MPSERS Pension Explainer: New Employees Are Not Necessary to Fully Fund a Pension Plan

There is a commonly held belief that defined benefit pension plans like MPSERS need contributions from new employees to help pay for the pension benefits promised to retirees. However, this is not true. The confusion is because Social Security operates by having new members contribute to fund benefits for current beneficiaries. But the funding process for defined benefit plans is actually quite different from Social Security.

(1) Defined Benefit Plans Are Designed to be "Pre-funded"

The intended process for funding defined benefit retirements is to have contributions into the pension fund at the same time that an employee accrues benefits. Contributions should be made to pay the benefits earned by each year of service during the same year the benefits are earned. The goal is to have enough money in the pension fund so that – when combined with expected investment returns – there will be enough dollars in the fund the day that the employee retires to pay all benefits throughout retirement.

(2) Employees Only Contribute Towards the "Normal Cost" of Pensions

The contributions necessary to "pre-fund" retirement benefits are called "normal cost" and they are shared between employees and employers. When investment returns are less than expected, or reality differs from other actuarial assumptions, the result is unfunded pension liability. In Michigan, employers (the state and school districts) pay 100% of the "unfunded liability amortization payments" (see other side). Employees do not contribute toward paying down unfunded liabilities.

(3) New Employees Mean More Promised Pensions

Every new hire into MPSERS increases the cash flow into MPSERS through more total employee contributions, but every new employee also means an increase in the "accrued liabilities" or promised pension benefits that will have to be paid out of MPSERS when these new employees retire. Hence, adding more employees on its own does not by itself improve the funded status of the defined benefit plan.

[FLIP FOR A VISUAL REPRESENATION OF THE FUNDING PROCESS FOR MPSERS "PENSION PLUS PLAN" BENEFITS]

Questions about this explainer or pension reform? Check out www.reason.org/MPSERS

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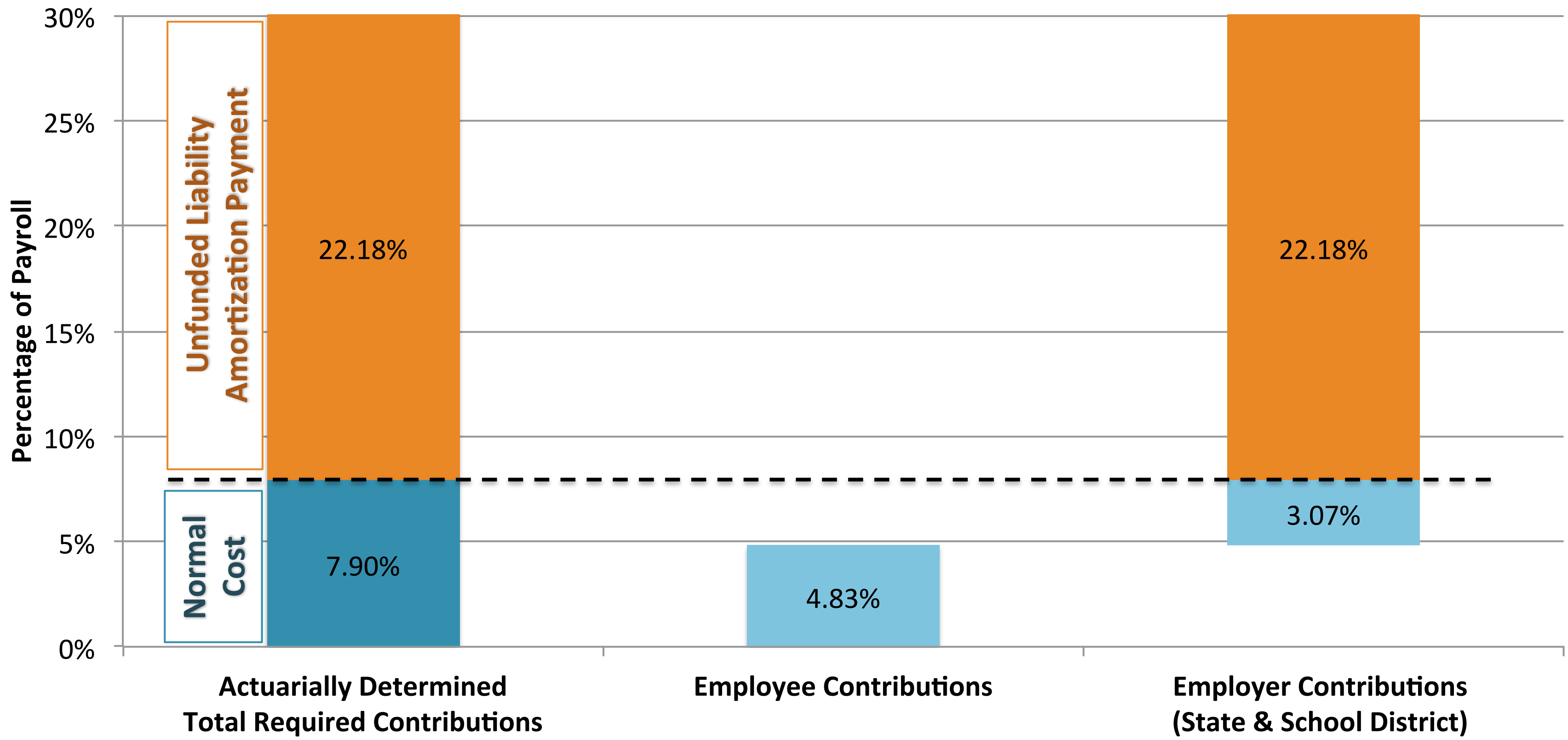
(Continued on other side)

Breakdown of Employer v. Employee Contributions, FY 2017-18
Defined Benefit Portion of the Pension Plus Plan



Source: MPSERS Fiscal Year End 2015 Valuation Report, p.A-1