests that the Legislature should consider repeating its successful MSERS reform with MPSERS, transitioning all new school hires to a defined-contribution plan. In this transition, the MPSERS defined-benefit plan would be closed to new participants, so that they would not increase the plan's total liabilities and the potential for unfunded liabilities. The MPSERS defined-benefit plan would stop incurring further liabilities with each new hire, making it easier for legislators to finance the unfunded liabilities owed to current employees.

* In order to keep the actuarial value of MPSERS pension fund somewhat stable compared to market fluctuations, the state uses a five-year average of the plan's market value. In 2007, the state marked up the plan's actuarial value to that year's market value and began a new five-year averaging process going forward from that point. According to the most recent investment report from the Michigan Department of Treasury, the market value of MPSERS portfolio was \$37.8 billion on Nov. 30, 2011 — somewhat less than the five-year average. "State of Michigan Retirement Systems Profile — November 2011," (Michigan Department of Treasury, Bureau of Investments, 2011), <http://goo.gl/lhBf0> (accessed Feb. 8, 2012).

And indeed, as discussed below, the current liabilities in the MPSERS defined-benefit plan are owed to employees under the Michigan Constitution. This does not mean, however, that reforms cannot legally be made to retirement benefits. In fact, such reforms can ensure that the constitutional promises are kept.

Legal Obligations

Public-sector pension reforms are subject to legal constraints. Defined-benefit pensions in government plans are protected by Article 9, Sec. 24, of the Michigan Constitution, which states, "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."¹³ While this statement seems relatively clear in theory, there has been litigation to determine what it means in practice.

In *Studier v. Michigan Public School Employees' Retirement Board*, the Michigan Supreme Court confirmed that employees are entitled to the pensions that they have already earned through participation under the system's rules so far, but the court did not hold that employees are entitled to future participation in that same system.¹⁴ Going forward, then, a government can "freeze" the pension benefits that an employee has earned, meaning they no longer earn further benefits under their current terms.

This does not mean the state is entirely off the hook, however. If a gap opens between the benefits earned by those employees before the freeze and the money set aside and invested to pay for those benefits, the state cannot renege on providing the earned benefits; employees still have the legal and constitutional right to expect that their earned benefits will be paid. The employees' right to these benefits is ultimately a claim on the Michigan taxpayer.

In reference to public pension plans, the Michigan Constitution also states, "Financial benefits arising on account of service rendered in each fiscal year shall be funded during that year. ..." The Michigan Supreme Court recognizes this constitutional injunction to mean that the state should be "prefunding" these benefits — that is, that pension liabilities should be saved for during the year they are earned, rather than being paid only when they come due years later.¹⁵

† Common pension fund rules include minimum service requirements, minimum ages to begin collecting a pension, and rules for annual payments typically determined by a formula that uses an employee's compensation, a percentage multiplier and the number of years he or she has served in the system.

This prefunding is usually accomplished by making annual payments to a pension fund that is invested in order to grow over time (the investment portfolio is managed by the state Department of Treasury¹⁶). For example, a single year of service might be worth an additional \$600 per year in pension benefits for an employee upon retirement. Under a series of assumptions, such as when that employee will retire, how long he or she will collect pension benefits after retirement, and how much the state's pension fund investments should grow, state actuaries calculate a "normal cost" of retirement to be set aside annually to cover the \$600 benefit to be paid each year to the retired employee as a result of the employee's earlier year of service.* The total annual normal payments deposited to the pension fund during the employee's preretirement years will generally be less than the total amount of money paid to the employee during his or her retirement years, since the earlier normal-cost deposits are assumed to grow through investment returns during the employee's working life. This prefunding is supposed to ensure that the state does not push its pension costs for current service into the future, and it is thus meant to thwart the temptation for policymakers to provide ever-increasing benefits paid for long after they've left office.†

While the state Supreme Court ruled that retirement costs are not supposed to be deferred under the Michigan Constitution, the court also ruled that it does not have the power to prevent the governor and Legislature from deferring them.¹⁷ On the whole, while the state constitution clearly requires the state to pay retirees the pension benefits they have accrued during their working years, the court does not have the power to mandate that these benefits be prefunded.

When pension benefits are not properly prefunded, unfunded future liabilities accrue.‡ Standard pension funding policies encourage the state to make annual payments to completely eliminate its unfunded liabilities over time. This process ensures that sufficient pension funds are available when employees retire. Based on the

* This hypothetical case is given as a simple example of how a pension would be prefunded. The state does not perform such calculations for each individual employee, but rather for the entire system.

† Unfortunately, a well-funded plan can also have the perverse effect of encouraging policymakers to increase pension benefits and increase the plan's long-term liabilities. For a discussion of this point, see "Political Incentives" in Richard C. Dreyfuss, "Estimated Savings From Michigan's 1997 State Employees Pension Plan Reform," (Mackinac Center for Public Policy, 2011), 7, <http://www.mackinac.org/archives/2011/2011-03PensionFINALweb.pdf> (accessed Feb. 16, 2012).

‡ Note that unfunded liabilities can accrue even with prefunding when the plan's investments or demographics do not meet initial actuarial expectations.

most recent annual actuarial valuation, school districts were paying down the defined-benefit plan's unfunded liability over a 26-year amortization period.¹⁸

The Michigan Constitution states that these unfunded liabilities cannot be paid off, however, using money meant to prefund benefits being earned in any particular year.¹⁹ In accounting terms, then, the constitution requires that the normal cost be paid before any money is used to address unfunded liabilities.

The state constitution is otherwise silent, however, about paying down unfunded liabilities.[§] It does not require that a particular payment method for unfunded liabilities be followed.

Inevitably, there is more to financing a pension system than the state constitution discusses. The constitution does provide a framework, however, within which the Legislature must operate when considering reforms.

MPERS and 'Transition Costs'

Concerns have been raised about the immediate costs of closing the MPERS defined-benefit plan to new hires and placing those hires in a defined-contribution plan. These costs have been discussed in a Michigan Senate Fiscal Agency paper titled "Examining a Change from Defined Benefit to Defined Contribution for the Michigan Public School Employees' Retirement System" and in a House Fiscal Agency memo titled "Converting MPERS from a Defined Benefit (DB) to a Defined Contribution (DC) System."²⁰ The costs were also discussed more recently in a paper by the Office of Retirement Services.²¹

The SFA Analysis

The SFA and HFA analyses present similar findings. The SFA report includes more detail, so it is the focus of the discussion below.

The SFA analysis assumes that the MPERS defined-benefit plan would be closed to new hires, and that these new hires would be placed in a defined-contribution plan for public school employees similar to the Michigan State Employees' Retirement System's defined-contribution plan. As noted above, the MSERS defined-contribution system caps the employer's annual retirement contributions at 7 percent of the employee's payroll —

§ This silence about unfunded liabilities may be due to the constitution's framers' assumption that the pensions would be properly prefunded. In that case, no unfunded liabilities would accrue to begin with.

an automatic contribution equivalent to 4 percent of payroll, with an employer match of any employee contributions up to 3 percent of payroll.

