



CRC Memorandum



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STATEWIDE ISSUES ON THE NOVEMBER GENERAL ELECTION BALLOT

PROPOSAL 2006-05: EDUCATIONAL FUNDING GUARANTEE LAW

This CRC Memorandum is a summary of Report 344, a more detailed analysis of the statewide ballot proposal.

Proposal 2006-05, the Educational Funding Guarantee Law, is a statutory initiative that will appear on the November 7, 2006, statewide ballot as a result of petitions circulated by The K-16 Coalition for Michigan's Future (www.michigank16.org/index.html) and the legislature's decision not to act upon the proposed initiated law within the required 40 days. The proposal would amend 179 Public Act 94, the State School Aid Act, to:

- Require, at least, inflationary spending increases in the K-12 schools, community colleges, and universities state budgets in Fiscal Year 2007 (FY07), using the FY05 budget levels as the base on which to apply the increases.
- Require, at least, inflationary spending increases in specific K-12 education spending categories in FY07, using the FY05 amounts as the base for the adjustments.
- Guarantee that future spending beyond FY 07 for K-12 schools, community colleges, universities, and specific K-12 school components would increase by inflation.
- Modify the method by which K-12 schools calculate their current-year student membership to allow the use of a three-year average, beginning in FY07.
- Reduce the gap between the basic and state-guaranteed maximum foundation allowance grants from \$1,300 to \$1,000 by FY12, beginning in FY07.
- Cap the annual employer contribution to the Michigan Public School Employees Retirement System

(MPSERS) at 80 percent of the actual contribution rate or 14.87 percent of payroll, whichever is less, for K-12 school districts, intermediate school districts, district libraries, community colleges and universities. The State of Michigan would be responsible to make up the difference between the capped employer's contribution and the actual retirement contribution made by these entities.

- Appropriate, from the State School Aid Fund and any available federal resources, amounts necessary to meet all the funding requirements of the proposal in FY07.
- Appropriate from the State General Fund in FY07 the amount necessary to cover the difference, if any, between all the funding guarantees and the amount of resources in the State School Aid Fund and from available federal sources.

The proposal is opposed by The Coalition to Stop the K-16 Spending Mandate (<http://www.stopthespendingmandate.com/index.htm>).

Components of Proposal 2006-05

Proposal 2006-05 consists of four components: various funding guarantees for education, a requirement to narrow the gap between the basic and the maximum foundation allowance grants, a declining enrollment provision for K-12 school districts, and a cap on the MPSERS employer contribution rate. These components have the potential to increase the amount of state dollars provided to local schools, community colleges, and universities.

Funding Guarantees

Base Funding Increases. The proposal would establish funding floors for total K-12 schools, community college, and university appropriations in FY07. Under the proposal, the FY07 minimum level of appropriations provided for K-12 schools, community colleges, and universities would have to be equal to the FY05 appropriation levels adjusted by the percentage increase in the United States Consumer Price Index (CPI)



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from 2004 to 2006. Because the proposal establishes floors and not ceilings, the legislature could provide appropriations in excess of the minimums required in FY07. The proposal limits the guaranteed increase for the K-12 education budget to state funds only, whereas the funding floors for community colleges and universities include all funds (e.g., state and federal resources).

Furthermore, the proposal guarantees inflationary increases for K-12 schools, community college, and university appropriations beyond FY07, using the FY07 appropriation levels as the base. The FY08 amounts would be equal to the FY07 levels adjusted by the change in the CPI for 2006. Whereas the proposal provides funding floors in FY07, it requires specific increases in future years and does not allow the State to

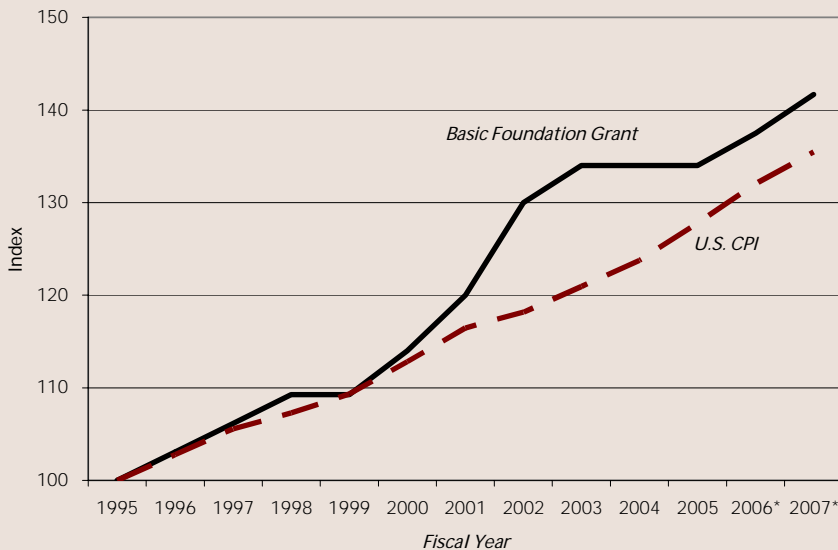
provide annual funding increases greater than the change in the CPI, beginning in FY08, *under the State School Aid Act*.

