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If Michigan Officials Believed School Pensions 'Vital' They Would Have Paid for Them

By James M. Hohman

Summary

Public officials say that creating a 401(k)-like system for new school employees is too expensive and the current pension system is working just fine. But they have failed to ensure that the pension system has been properly funded and managed, resulting in a $29.1 billion shortfall.

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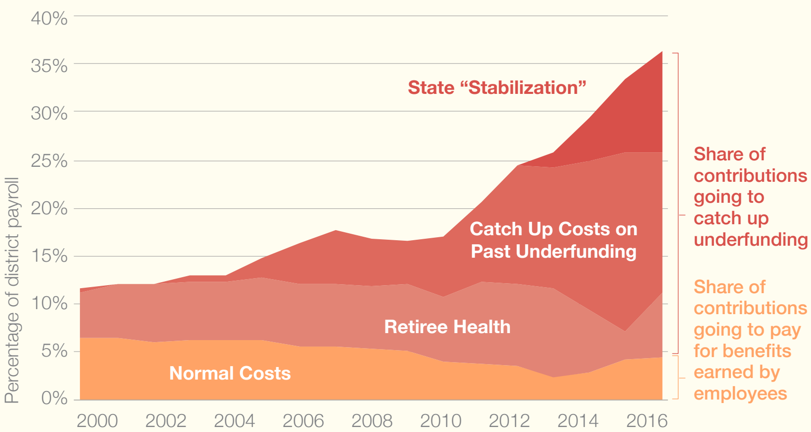
Defined benefit pensions could work just fine for both employers and employees. But government pensions have a major problem: They are run by politicians who make promises and hate to pay for them. The consequences of failing to pay what's promised fall most heavily only decades in the future, so it's too easy to push the burden onto future taxpayers.

Michigan's largest government pension system, the one for school employees, is a slow-motion fiscal disaster. Lawmakers have promised current and past employees some $72.3 billion in benefits but only saved enough to pay 60 cents on the dollar of those promises. The pension fund, then, is $29.1 billion short of the amount the state's own actuaries estimate is needed.

The costs of the shortfall are immense. The annual interest payments on this debt alone cost more than the state budget for prisons.

In fact, that $29.1 billion unfunded liability makes school employees and retirees the state's largest creditors. This is not fair, for employees were never asked to consent to letting the state borrow money from them.

School Pension Fund Contribution Rates



Source: Michigan Office of Retirement Services

Though some officials say that pensions are vital, the state has a poor recording of funding the state's pension system for school employees.

When an employee earns benefits in a pension system, the employer is supposed to set aside enough in the same year to pay for that benefit. In the case of public employment, this practice keeps the cost of today's service from being a burden on future taxpayers and assures employees their benefits will be there when they retire.

The future is uncertain, so to determine how much to save and invest to meet the system's promises, pension managers must make assumptions: how much will employees earn, how long they will live, and what kind of returns can be expected from pension fund investments going forward.

There are many ways to get it wrong, and the biggest one is to make overly optimistic assumptions, particularly about investment returns.

Unfortunately, the state's been too optimistic for a long time. There are other ways that pensions get underfunded as well, but the result is that Michigan's school pension system has been underfunded in 42 out of the past 43 years.

When pension administrators recognize there's a funding gap, they develop a plan to fill it. But the plan that Michigan's pension managers chose for the school system was so inadequate that until recently, it wasn't even covering interest on the system's debt.

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The solution is simple: State leaders must stop the practice of promising benefits now and paying for them later. This means no longer promising lifetime pension benefits to every new employee hired by a Michigan school. New employees should instead be offered automatic contributions, with optional matching funds, to 401(k)-like savings plans that generate no long-term taxpayer liabilities. People still in the system can continue to earn pensions, and the state will continue to pay out what has been promised, but over the long term, lawmakers will be prevented from pushing retirement costs onto future taxpayers.

Some interest groups are concerned about this proposal. They include school administrators, unions and the managers of the big, complex status quo school pension system. Some of them have falsely claimed that the current system poses little risk and that no longer enrolling new hires would incur "transition costs."

But this is not correct. Such costs are entirely optional, and even if they are paid, it saves taxpayers in the long run. Interest on pension debt comes with perhaps the highest rate the state has on debt.

The other claim is that a newer so-called hybrid retirement plan has fixed the problem. But it remains susceptible to underfunding, like the older plan, and has only existed since 2010. During its brief life, the plan has benefited from stellar returns from the stock and bond markets; even so, it has just 0.1 percent more in assets than liabilities. So to say that the plan will never go into debt is Panglossian and irresponsible.

Finally, the system's defenders argue that defined benefit pensions are inherently better for employees than a 401(k) plan. If they really believe this, though, they have a moral obligation to match their deeds to their words to ensure that pensions are funded as they are earned.

Defenders argue that defined benefit pensions are inherently better for employees than a 401(k) plan. If they really believe this, though, they have a moral obligation to match their deeds to their words to ensure that pensions are funded as they are earned.

This means that managers should have used realistic assumptions — not pie-in-the-sky ones — about future payroll growth and investment returns. They should have actually made the required annual contributions. And long ago, they would have stopped kicking the costs into the future. School interest groups should have been watchdogs to ensure that this happened.

The system's current $29.1 billion unfunded liability is a testament to how far short these groups fell in this endeavor.

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