In a defined-contribution plan, such as MSERS,[†] the employer's contributions are commonly expressed as a percentage of payroll and can therefore be compared to a defined-benefit plan's normal cost and its payments toward unfunded liabilities, both of which are also expressed as percentages of payroll. As explained above, the annual normal cost of the pension is calculated by state actuaries and represents an estimate of the amount of money required to prefund the retirement benefits earned by employees in a given year, so that on the whole, if all goes well, their pension benefits are fully funded at the time they retire. Amortization payments toward unfunded liabilities are likewise calculated by state actuaries according to yearly payment schedules determined by a number of assumptions.

The 2009 SFA paper, reflecting on the state's funding policies and actuarial assumptions, observed that aside from the relatively small costs to develop and administer a new defined-contribution MPSERS retirement system, such a system would cost more than the current MPSERS defined-benefit system in two ways.

- **Normal Cost.** The public school system's annual payments to a defined-contribution plan would be higher than the current normal cost of the MPSERS defined-benefit plan, the paper observed.²² Using the MSERS system as a basis of comparison, the SFA paper found that the normal cost of the existing MPSERS defined-benefit plan is lower: 4.21 percent of payroll, rather than the 6.55 percent of payroll paid by the state to the MSERS defined-contribution system.^{*} After adding a supplemental piece for pension benefits offered to defined-contribution members in special cases,[†] a defined-contribution retirement system would cost the state an additional \$7 million in the first year, and the extra costs would increase significantly as more members became participants in the new plan.

* The MSERS figure is not quite 7 percent because some state employees do not take full advantage of the state's 3 percent match.

† MSERS defined-contribution members are also offered pension benefits in case of death or disability, and employers set aside some money to prefund this benefit. See Summers-Coty, "Examining a Change from Defined Benefit to Defined Contribution for the Michigan Public School Employees' Retirement System," (Michigan Senate Fiscal Agency, 2009), 3, <http://goo.gl/jnzaB> (accessed May 8, 2010); State Employees' Retirement Act, MCL 38.21-38.25, 38.27, <http://goo.gl/2QRzQ> (accessed Feb. 13, 2012).

- **Initial Payments on Unfunded Liabilities.**

The initial annual payments toward the unfunded liability in the MPSERS defined-benefit pension plan would rise once the plan is closed to new members, the paper stated.²³ The increase would be due to the shift in accounting treatment that occurs when closing a defined-benefit plan.

When paying down any existing unfunded liability in an open pension system — that is, a pension system accepting new entrants — government accounting rules are generally interpreted to mean that employers should calculate their contributions as a level percentage of the payroll.[‡] As a result, the amortization payments on the unfunded pension liability of an open system are "backloaded" — as payroll increases over time, payments also increase, since these are calculated as a fixed percentage of payroll. This dynamic allows the amortization cost to be a lower percentage of payroll in the early years than it would be if it were paid in equal annual dollar amounts. The payment dynamic is reminiscent of a variable rate mortgage with a rising interest rate, where payments increase in the later years.

When closing a defined-benefit pension system, however, government accounting rules are usually interpreted to require that employers pay for the unfunded liability as a level-dollar amount each year, rather than as a percentage of an eventually declining payroll.[§] In comparison to the level-percentage payment schedule, this level-dollar method is "frontloaded" (though it is technically flat), generating a higher cash payment schedule in the early years. The SFA paper indicates that this level-dollar payment method for a closed MPSERS defined-benefit system would cost \$208 million more in payments during the first full year in which the MPSERS system was closed.²⁴

The second of these issues — the immediate increase in the calculated payments on the plan's unfunded liability — is

‡ As a practical matter, the percentage never remains the same from year to year; rather, it changes as the plan's actual performance diverges in various ways from the initial assumptions the actuaries used to calculate the percentage. For instance, in fiscal 2007, the percentage of payroll that school districts were instructed to set aside was 5.70 percent; now, in fiscal 2012, the figure is 12.49 percent. "Employer Contribution Rate," (Michigan Office of Retirement Services, 2012), <http://goo.gl/xDLlk> (accessed March 4, 2012).

§ GASB rules on the method of amortizing the unfunded liability appear to be less clear than the common interpretation might suggest. See the discussion below under "2) Freeze and Close: Maximize the Results."

the primary concern over closing the MPSERS defined-benefit pension plan to new public school employees and placing them in a defined-contribution plan. Indeed, this issue was raised even during Michigan's 1996 state employee pension reforms, when the state closed its state employee defined-benefit plan, but not its school employee defined-benefit plan. According to a Dec. 5, 1996, article from Gongwer News Service, "Public school employees were given a late-hour reprieve from a similar [defined-contribution] plan when administration officials agreed to a compromise proposal that allows [school employees] to remain under the defined benefits system until the state pays off a \$6 billion unfunded liability."²⁵

It should be noted that the SFA's \$208 million first-year estimate for the increase in unfunded liability payments is probably no longer accurate. MPSERS unfunded liability has risen substantially since the report was written — from \$8.9 billion in fiscal 2008 to \$17.6 billion in fiscal 2010. This hike has increased the amortization payments and the likely gap between level-dollar and level-percentage accounting treatments.²⁶

The Office of Retirement Services' Estimates

A recent unsigned, undated, unpublished memo from the Office of Retirement Services also explores costs from transitioning MPSERS to a defined-contribution retirement system. The paper reiterates the three types of costs listed by the SFA paper. These are:

- The calculation that MSERS employer automatic- and matching-contributions exceed the MPSERS employer normal cost
- Increased upfront cash requirements due to actuarial assumption changes
- Relatively small administrative costs from setting up a new retirement system.²⁷

There are a few key differences between this memo and the SFA report. There are slight differences in the annual employer service costs. Under the assumption that employees will mimic the contribution rates of employees in MSERS, the ORS paper reports that the defined-contribution plan would cost an extra \$9 million in the first year, \$20 million in the second, and \$32 million in the third.²⁸ These annual costs increase as more employees enter the defined-contribution system after the defined-benefit system is closed. The ORS' reported costs are \$2 million more, \$4 million less, and \$6 million less than the figures in the SFA paper, respectively.²⁹

Under the assumption that the employees would maximize the employer's matching contributions, the ORS memo reports that the state's costs would be \$12 million more in the first year, \$27 million in the second year, and \$42 million in the third year.³⁰ These costs are \$3 million more, \$1 million less, and \$3 million less than the SFA paper, respectively.³¹

Because the ORS paper is more recent and unfunded liabilities have grown since the SFA published its analysis in 2009, the ORS reports an increase in the cost of conforming to a closed system's level-dollar schedule to catch up on MPSERS' unfunded liabilities. The total first year costs are \$360 million in the ORS report³² — \$152 million higher than the SFA paper.³³

The SFA and ORS reports provide similar estimates on the costs of setting up a defined-contribution retirement plan; the numbers, at most \$8 million to \$10 million, are relatively small in comparison to the calculated increase in cost for the unfunded liabilities.³⁴

Dealing With 'Transition Costs'

Closing the Michigan Public School Employees' Retirement System to new employees would prevent state legislators from passing retirement system costs on to future taxpayers through unfunded liabilities and questionable tinkering with abstract funding assumptions. There are also ways a defined-contribution reform can minimize or even eliminate the transition costs discussed above.

These dynamic approaches to transition costs appear immediately below. Nevertheless, three observations should be made to put the entire "transitions costs" argument into context, since "high transition cost" is not as definitive an objection as it sounds.