Basic Foundation Allowance. Proposal 2006-05 would require inflationary increases in specific components of K-12 education spending. The largest component of annual K-12 spending, the foundation allowance, is guaranteed automatic increases under the proposal, beginning in FY07. Under the proposal, the FY07 basic foundation allowance would have to be set at a level at least equal to the FY05 basic foundation allowance adjusted by the percentage change in the CPI from 2004 to 2006. The proposal guarantees increases in the basic foundation allowance beyond FY07 equal to inflation. *Chart 1* compares the growth of the basic foundation al-

lowance since FY95 with the growth in the CPI.

Other Guaranteed Funding Increases. Proposal 2006-05 also sets funding floors for certain categorical grants in the State School Aid Act, effectively isolating these programs from future budget reductions. The proposal guarantees that these grants will receive, in FY07, an amount of state funding at least equal to their FY05 base adjusted by the percentage change in the CPI from 2004 to 2006. The proposal would guarantee a funding floor for "At-Risk" pupil support, special education, and intermediate school districts operations, beginning in FY07. Again, nothing in the proposal prevents the legislature from appropriating funds in excess of the minimums required in FY07; however, beginning in FY08 the proposal guarantees only inflationary annual increases for these programs, *under the State School Aid Act*.

Chart 1
Growth of Foundation Allowance and Inflation

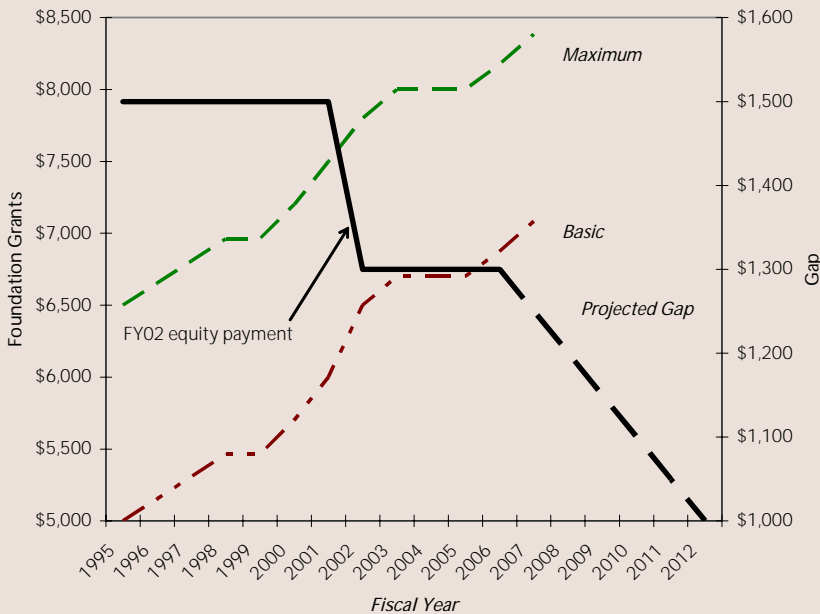


* U.S. CPI estimates, May 2006 Consensus Revenue Estimating Conference
Source: various appropriations acts, CRC calculation.

Narrow the Foundation Allowance Gap

In addition to the guaranteed funding provisions, Proposal 2006-05 requires the State to narrow the gap between the basic foundation allowance and state-guaranteed maximum foundation allowance grants. *Chart 2* shows the basic and maximum foundation allowance grants since the implementation of Proposal A of 1994 and the gap between these two amounts. The proposal would reduce the gap from \$1,300 to \$1,000 by FY12. For this analysis, it is assumed that the gap is narrowed in six annual \$50 increments, beginning in FY07.

Chart 2
Foundation Grants Under Proposal A



Source: various appropriations acts, CRC calculation.

Declining Enrollment

The proposal includes a declining enrollment provision to address K-12 school districts that are experiencing falling pupil membership. Under the State School Aid Act, a district's pupil membership is determined by a combination of enrollment figures from the current year, as well as the preceding year, referred to as a "blended count". This membership figure is used to calculate the total per pupil funding provided to a district under the foundation allowance program.

