Policy Brief

MACKINAC CENTER FOR PUBLIC POLICY

OCTOBER 25, 2010 S2010-05 ISBN: 1-890624-95-0

# 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 "MPSERS," 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 MPSERS 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, MPSERS and MSERS pensions had unfunded liabilities of $15.1 billion, while MPSERS 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 MPSERS 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.

MPSERS 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 MPSERS and MSERS defined-benefit plans by accumulating sufficient assets to finance current and future benefits. In contrast, MPSERS 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 MPSERS 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 MPSERS and MSERS systems. As of Sept. 30, 2009, MPSERS' and MSERS' defined-benefit pension plans were 78.9 percent and 78.0 percent funded, respectively.

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

* Citations provided in the study's main text.

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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 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 concerns[1] 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.¶

* 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.

‡ 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 MPSERS 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 MPSERS 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 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 MPSERS 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 MPSERS 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.[6]

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.¶

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 MPSERS, the state Legislature and the MPSERS 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 MPSERS pension cost is covered by mandatory pension contributions from MPSERS members.

† Under Public Act 75, public school employees hired after July 1, 2010, are still part of a defined-benefit MPSERS 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).

‡ 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://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 MPSERS' 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, MPSERS 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 MPSERS 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.

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, MPSERS' 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 MPSERS 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 MPSERS and MSERS. Combined with an assumption of a 6 percent investment return, this shorter amortization period would cause MPSERS 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, MPSERS 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 MPSERS and MSERS defined-benefit pension plans were scheduled to be paid off during the next 27 years, even as the average age of MPSERS and MSERS members in the plans was 45.4 and 52.1, respectively — far less than 27 years from retirement age.[10]

* "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. MPSERS 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).

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 threshholds 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 law[12] 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 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

* 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).

† *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 2010[14] 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 10. 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 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-contribution plan for new state employees and for public

* 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.

‡ 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 10.

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

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 MPSERS defined-contribution plan established under Public Act 75 of 2010 did not significantly alter the basic challenges of MPSERS' defined-benefit pension system. While the modifications introduced by Public Act 75 were generally positive, new MPSERS 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, MPSERS 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 MPSERS cost-of-living benefit is generally offset by the required employee contribution to the plan, a place where MPSERS 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, MPSERS and MSERS requirements are more generous.[21]

### Graphic 3: Comparison of Pension Benefits for 24 Major Michigan Employers and MPSERS 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 completed[22]
- 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' service[25]
- 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 $300[26]
- No employee contributions[27]

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 care coverage to retirees who are not yet eligible for

* 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.

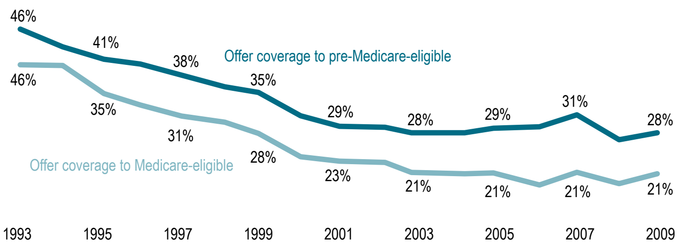
‡ Public Act 75 of 2010 actually sets this as the highest five years of compensation (see "Public Act 75 of 2010," Sec. 4 (12), http://www.legislature.mi.gov/documents/2009-2010/publicact/pdf/2010-PA-0075.pdf (accessed Aug. 3, 2010)). These will typically be the final five years.

§ 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.

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™.

#### 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[28]
- Retirees pre-Medicare pay an amount equal to the Medicare Part B Premium[29]
- 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.[30]

Defined-Benefit Participants (MSERS Tier 1)

- All MSERS Tier 1 retirees are eligible for benefits[31]
- MSERS Tier 1 retirees receive 90 percent employer-paid health insurance premiums and 90 percent employer-paid dental and vision insurance premiums[32]

* 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.

† "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' service[33]
- *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 MPSERS 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 prior state budgets, tax increases to address MPSERS 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 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 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 MPSERS 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 MPSERS 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

* 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 4 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.

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.

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 MPSERS 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 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.

* 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&cid=1176156938146 (accessed Sept. 8, 2010).

# 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.

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ISBN: 1-890624-95-0 S2010-05



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