First, using the flat (or relatively "frontloaded") level-dollar method for paying down unfunded liabilities is (at best) a guideline of the Governmental Accounting Standards Board, not of the Michigan Constitution.* The Michigan Legislature is free to amortize its unfunded liabilities as it sees fit, as long as it (or the various state employers) first makes sure to prefinance retirement benefits — that is, to pay the normal cost.†

* Regarding GASB requirements for paying unfunded liabilities for a closed defined-benefit plan, see the discussion below under "2) Freeze and Close: At Least Maximize the Results."

† The Michigan Constitution states, "Financial benefits arising on account of service rendered in each fiscal year shall be funded during that year and such funding shall

Indeed, GASB rules address how to account for financial problems, not how to solve them. The rules are not meant to guide policy, nor are they meant to allow governments to play games with payment schedules. In fact, the board has emphasized that its rules should not be “about acceptable public policy with regard to an employer’s contributions to a pension plan.”³⁵

Thus, while GASB’s methods of calculating an annual required contribution have been widely adopted by state and local governments, and they will continue to be used in the state’s financial reporting, there are no requirements that they guide funding policy. Indeed, as discussed later, Michigan has frequently chosen to make payments that diverge from them. This history makes the rigid insistence that funding be driven by a different GASB accounting treatment for a closed pension plan seem artificial. GASB’s rules for reporting financial activity should not be a barrier to implementing a defined-contribution policy that would ensure that retirement benefits for future members are affordable, predictable and current.

Second, in an important sense, the phrase “transition costs” is misleading when applied to the amortization payments on the unfunded liability. If MPSERS pension system is closed, the frontloaded amortization payments recommended under GASB guidelines in order to catch up on unfunded pension liabilities do not represent increased total expenses, only increased immediate cash outlays. The larger upfront deposits are similar to making early payments on a mortgage. The payments do not change the underlying value of the home (though it would lower the total cash payments on the mortgage).

Third, the “transition costs” objection to changing MPSERS to a defined-contribution plan rests on the assumption that the normal cost and the amortization payments on the unfunded liability provide a proper accounting of the costs involved — an incorrect assumption that will be analyzed later in this paper.

Normal Cost

One assumption in the SFA, HFA and ORS analyses will be addressed directly, however: the idea that the current normal cost is an adequate reflection of the cost of prefunding employees’ benefits as they are earned each year. Currently, the normal cost — and particularly the employer’s normal cost — for the MPSERS defined-

benefit plan is artificially lowered by the state’s optimistic assumption that nearly all of the plan’s assets will achieve an 8 percent annual rate of return.* But from the end of fiscal 1997 to the end of fiscal 2011 — a 14-year period that includes the substantial market returns of the late 1990s — MPSERS’ defined-benefit portfolio realized an approximately 5.4 percent annual rate of return.³⁶ This performance raises doubts about the reliability of the 8 percent assumption.

Assuming an 8 percent rate of return, however, has reduced the plan’s apparent normal cost (and, of course, led to additional unfunded liabilities). It also means the SFA, HFA and ORS analyses, which implicitly relied on this assumption, have almost certainly overstated the difference between the normal cost of the MPSERS defined-benefit plan and the annual employer deposits to the MSERS defined-contribution plan.

But even taking the SFA, HFA and ORS comparisons at face value, the transition costs due to the “lower” normal cost of the MPSERS defined-benefit plan can be addressed without increasing the employer’s annual obligations. There are no requirements to duplicate the MSERS defined-contribution provisions in every regard.† An employer can choose the cost of benefits in a defined-contribution system.

For instance, if the state simply wants to duplicate its employer costs for pension contributions, it can structure a defined-contribution plan accordingly. The state’s most recent actuarial valuation, with figures more recent than those in the SFA analysis, shows that MPSERS’ active members pay an average of 5.38 percentage points of the total 9.22 percent normal cost.³⁷ This leaves school districts paying only 3.84 percentage points of the normal cost. To maintain the same employer-employee contribution ratio and overall costs, the state would simply require school districts to offer 71 cents for every dollar contributed by the public school employee and cap the schools’ payments at an employee contribution of 5.38 percent of salary.‡

* Statutory reforms in 2010 required that assets set aside for MPSERS Pension Plus members — i.e., MPSERS members hired on or after July 1, 2010 — be discounted at 7.0 percent, rather than the traditional 8.0 percent. Public Act 75 of 2010, Sec. 41(11), <http://www.legislature.mi.gov/documents/2009-2010/publicact/pdf/2010-PA-0075.pdf> (accessed March 12, 2012).

† As mentioned earlier, the MSERS plan contained a 4 percent automatic deposit and a 3 percent matching payment.

‡ This figure of 71 cents is simply the ratio of 3.84 percent to 5.38 percent — approximately 0.714.

not be used for financing unfunded accrued liabilities.” “Michigan Constitution of 1963,” 1963), <http://goo.gl/eqXKV> (accessed Jan. 23, 2012).

Note that the figures above involve average contributions from employers and employees for a single year (fiscal 2010). Individual employees contribute varying percentages based on when they were hired and their annual salaries. The overall normal cost contribution also varies from year to year based on new actuarial assessments of the plan; for example, the figure was 9.55 percent in fiscal 2009.³⁸

In a defined-contribution plan, however, the Legislature can choose a particular employer contribution rate, and legislators should recognize that the plan described here is in fact similar in size to the MSERS defined-contribution plan. The money currently set aside for the MPSERS defined-benefit plan is the sum of a 5.38 percent employee contribution and a 3.84 percent employer contribution — a total of 9.22 percent of payroll. The MSERS defined-contribution plan, on the other hand, is a 6.55 percent employer contribution and a 2.55 percent employee contribution — a total estimated 9.10 percent of payroll.* In other words, these two plans would set aside similar payroll percentages to pay for retirement benefits.

The remaining question, then, is to address the change in unfunded liability payment assumptions that accompanies the closing of a defined-benefit pension plan.

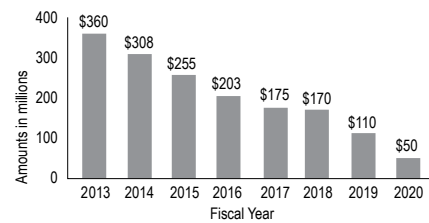
Amortization Payments on Unfunded Liability

As noted above, the “transition cost” causing policymakers the most concern is that for switching to a level-dollar reporting schedule for paying down the unfunded liabilities of a closed MPSERS defined-benefit plan. The ORS calculates this figure could be \$360 million in the first year of the transition (assuming the state made the full payment on a level-dollar schedule), though the figure would be lower and eventually negative in subsequent years, yielding “savings” (see Graphic 1).

Below are five options for dealing with “transition costs.” If legislators would like to ensure that closing the system will not require additional cash in the near-term, they can consider all of the options below with the exception of option three. In option three, reasons are presented for why legislators could simply embrace these “transition

* Author’s calculations based on Kathryn Summers-Coty, “Examining a Change from Defined Benefit to Defined Contribution for the Michigan Public School Employees’ Retirement System,” (Michigan Senate Fiscal Agency, 2009), 3, <http://goo.gl/jnzaB> (accessed March 12, 2012). Total contributions in the MSERS plan could reach 10 percent of payroll if employees contribute the maximum amount matched by the state.