Under the declining enrollment provision of the proposal, a school district would be able to use, for the purposes of determining its membership, the average of the district's "blended" membership for the three-year period ending with the current year or the actual membership for the current year, whichever is greater. Use of this three-year average would further exaggerate

the total number of students actually attending Michigan schools and require an increase in the amount of state resources dedicated to the foundation allowance program. The School Aid Act currently has a declining enrollment provision that applies only to small, geographically dispersed rural districts.

Retirement Funding Guarantee

The Michigan Public School Employees Retirement System (MPSERS) is the largest public employee pension system in the state, providing pension and health care benefits to over 488,000 members and beneficiaries. Pension benefits are financed on an advance-funding basis while the health benefits are on a cash disbursement basis. In both cases, these benefits are funded by employer contributions. The level of total contributions to the system to fund benefits, expressed as a

percentage of payrolls, is annually set by the State and has been on the rise since FY98. Employers are responsible for the entire amount of the contribution to the system. Proposal 2006-05 would shift the responsibility for a portion of the contribution from the employer to the State of Michigan.

Under the proposal, beginning in FY07, the employer contributions to MPSERS would be capped at the lesser of 80 percent of the contribution rate or 14.87 percent of payroll, which was the FY05 rate. The State of Michigan would be responsible for making up the difference between the capped employer contribution and the total actual contribution required. To meet its new fiscal responsibility, the State would be required to appropriate, to the various MPSERS employers, a sufficient amount from the General Fund to make up the difference in FY07. The proposal does not contain a specific appropriation or funding source to cover the State's obligation beyond FY07, although the employer cap would be in effect after FY07.

For FY07, the MPSERS employer contribution rate for all non-university employers is 17.74 percent of payroll. Under the proposal, the employers' contribution would be capped at 80 percent of this figure (14.19 percent of payroll) and the State of Michigan would be responsible for the remaining 20 percent (3.55 percent of payroll). The cost to the State would be calculated by multiplying its share of the total rate by the total payroll for FY07. The proposal appropriates this amount to each employer for subsequent deposit with MPSERS.

Fiscal Impacts of Proposal 2006-05

The Citizens Research Council of Michigan estimates that the total FY07 cost of Proposal 2006-05 will be between \$565 million and \$707 million above the enacted budget for FY07, depending on how the legislature implements the K-12 funding guarantees. Because the proposal sets funding floors in FY07, the actual total cost could be even higher than the \$707 million figure. For FY07 only, the proposal requires the State School Aid Act to pay for all of the funding guarantees, and, if insufficient, appropriates the requisite amount from the General Fund to make up the difference. For years beyond FY07, the proposal is silent as to the source of funds to finance the new requirements. Proposal 2006-05 would redirect more of the General Fund/General Purpose (GF/GP) budget towards education spending and require state finances to be organized in such a manner to meet the various funding guarantees. For the non-retirement costs, *Table 1* examines the guarantees in light of the recently enacted FY07 state budget. The retirement costs represent a new financial obligation to the State of Michigan.

Overall, it is estimated that the K-12 education funding provisions will cost between \$153.4 million and \$295.2 million above the enacted FY07 state budget. The actual cost to the budget will depend on how the legislature addresses the specific K-12 school funding guarantees, the foundation gap provision, and the declining enrollment provision, which total \$295.2 million. A portion of this total could be financed by the

additional resources provided through the base funding guarantee (\$153.4 million). The legislature would have to consider two alternatives to finance the remaining \$142.2 million of the total, either reduce/eliminate other "discretionary" or "non-guaranteed" K-12 education programs by this amount or, provide additional resources from the General Fund to cover these costs, above the base funding amount. The latter alternative would draw more resources from other non-education areas of the General Fund budget.

The costs to the State of Michigan beyond FY07 will be contingent on changes in the rate of inflation. Once the base funding levels for K-12 education, community colleges, and universities are established in the budget, the State's ability to finance the marginal annual costs will depend, in large measure, on the growth in state revenues, assuming state revenues are not raised to meet the funding guarantees. With respect to the K-12 education components, State School Aid Fund revenues are likely to increase with inflation, given moderate economic growth, and therefore provide the resources to meet future required annual increases. Financing the higher education components, which are almost entirely funded from GF/GP appropriations, will depend on future growth in GF/GP revenues. Annual revenue growth below the rate of inflation will make it more difficult to meet the spending mandates of the proposal, especially in light of other spending pressures on the State's GF/

GP budget.

