MPSERS: Defined Benefit v Contribution

There have been periodic recommendations during recent years to transition Michigan's public school employees from a Defined Benefit (DB) pension plan to a Defined Contribution (DC) pension plan. They are typically proffered with an underlying invalid assumption that any conversion of a DB plan to a DC plan must result in savings for an employer. As explained below, for the Michigan Public School Employees' Retirement System (MPSERS), conversion from DB to DC would cost Michigan billions of dollars over the next two decades and results in little savings over the next 40 years.

An important factor for MSPERS, as opposed to a typical DB pension plan, is that MSPERS requires employees to contribute to the plan - 4.3% of their wages for employees hired before July 1, 2008, 6.4% for employees hired between 2008 and 2010 and 7% for the most recent hires. The employers' contribution is currently approximately 15% of employee wages (an addition 8.55 is levied on employers for retiree health care).

When a DB plan is ended (closed to new entrants, but existing participants remain enrolled, accruing service credit), the DB plan gets more expensive for the remaining participants. Frequently, as is the case with MSPERS, DB plans are built on the assumption that not all contributing employees will actually earn a benefit (they will not "vest"). As indicated earlier, participants in MPSERS' DB plan pay between 4.3% and 7% of their earnings into the system while the employer pays an additional 16%. If the employee leaves before they vest the system will refund the employee's contribution but not the employer's. Therefore, the employer's overall rate per employee stays lower over time because the plan is realizing contributions (and investment returns) without an attendant benefit liability. If the plan is ended or closed to eliminate the possibility of non-vesting participants, the cost of the plan would increase approximately 15% or about $200M per year. According to the Office of Retirement Services (ORS), the increased cost would continue for 15 to 20 years, resulting in $2B to $3B in additional costs for Michigan over the next two decades.

In 2010, the House Fiscal Agency issues a memo on the cost of conversion (see attached). HFA made two significant conclusions. First, the cost to implement a DC system for new hire would run between $234m and $279m annual above the cost of running the DB system for current employees. Second, the total savings of the conversion would only amount to $304m and those savings would not be fully realized for 30 to 40 years.

Today, ORS projected that the first year cost of conversion would be just over $400m and the cost for the first 6 years would be an additional 1.4B (yep, with a "B"). Such significant short term costs simply cannot be justified for what amounts to only a $300m overall savings on a 30-40 year horizon. As a result, we simply cannot support converting MPSERS to DC.