Graphic 1: Office of Retirement Services’ Estimates of Unfunded Liability ‘Transition Costs’ in Closing MPSERS Defined-Benefit Plan



Source: “The Cost of Converting the Michigan Public School Employees Retirement System to a Defined Contribution Plan,” Michigan Office of Retirement Services, Page One.

costs” and make payments according to the level-dollar schedule. The five options are presented in order from the most comprehensive to the most limited reforms — and hence presented in the order in which the author recommends them.

There is a special consideration for policymakers interested in closing the MPSERS defined-benefit system in the near future. The fiscal 2012 state budget includes a special \$133 million appropriation for the “MPSERS retirement obligation reform reserve fund.” A workgroup has been called to identify reforms to the pension fund and estimate the costs and savings of those reforms.³⁹ The money set aside could be used to reduce the size of the transition costs independent of the methods discussed below.

1) Reining in ‘OPEB’ and Setting Priorities

While underfunded pensions are a problem, they pale in comparison to the underfunding of other post-employment benefits. These benefits are “comprehensive group medical, prescription drug, hearing, dental and vision coverages for retirees and beneficiaries,” according to the MPSERS annual actuarial valuation report for health benefits in 2010.⁴⁰ Michigan provides health insurance coverage to MPSERS retirees in an amount that depends on the years of service they earned and when they were hired. At the maximum, the state pays 90 percent of the cost of the premium.⁴¹

With these “other post-employment benefits” — frequently called “OPEB” — the state has not set money aside as the benefits are earned, as it has tried to do with pension benefits. Instead, it assesses additional contributions from MPSERS employers to pay for the bills of retirees as they come due — a “pay-as-you go” approach, rather than prepayment.⁴² In the Michigan Constitution, there is no requirement to prefund OPEB, as there is for pensions.

Under the state's current policies, state actuaries project that the present value of all future payments for benefits already earned under the state's current policies exceed the present value of the few state assets set aside for these benefits by between \$16.7 billion and \$27.6 billion.^{*,43} The magnitude of this gap is similar to the state's \$17.6 billion unfunded liability for MPSERS defined-benefit pension plan.⁴⁴

To cover the pay-as-you-go costs of providing other post-employment benefits in fiscal 2012 and fiscal 2013, the state is requiring school districts to pay to MPSERS amounts equivalent to 8.5 percent of payroll and 8.75 percent of payroll, respectively. In fiscal 2011, the state set aside \$958.8 million to cover this benefit.⁴⁵

The state has latitude to change this benefit for current members and retirees alike. Unlike public employee pension benefits, these retirement benefits are not protected by the Michigan Constitution.[†] Moreover, retiree medical care is a benefit that is rarely afforded in the private-sector. In a 2010 Mackinac Center Policy Brief, actuary Richard C. Dreyfuss found that only three of a sample of 24 major Michigan private-sector employers provided this benefit to members.⁴⁶ A key reason such benefits are uncommon is that once retirees get to age 65, they are entitled to Medicare benefits that cover a substantial portion of their health expenses.[‡]

Instead of levying substantial payments on schools and taxpayers for benefits that few private-sector taxpayers can afford, and rather than committing taxpayers and school districts to substantial long-term risk and financial expense, policymakers could scale back this benefit. The Legislature can use the savings to catch up on financing

* Note that MSERS has a similar OPEB gap between assets set aside and benefits earned under the state's current policies. Also note that the Legislature has closed the MSERS OPEB plan to new members as of Jan. 1, 2012. These MSERS members are instead offered a higher employer payment to their defined-contribution plan and a small deposit to a health reimbursement account upon retirement. Bethany Wicksall, "A Summary of House Bills 4701 and 4702 as Enacted," (Michigan House Fiscal Agency, 2011), <http://goo.gl/siUab> (accessed March 4, 2012).

† In *Studier v Michigan Public School Employees' Retirement Board*, the Michigan Supreme Court ruled that "health care benefits paid to public school retirees [do not] constitute 'accrued financial benefits' subject to protection from diminishment or impairment" under Article 9, Section 24, of the Michigan Constitution. *Studier v Michigan Public School Employees' Retirement Board*, 472 Mich 642, A-1 (2005).

‡ It should be noted that the most important determinant of health does not appear to be the expense of health insurance. See Robert H. Brook et al., "The Effect of Coinsurance on the Health of Adults: Results from the Rand Health Insurance Experiment," (The RAND Corporation, 1984), <http://www.rand.org/pubs/reports/2006/R3055.pdf> (accessed Jan. 24, 2012). Thus, while retiree medical insurance benefits may reduce the financial risk attendant on paying for health care, the health benefits are likely inconsequential, especially given the availability of Medicare.

earned pension benefits, which, unlike OPEB, cannot be reduced under the Michigan Constitution.

The level of savings from this would depend on how much health care expenses increase in the future, how much legislators cut back this benefit and whether the reforms are applied to current retirees or to future ones only. In fiscal 2011, MPSERS employers paid \$795 million to retiree medical care benefits. The first-year "transition cost" would be \$360 million — nearly half of the 2011 retiree medical coverage payments.

This figure does not mean legislators would need to cut retiree medical costs in half, since reductions to retiree medical coverage would not have to net \$360 million in savings each year. The "transition cost" for the amortization payments is lower in subsequent years, and the Legislature has already set aside \$133 million that can be used to mitigate the upfront "transition costs."

It is worth noting that the state has scaled retiree medical benefits back in the past. The state's 1996 reforms revised MSERS retiree benefits to require 30 years of service before an employee received 90 percent of a retiree's health care premium, with employees earning 3 percent of the health care premium for each year of service. Previously, an employee was fully vested in retiree health benefits after just 10 years of service.⁴⁷

2) Freeze and Close: Maximize the Results

The reason policymakers may close the MPSERS defined-benefit system is to provide some containment of growing unfunded liabilities. The concern over transition costs and potential political conflict also suggests that the remedy should be worth the trouble. In that case, legislators could also consider not just closing the defined-benefit plan to new members, but freezing the benefits earned by current members.

Consider, for instance, how lopsided employer contribution rates are for new MPSERS members. As Graphic 2 on Page 43 shows, in the coming fiscal year, hiring new public school employees in Michigan will require a school system to pay not only their salary and benefits, but also an additional contribution — more than 26 percent of their salary — into MPSERS for OPEB and pension benefits.^{§,48} Only 2.24 percentage points of

§ This figure assumes the employee was hired on or after July 1, 2010. These employees are part of the MPSERS Pension Plus Plan established by Public Act 75 of 2010. "Public Act 75 of 2010," <http://www.legislature.mi.gov/documents/2009-2010/publicact/pdf/2010-PA-0075.pdf> (accessed Aug. 3, 2010).

those contributions pay for the pension benefits that the employees will earn for their work that year — i.e., the employer’s portion of the pension’s normal cost.⁴⁹ Much of the remainder — 12.49 percentage points — will pay off previous unfunded accrued liability.* For new employees, then, a substantial portion of the retirement money that school districts set aside after hiring them actually will pay for benefits that other employees and retirees have already earned.