The retirement component represents, by far, the most significant costs to the State of Michigan, in both the short and long term. It is estimated that the proposal's retirement funding guarantee will cost the State \$361.3 million for K-12 schools, intermediate school districts, and district libraries and \$19.2 million for community colleges, and \$4.3 million for universities. The proposal requires the General Fund to shoulder these costs in FY07, but is silent beyond FY07.

Determining the State's total share of the retirement funding guarantee for the universities is somewhat difficult due to the manner in which the retiree health care component is currently financed. The health care portion is not included in the annual contribution rates calculated by the State and therefore the fiscal impact of this component can not be determined in the context of the proposal's cap language.

Determining the cost of the retirement funding guarantees beyond FY07 also is difficult. It is likely that these costs will account for the majority of the future costs to the State, after the non-retirement costs are incorporated into the FY07 budget and assuming moderate revenue growth. In general, the State's share of the retirement funding guarantee will depend on the total MPERS contribution rate and payroll levels. Predicting the increases in payroll is much easier than estimating future contribution rates.

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Table 1
Fiscal Year 2007 Impact of Proposal 2006-05
(millions of dollars)

Non-Retirement Costs

	<u>FY05</u> <u>Base</u>	<u>Minimum</u> <u>Increase (6.5%)</u>	<u>Proposal 2006-05</u> <u>FY07 Minimum</u> <u>Guarantee</u>	<u>FY07</u> <u>Budget</u>	<u>FY07</u> <u>State Costs</u>
K-12 Budget Base Increase	\$11,113.5	\$722.4	\$11,835.9	\$11,682.5	\$153.4
Other K-12 Costs					
Foundation Allowance	6,700 per pupil*	436 per pupil*	7,136 per pupil*	7,085 per pupil*	84.1
At- Risk	314.2	20.4	334.6	319.4	15.2
ISD Operations	77.7	5.1	82.8	80.1	2.7
Narrow the Foundation Gap			33.8	20.0	13.8
Declining Enrollment			199.4	20.0	179.4
Subtotal Other K-12 Costs:					295.2
Additional Resources/Reductions:(net of Other K-12 costs minus Base K-12 costs)					141.8
Community Colleges Budget	285.7	18.6	304.3	289.9	14.4
Universities and Financial Aid Budget	1,690.2	109.9	1,800.1	1,787.5	12.6
Total Non-Retirement Costs:					\$180.3** to \$322.1***

* Actual dollars, not millions.

** Assumes that specific K-12 funding guarantees will be met within resources provided under the base funding increase required by the proposal and reductions/eliminations to existing K-12 discretionary programs.

*** Assumes that specific K-12 funding guarantees will be met by additional resources provided above base funding, without reductions/eliminations to existing K-12 discretionary programs.

Sources: annual appropriations acts; Senate Fiscal Agency, CRC calculations.

Retirement Costs

<u>Employer</u>	<u>Est. FY07</u> <u>Payroll*</u>	<u>FY07</u> <u>Rate</u>	<u>State Share of</u> <u>FY07 Rate</u>	<u>FY07</u> <u>State Costs</u>
K-12 schools, ISDs, libraries**	\$10,182.3	17.74%	3.55%	\$361.3
Community Colleges**	541.0	17.74%	3.55%	19.2
Universities***				
Normal Pension Cost	127.2	6.38%	1.28%	1.6
Unfunded Pension Cost	194.6	6.85%	1.37%	2.7
Total Retirement Costs:				\$384.8

* Based on FY05 payroll figures with three and a half percent annual increases for FY06 and FY07.

** Assumes that the employer contribution rate would be capped at 80 percent of total FY07 rate or 14.19 percent of payroll.

*** Assumes that the employer contribution rate would be capped at 80 percent for each pension component.

Sources: Office of Retirement Services, Michigan Department of Management and Budget; CRC calculations (numbers may not add due to rounding).

Factors influencing the rate include the escalating unfunded accrued liability for retiree pension benefits, the increasing costs of health care for retirees and their beneficiaries, and the rising number of individuals eligible for retiree health care benefits. In most cases, employers have very little, if any, control over these factors. **Table 2** projects the future employer and state shares of the total MPERS contribution rate under Proposal 2006-05 and the future state costs. Beginning in FY08, the employer share of the total will be capped at 14.87 percent of payroll and the State of Michigan will be responsible for the remainder of the contribution rate. The State's share continues to grow as it shoulders the full responsibility for the marginal costs associated with annual rate increases, rising from 20 percent of the total in FY07 to over 50 percent of the total by FY20.