As discussed under “Normal Cost” above, one reason for the low employer normal cost is the state’s questionably optimistic assumptions about the plan investments’ rate of return. But another reason for the relatively low employer normal cost is the state’s mandate that most members contribute directly to MPSERS by making payments straight from their paychecks toward their retirement benefits.[†] In fiscal 2010, active members hired before July 1, 2010, contributed an average of 5.42 percent of their salary to the system, while active members hired on or after that date contributed 4.69 percent.^{‡, 50} Most MPSERS members are required to make contributions on a sliding scale, ranging up to “\$510.00 plus 6.4 percent of the excess [of salary] over \$15,000.”^{§, 51}

* Kerrie Vanden Bosch, email correspondence with James M. Hohman, Sept. 2, 2011; Foss, “All Reporting Unit Business and Payroll Personnel of the Michigan Public School Employees Retirement System,” (Department of Technology, Management & Budget, 2011), 1, <http://goo.gl/H4n52> (accessed Jan. 23, 2012). The other major portion of school districts’ mandatory MPSERS contribution — 8.5 percentage points — is dedicated to retiree health care benefits. These are defrayed on a pay-as-you-go basis and therefore subsidize the health costs of current, not future, retirees.

† Depending on when an employee was hired (and whether he or she exercised the option to switch plans), he or she is a member of MPSERS defined-benefit Basic Plan, Member Investment Plan or new Pension Plus Plan. Only Basic Plan members do not contribute to their pension.

‡ Essentially, active MPSERS members pay for the majority of the normal pension costs — i.e., the benefits they are currently earning. The employers pay for the remainder of those costs plus the “catch-up” — i.e., the unfunded liability — for benefits that have already been earned. As noted above, the employers also pay for retiree health care and other items.

§ This maximum is the figure for MPSERS members who are part of the Member Investment Plan and who started work on or after Jan. 1, 1990, and before July 1, 2008. This maximum contribution is also the requirement for MPSERS members who are part of the new Pension Plus Plan. “Michigan Public School Employees’ Retirement System 2010 Annual Actuarial Valuation Report,” (Gabriel Roeder Smith & Company, 2011), F-3.

Graphic 2: MPSERS Employer Contribution for Fiscal 2013 as a Percentage of Payroll

Purpose of payment	Employees Beginning Before July 1, 2010	Employees Beginning on or After July 1, 2010
Pension Normal Cost (Prefunded)	3.47	2.24
Pension Unfunded Accrued Liability	12.49	12.49
Payment to Amortize Early Retirement Incentive Program	2.66	2.66
Retiree Health (Pay-As-You-Go Cash Basis)*	8.75	8.75
Total	27.37	26.14

Source: “Employer Contribution Rate,” (Michigan Office of Retirement Services, 2012), <http://goo.gl/xDLik> (accessed March 4, 2012).

* Three percentage points of this contribution are subject to ongoing litigation.

Freezing the plan means the state would honor all pension benefits already earned and all liabilities already generated, but would no longer allow existing active MPSERS members to earn new benefits (and generate new state liabilities) in the defined-benefit system. This step would also likely eliminate all of the employee payments to the MPSERS defined-benefit system, since these employee contributions are currently dedicated to paying the normal cost of any new pension benefits being earned, and under a freeze, no new benefits would be available. As discussed above under “Normal Cost,” this money would then be available as contributions to a new MPSERS defined-contribution plan.[¶]

GASB guidelines are not entirely clear about the preferred accounting treatment for amortization payments on the unfunded liability in a frozen-and-closed system. In light of this, the state could consider constructing a responsible but backloaded amortization schedule. The state would meet its constitutional requirement to honor the accrued financial benefits of MPSERS retirees. Ideally, as discussed under “3) Just Pay It,” MPSERS employers would shorten the amortization period to pay these liabilities down within the average working lifetime of the workers who earned benefits under the defined-benefit plan.

Alternatively, policymakers could consider continuing to use a level-percentage payment method, since the only caveat GASB states explicitly for the use of a level-percentage payment method with a closed plan is that the actuaries assume a decrease in membership over time.⁵²

¶ Some early MPSERS members are part of the system’s Basic Plan and do not make payments into the retirement plan. All other members do, however. Ibid.

The level-percentage payment in a frozen-and-closed system would no doubt be higher than in an open system, but upfront “transition costs” might be mitigated by payroll increase assumptions.

Finally, if policymakers still decided to follow a level-dollar payment schedule and faced upfront “transition costs,”* they would at the same time be adopting a reform that created an even higher long-term cost containment than simply closing the plan would. MPSERS defined-benefit plan would incur no new liabilities for further service, even for current public school employees.

Freezing-and-closing would relieve uncertainty about Michigan’s public pensions by producing a predictable and a well-funded pension system. While the state might still face upfront “transition costs,” depending on the payment it adopts, this reform would fortify the protections afforded to taxpayers. Moreover, this reform could be coupled with others, such as reducing OPEB, to address any remaining “transition costs.”

3) Just Pay It

As mentioned above, the phrase “transition costs” is misleading when applied to the unfunded liability, since the underlying cost of pension benefits does not change as a result of closing the plan. The shift in accounting treatment to a level-dollar schedule is a matter of the timing of the payments of that cost.

Moreover, if the state met the level-dollar payment schedule, it would actually lower the net cash necessary to pay down the unfunded liability. The earlier payments would essentially allow deposits into the plan to grow over longer periods of time. This, in turn, would allow the total deposits over time to be smaller than they would be under a backloaded level-percentage payment schedule.

The state’s current timing of payments is questionable. The amortization period for the net unfunded liability in the MPSERS defined-benefit plan was stated as 26 years in the 2010 annual actuarial valuation.⁵³ Since the average active plan member was 45.2 years old in fiscal 2010, this amortization period far exceeds the likely remaining working life of the average MPSERS plan member.⁵⁴ The better policy would be to ensure that the benefits are fully paid up — i.e., that the unfunded liability is completely paid down — as workers retire. This would imply a much shorter period for the amortization window

— say, 15 years — and require more cash regardless of whether the payment schedule involves a level dollar or a level percentage.

In that sense, the state could consider embracing the level-dollar funding policy of a closed defined-benefit plan and simply paying more cash up front. In fact, it’s not clear the state should be using a level-percentage funding policy in the first place. The number of MPSERS active members and their corresponding payroll has been decreasing, rather than increasing, of late. According to the SFA, payroll hit a peak of \$10.4 billion in fiscal 2004, but declined to \$9.9 billion in fiscal 2009, the most recent year for which SFA provided data.⁵⁵ This decreasing payroll and number of active members simulates the dynamics of a closed plan and would presumably call for the more conservative treatment of a level-dollar reporting schedule.

The state already has some precedent for devoting more cash to liabilities of the pension system. The 2012 budget includes \$280 million in extra money from the state’s general fund to begin prefunding MSERS retiree health care costs.⁵⁶

The state has also recognized that more cash may be necessary to prefund MPSERS retirement benefits. In the past, the state has assumed an 8 percent annual rate of return on the investment of MPSERS’ assets, but Public Act 75 of 2010 revises the assumed rate of return to 7 percent for the assets of members who joined MPSERS on or after July 1, 2010.⁵⁷ This lower rate assumption increases the amount of upfront cash required to prefund MPSERS pension benefits.