Table 2
Projected MPERS (Non-University) Contribution Rates and State Costs
(millions of dollars)

<u>Fiscal Year</u>	<u>Projected Rate</u>	<u>Employer Share**</u>	<u>State Share</u>	<u>State Costs***</u>
2007*	17.74%	14.19%	3.55%	\$ 380.5
2008	19.15	14.87	4.28	474.5
2009	20.15	14.87	5.28	606.3
2010	20.61	14.87	5.74	682.3
2011	21.25	14.87	6.38	784.9
2012	21.89	14.87	7.02	894.3
2013	22.58	14.87	7.71	1,016.6
2014	23.44	14.87	8.57	1,168.5
2015	24.35	14.87	9.48	1,339.3
2016	25.35	14.87	10.48	1,531.1
2017	26.42	14.87	11.55	1,746.5
2018	27.57	14.87	12.70	1,988.2
2019	28.81	14.87	13.94	2,259.3
2020	30.15	14.87	15.28	2,563.3

* Actual rate

** Employer share equal to lesser of 80 percent of rate or 14.87 percent

*** Based on annual payroll increases for K-12, intermediate school districts, libraries, and community colleges of three and a half percent.

Source: Citizens Research Council of Michigan

Per Pupil Funding Equity. This proposal would further reduce the per pupil funding disparities across districts by narrowing the gap between state-guaranteed low and high spending districts by FY12.

Increases Provided Regardless of State Fiscal Health. The funding guarantees are provided regardless of the condition of the state budget. Various components of education funding would be assured annual increases equal to increases in the CPI, whether or not the revenue is available. The proposal does not tie the future funding increases to any measure of the fiscal health of the State; instead it

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links these increases to changes in inflation. Furthermore, there is no close relationship between what the CPI measures and the goods and services purchased by the public sector. While the proposal provides a level of guaranteed spending for education irrespective of the State's fiscal condition, it does not isolate these programs from the constitutional responsibility of the Governor to maintain a balanced budget.

Earmarking. At its most basic level, Proposal 2006-05 would guarantee a specified level of spending for select programs in the state budget. GF/GP revenue represents the

pool of resources with which the legislature has the most flexibility and discretion with when making annual appropriation decisions. The proposal would increase the amount of GF/GP appropriations in FY07 dedicated to education spending from \$1,949.7 million (21.1 percent) to \$2,514.8 million (27.2 percent). As a result, policymakers' flexibility to craft annual spending plans is reduced, as fewer GF/GP resources are available for other programs. The required earmarking in years after FY07 prevents the legislature from providing funding increases in excess of the change in inflation, even if revenue growth surpasses changes in the CPI.

Fiscal Relationship Between Schools and State. Prior to Proposal A, local schools' and intermediate school districts' contributions to MPSEERS were capped at 5 percentage points of the total contribution rate and the State of Michigan was responsible for the remainder of the annual contribution. Under this arrangement, the State was responsible for the marginal costs associated with any year-to-year increase in the contribution rate. After implementation of school finance reform in 1994, full responsibility for the employer contribution to MPSEERS was shifted to local schools and intermediate school districts.

Proposal 2006-05 would change the relationship between the State and the employers participating in MPSEERS, and result in a new, additional cost to the state budget. By capping the employer contribution, the State of Michigan will be responsible for directly funding benefits of MPSEERS members. This represents

a return to the pre-Proposal A relationship between local schools and the State with respect to MPSEERS funding. The State has little control over negotiations between MPSEERS employers and their employees that will ultimately affect the pension benefit and its costs. The State of Michigan will be responsible for the marginal costs associated with yearly increases in the contribution rate. By FY20, the State of Michigan would be responsible for over one-half of the total required contribution to the system.

University Retirement Funding Guarantee. Implementing a portion of the retirement provision, as written, may be difficult given how universities fund MPSEERS retiree health care costs. The proposal caps the employer retirement contribution, which is reported as a percent of payroll. Because each university pays for its retirees' health care benefits directly, it is unclear how the proposal's cap would be applied. Further, the proposal would provide

a new source of state funding to the seven public universities currently participating in MPSEERS that would not be provided to Michigan's other eight public universities. This new funding could be used to replace other university resources, currently dedicated to MPSEERS contributions.

Legislative Oversight. The State budget process is the arena in which policymakers determine priorities by allocating finite financial resources among competing claims. During this process, lawmakers are able to review and evaluate programs and adjust annual spending plans accordingly. Proposal 2006-05 would reduce the effect of legislative oversight by removing a significant portion of the budget from the appropriations process. Lawmakers will lose the ability to make certain resource allocation decisions in response to their oversight findings, as the funding guarantees effectively make these decisions for them.

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