Regardless of whether the state pays its unfunded liabilities using a backloaded or a flat (and therefore relatively frontloaded) method, the payments do not represent an increased expense for the underlying benefits paid to participants. Hence, this discussion of level-percentage and level-dollar payments is entirely one of timing. The state developed its unfunded liabilities by deferring the costs of compensation into the future, so the difference has to be made up at some point. Doing it sooner rather than later is justifiable, even though it means that the state Legislature has to forgo other spending in the near term. In other words, simply abiding by the change to level-dollar payments may be appropriate.

4) Business as Usual: Do Not Pay the Full ‘ARC’

While the state should consider embracing the switch to a level-dollar payment schedule, policymakers could also

* Note that larger upfront payments under a level-dollar payment schedule would lower overall amortization costs. See the discussion under “3) Just Pay It.”

note that in the past, the Legislature has not met the annual required contribution computed under GASB guidelines.

For instance, in 2007, Michigan legislators voted to skip the calculations for paying down MPERS' defined-benefit plan's unfunded liability and simply pay "4.5 percent of the unfunded actuarial accrued liability."* This essentially equated to paying the interest on the debt, but not any of the principal.⁵⁸

Similarly, legislators have twice marked the MPERS and MSERS defined-benefit plans' assets to market values since 1997. This revaluation had to be done legislatively, and it resulted in increasing the stated value of MPERS and MSERS pension fund assets by \$4.6 billion and \$1.3 billion, respectively, in fiscal 1997, and by \$3.1 billion and \$779 million, respectively, in fiscal 2006. This bumped the total of the stated asset values of the two defined-benefit plans by 17.8 percent in fiscal 1997 and 7.8 percent in fiscal 2006.⁵⁹ These moves were made specifically to temporarily lower pension contributions at the expense of future costs and violated the rationale for the five-year smoothing process, which ensures smaller year-to-year fluctuations in the state's annual pension contributions.

Despite manipulating the rules to policymaker's advantage, and even aside from intentional underfunding of the pension system, the state's funding policies have proved insufficient to ensure payment of the actuarially determined annual required contributions to MPERS or MSERS anyway (see Graphic 3, Page 46).[†]

Graphic 3 shows the ARC and the actual payments for both MPERS and MSERS since 2001. Note that in most

* "Public Act 15," (Michigan Legislature, 2007), 3, <http://goo.gl/zSlem> (accessed Jan. 23, 2012). A similar interest-only payment was made that year for the MSERS defined-benefit plan as well. Kirk Sanderson, "H.B. 4766: Floor Analysis," (Michigan Senate Fiscal Agency, 2007), <http://goo.gl/o0jYx> (accessed Feb. 14, 2012).

† In addition, the state has revised its actuarial assumptions four different times. While adjusting assumptions to reflect recent experience is appropriate to ensure that the system is properly funded, this complexity and unpredictability is inherent in a defined-benefit plan, and it can be costly. Revisions made since 1997 increased actuarial liabilities by about \$1.7 billion, though the 2004 revisions were not quantified in state financial reports. "Michigan State Employees' Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2010," (Michigan Office of Retirement Services, 2010), 42, <http://goo.gl/1U8oA> (accessed March 17, 2011); "Michigan Public School Employees' Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2010," (Michigan Office of Retirement Services, 2010), 46, <http://goo.gl/CZivR> (accessed June 14, 2010); "Michigan Public School Employees' Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2000," (Michigan Office of Retirement Services, 2000), 31, <http://goo.gl/LzHpV> (accessed Feb. 15, 2012); "Michigan State Employees' Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2000," (Michigan Office of Retirement Services, 2000), 29, <http://goo.gl/xljq1> (accessed April 20, 2011).

years, the actual payments are less than the ARC. In other words, the "annual required contributions" are not legally required — or perhaps more to the point, missing the ARC does not appear to have material consequences, especially if the "underpayment" is not a gross departure and the normal cost is paid.

Thus, the state has ignored GASB's implied funding policy when convenient; in some cases, the state has simply failed to pay the ARC. Hence, if the state has departed from paying the ARC in pursuit of questionable policies, it can consider departing from paying the ARC in pursuit of better policies.

Specifically, the Legislature could just decide to adopt the level-dollar payment schedule, but fail to meet the payment schedule, just as it has in the past. The "transition costs" could be zero if the Legislature decided to make them so.

There are potential downsides. The state would note its failure to pay the ARC in its financial statements, and bond raters and buyers could react negatively to this departure from the implicit norm.

Still, small changes to the unfunded liability payment method could well be considered somewhat inconsequential by the bond marketplace if the state is finally pursuing a legitimate defined-contribution strategy to cap and retire its huge unfunded MPERS pension liabilities. In fact, following the Legislature's 2007 underpayment and a second departure from standard practice, there was a note in the MPERS financial statements that remarked on the changes.⁶⁰ If there was a notable reaction in the bond market, it was too small to have a material impact on the rest of state policy.

This is not to say there is no value to GASB standards, and there is every reason for the state to abide by those standards in its reports, even if it does not make the ARC. As Andrew Biggs of the American Enterprise Institute has written, "[G]iven governments' track record of underfunding their pensions I think these rules (however badly designed they currently are) have some purpose."⁶¹ Nevertheless, GASB is simply suggesting an accounting change. Allowing this to prevent significant and necessary pension reforms is penny-wise and pound-foolish.

5) Apply Amortization Payments to All Employees

Under most pension funding policies, employers calculate payments toward unfunded liabilities for a particular benefit as a percentage of the payroll of the employees

Graphic 3: MPSERS and MSERS Annual Payments and Required Contributions, 2000-2011

Year	MSERS DEFINED-BENEFIT				MPSERS DEFINED-BENEFIT			
	Annual Required Contribution	Actual Contribution	Difference: ARC - Actual	Percentage Contributed	Annual Required Contribution	Actual Contribution	Difference: Actual - ARC	Percentage Contributed
2000	\$120,906,261	\$121,817,366	\$911,105	100.8	\$572,605,695	\$655,258,923	\$82,653,228	114.4
2001	\$102,989,963	\$112,299,808	\$9,309,845	109.0	\$582,404,345	\$756,002,136	\$173,597,791	129.8
2002	\$111,551,549	\$87,486,128	-\$24,065,421	78.4	\$668,956,633	\$603,949,327	-\$65,007,306	90.3
2003	\$184,214,419	\$79,291,845	-\$104,922,574	43.0	\$812,891,416	\$697,906,265	-\$114,985,151	85.9
2004	\$262,546,900	\$103,873,294	-\$158,673,606	39.6	\$978,035,492	\$697,647,338	-\$280,388,154	71.3
2005	\$308,208,544	\$256,433,052	-\$51,775,492	83.2	\$1,023,336,739	\$774,277,778	-\$249,058,961	75.7
2006	\$366,650,515	\$270,705,017	-\$95,945,498	73.8	\$1,161,843,239	\$995,932,425	-\$165,910,814	85.7
2007	\$316,138,419	\$150,858,506	-\$165,279,913	47.7	\$919,560,821	\$835,366,382	-\$84,194,439	90.8
2008	\$308,019,761	\$355,732,115	\$47,712,354	115.5	\$904,409,331	\$999,374,879	\$94,965,548	110.5
2009	\$351,646,663	\$343,787,486	-\$7,859,177	97.8	\$989,150,149	\$1,000,375,355	\$11,225,206	101.1
2010	\$418,427,738	\$369,952,868	-\$48,474,870	88.4	\$1,182,164,061	\$1,001,251,673	-\$180,912,388	84.7
2011	\$447,924,105	\$424,546,805	-\$23,377,300	94.8	\$1,418,354,753	\$1,156,060,903	-\$262,293,850	81.5
TOTAL	\$3,299,224,837	\$2,676,784,290	-\$622,440,547	81.1	\$11,213,712,674	\$10,173,403,384	-\$1,040,309,290	90.7

Source: "Michigan State Employees' Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2009," (Michigan Office of Retirement Services, 2009), 44, <http://goo.gl/LKl6O> (accessed Feb. 15, 2012); "Michigan Public School Employees' Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2009," (Michigan Office of Retirement Services, 2009), 47, <http://goo.gl/Y7tfQ> (accessed Feb. 15, 2012); "Michigan Public School Employees' Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2011," (Michigan Office of Retirement Services, 2011), 47, <http://goo.gl/hyUcr> (accessed Feb. 15, 2012); "Michigan State Employees' Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2011," (Michigan Office of Retirement Services, 2011), 44, <http://goo.gl/0drvN> (accessed Feb. 15, 2012).

who will receive those benefits. This convention can be changed, however. For instance, Michigan began computing employer contributions toward the unfunded liability for the MSERS defined-benefit plan by using a percentage of the payroll of the employees not just in the defined-benefit plan, but in the defined-contribution plan as well, even though the latter will not receive pension benefits from the defined-benefit plan.^{*, 62}

This general approach could be applied consistently to other pension funding policies. For instance, the state could keep its current level-percentage amortization policies and apply the percentage to the payroll for both the new defined-contribution plan and the closed defined-benefit plan.

A similar approach was recently taken in Utah, which passed substantial reforms of a number of its government pension systems. State legislators there were similarly concerned about the immediate cost of the level-dollar payment schedule that is typically applied to a closed pension system.

So the Utah Legislature did not close the system. Instead, it maintained the same backloaded, level-percentage

method for paying down unfunded liabilities by adding a "tier" for new employees to the existing pension system. Members of the new tier can opt for a defined-contribution pension plan or for a "hybrid" plan that caps the employer contribution at 10 percent of pay[†] and requires employee contributions to cover any actuarially determined cost above that. State employers set aside a percentage of the payroll for all employees — not just employees in the original tier — as payments on the unfunded liabilities of the existing defined-benefit system. In other words, each new employee's income was included in the payroll calculations for the unfunded liabilities, regardless of his or her choice of plans as part of the new tier.⁶³

In Michigan, members placed in a new MPSERS tier would be treated like the participants in MSERS defined-contribution plan following the 2011 MSERS reform. Under that reform, the state began applying amortization payments to participants in the MSERS defined-contribution plan, not just to participants in the (closed)

[†] This 10 percent employer contribution is more generous than the private-sector norm of 5 percent to 7 percent, according to actuary and Mackinac Center Adjunct Scholar Richard C. Dreyfuss. See Dreyfuss, "Michigan's Public-Employee Retirement Benefits: Benchmarking and Managing Benefits and Costs," (Mackinac Center for Public Policy, Oct. 25, 2010), 4, 9, <http://www.mackinac.org/archives/2010/S2010-05.pdf> (accessed March 28, 2011).

* While this may diverge from more commonly used funding mechanisms, this approach is entirely constitutional, since accrued financial benefits are not mitigated and contractual obligations are maintained.

MSERS defined-benefit plan.⁶⁴ With MPSERS, then, the state would still use the payroll of new employees — that is, participants in the defined-contribution plan — when calculating the payroll percentage that school districts and other MPSERS employers would need to contribute to the unfunded liability in the MPSERS defined-benefit plan.

Under this approach, the state would not have to alter its amortization schedules and would still be able to use its backloaded method for catching up with its unfunded liabilities. Because there would be no switch to the level-dollar schedule typically recommended for a closed system, there would be no “transition costs” associated with paying unfunded liabilities.

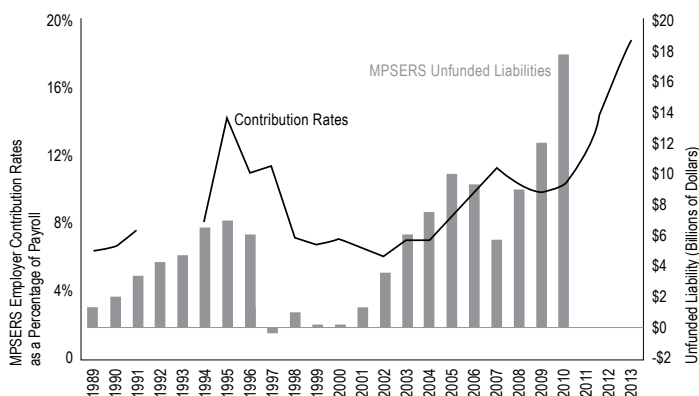
The Benefits of Reform

The preceding discussion shows there are several avenues for reforming MPSERS while minimizing or eliminating near-term “transition costs.” Each has costs and benefits, and it is important not to blow the costs out of proportion or to ignore the benefits.

Take the question of “transition costs.” The papers on this issue by the SFA, HFA and ORS analyze the near-term impact of a defined-contribution reform on both the normal cost and unfunded liability payments. The papers do not consider, however, a very real risk: the possibility that unfunded liabilities will become burdensome to present and future generations in a defined-benefit system. Recent history indicates just how much unfunded liabilities can increase: From fiscal 2009 to fiscal 2010 in the MPSERS defined-benefit plan, the unfunded liability grew from \$12.0 billion to \$17.6 billion.⁶⁵ Some of this increase, of course, was due to an early retirement incentive, but at the very least, the unfunded liability due to the nature of the defined-benefit plan was \$16.3 billion.⁶⁶ This \$4.3 billion increase in a single year was equivalent to a tenth of the annual state budget and more than half of the fiscal 2010 general fund.

In fact, since fiscal 2000, the unfunded liability of MPSERS defined-benefit has leapt more than 6,500 percent from a relatively “modest” \$246 million. In that same period, the state has failed to make the ARC eight times (see Graphic 3), despite increasing the employee and employer contributions to the plan. All of these costs have hit the state during a time when its economy has been depressed and taxpayers’ personal finances have been stressed. MPSERS employer contribution rates for the defined-benefit pension plan have risen drastically along with the unfunded liabilities, as Graphic 4 shows.

Graphic 4: Employer Contribution Rates and Unfunded Liabilities for MPSERS Defined-Benefit Pension, 1989-2013



Source: Kerrie Vanden Bosch, email correspondence with Hohman, Sept. 2, 2011; “Michigan Public School Employees’ Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2011,” (Michigan Office of Retirement Services, 2011), 46, <http://goo.gl/hyUcr> (accessed Feb. 15, 2012); “Michigan Public School Employees’ Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 2000,” (Michigan Office of Retirement Services, 2000), 31, <http://goo.gl/LzHpV> (accessed Feb. 15, 2012); “Michigan Public School Employees’ Retirement System: Comprehensive Annual Financial Report for the Fiscal Year Ended Sept. 30, 1997,” (Michigan Office of Retirement Services, 1997), 29, <http://goo.gl/9kjlV> (accessed Feb. 15, 2012). Note: The Department of Management & Budget letters for MPSERS employer contribution rates in fiscal 1992 and fiscal 1993 are unavailable from the Office of Retirement Services. Unfunded liabilities for the MPSERS defined-benefit plan are not available for fiscal 2011, fiscal 2012 and fiscal 2013. Contributions for MPSERS OPEB are excluded from the data.

In comparison, during this same period, the MSERS defined-contribution plan has accrued no unfunded liability. The required contributions have been made every year, and the employer contribution rates have remained all but unchanged. Indeed, the MSERS defined-contribution plan has been current, predictable and affordable. And unlike the MPSERS defined-benefit plan, the MSERS defined-contribution plan has clearly satisfied the requirements of the Michigan Constitution, having financed all benefits in the year they were earned. In effect, the MSERS defined-contribution plan has been the mirror opposite of the MPSERS defined-benefit plan.

The defined-contribution plan also provides an element of control missing in the defined-benefit plan. The Legislature can halt any employer payments to a defined-contribution plan when cash is tight without generating new, long-term claims on taxpayers.⁶⁷ At the same time, note that during Michigan’s decade-long recession, the Legislature has never once reduced contributions to the MSERS defined-contribution plan.

In fact, a defined-contribution program can allow generous contributions on the upper end. A 401(k) plan, for instance, allows a maximum of \$17,000 of annual tax-deferred contributions, regardless of whether it is from

an employer or employee, though these restrictions are loosened as employees approach retirement age.⁶⁸ Given that the average salary of a school employee is \$63,024,⁶⁹ a maximum employer contribution would represent 27 percent of pay.* Note, too, that such generosity would not need to affect decisions about the plan in future years.

In contrast, the Legislature often provides generous increases in benefits that have ramifications for years to come. For instance, with MSERS defined-benefit plan, the Legislature bumped cost-of-living benefits for retirees 6 times in the 16-year period between 1972 and 1987.⁷⁰ The effects of those decisions are still being felt in the MSERS plan, even in fiscal 2010, when the MSERS defined-benefit plan recorded a \$4.1 billion unfunded liability.⁷¹

Similarly, the state has generally assumed that MPSERS' defined-benefit plan investments will achieve an 8 percent return.† But as mentioned above under “Normal Cost,” MPSERS' defined-benefit portfolio realized an approximately 5.4 percent annual rate of return from the end of fiscal 1997 to the end of fiscal 2011.⁷² The gap between state investment performance and its estimations adds to its unfunded liabilities while reducing the plan's apparent normal cost.

The volatile nature of defined-benefit pension expenses is borne by taxpayers. The cost of these plans depends on numerous uncertainties: the life-length of retirees and beneficiaries, how long employees will work before retiring and employees' final salaries, among other continually changing assumptions. Shifting contribution rates are a risk to state employers and ultimately taxpayers.

Closing the MPSERS defined-benefit plan reduces this risk. Even if that closure prevents the state from backloading its pension contributions, the larger fiscal danger lies in developing unfunded liabilities in the first place and in the number of actions that the state can take to exacerbate that problem, such as failing to make the annual required contribution.

* Moreover, employers can offer any other sort of additional contributions for retirement provided that it is treated as normal income for tax purposes.

† As mentioned in the first full footnote on Page 40, statutory reforms in 2010 required that assets set aside for MPSERS Pension Plus members be discounted at 7.0 percent, rather than the traditional 8.0 percent. “Public Act 75 of 2010,” Sec. 41(11), <http://www.legislature.mi.gov/documents/2009-2010/publicact/pdf/2010-PA-0075.pdf> (accessed Aug. 3, 2010).

Conclusion

The Legislature has systematically failed to provide the contributions necessary to fully fund the MPSERS defined-benefit pension plan. If the state hasn't insisted on meeting its payment schedule under current rules, then a temporarily more demanding payment schedule after switching rules should be an immaterial concern. Nevertheless, this paper has offered a number of ways for legislators to mitigate any concerns they may have in closing the MPSERS defined-benefit plan.

The size of the so-called “transition costs” is determined entirely by how legislators choose to close the MPSERS defined-benefit plan. In essence, outside of the relatively small costs for setting up a defined-contribution system, legislators face “transition costs” only if they choose to, as this Policy Brief makes clear. There are viable ways to eliminate, mitigate or accept the additional cash required by GASB rules when closing a defined-benefit system.

State Sen. Dan Liljenquist of Utah, the legislator who spearheaded pension reform in his state, has remarked that pension funds are like chemical spills: They can be long-term problems, take years to clean up and have disastrous consequences. Defined-contribution reforms are necessary for containing this pension “spill,” since in time they stop the problem from spreading.

Though the five reforms discussed above range from comprehensive to limited, each has trade-offs. Two of the ideas — cutting back on OPEB, and freezing and closing the defined-benefit plan — would do more to contain the problem than just closing the system would. Reducing the MPSERS OPEB would scale back a post-employment benefit the state is not obligated to pay under the state constitution and use the proceeds to solidify the pension commitments the state *is* obligated to pay under the state constitution.

Freezing and closing the MPSERS defined-benefit plan, on the other hand, would substantially lower the long-term commitments in the pension system, since the state would no longer incur new pension liabilities for current public school employees, not just future public school employees. Even if freezing and closing the plan left residual “transition costs” for paying unfunded liabilities, the additional containment of liabilities in the system would even more substantially limit taxpayer exposure than simply closing the plan would.

Implementing these two ideas, in other words, would include some clean-up efforts as well as containment.

If policymakers feel unable to pursue these, they could simply embrace make the higher upfront payments suggested by a level-dollar amortization schedule. Catching up on unfunded liabilities more quickly means that future taxpayers will not have to contribute as much to cover promises that were made when many of them were too young to vote. A level-dollar payment approach would simply change the time that the liabilities are paid; it would not constitute an additional liability.

Two of the other ideas — not paying the ARC or applying amortization payments to all employees — would still provide containment while avoiding upfront cash contributions. They would not be as comprehensive a reform, but they would deal with much of the opposition to closing the pension system.

MSERS remains a case study of the benefits of transitioning to a defined-contribution plan. While the state has developed additional unfunded liabilities in the MSERS defined-benefit plan since closing it March 31, 1997, a recent estimate by Mackinac Center Adjunct Scholar Richard C. Dreyfuss indicates that closing the plan reduced the unfunded liabilities by between 36 percent and 51 percent from what they would have been otherwise.⁷³

Of course, there were no “transition costs” for amortization payments when the MSERS plan was closed; the plan was fully funded. But the unfunded liabilities in the MPSERS plan do not mean the reform no longer makes sense; rather, they are powerful evidence of the need for reform.

Michigan policymakers have a range of options to deal with the shift in accounting rules that comes when a defined-benefit plan is closed to new entrants. So-called “transition costs” should not prevent the state from following the private-sector’s lead and offering new public school employees a defined-contribution plan that is current, affordable, predictable and constitutional. By closing MPSERS defined-benefit plan, the state can help ensure that it meets the promises it has made to retirees and vested employees while capping the state’s open-ended and expensive obligations in the future. ㉿

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ISBN: 978-0-9833004-7-2 SP2012-01

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