



MAKING SENSE OF K-12 FUNDING

The current political debate seems fixated, at times, on the issue of state funding for public K-12 schools. Specifically, claims and counterclaims have been leveled about whether state funding has increased or decreased in recent years. Although disputes over public education finances are nothing new, recent changes in the way the state allocates funds to local school districts has created confusion and has fueled the present debate. These changes have made it more difficult to provide straightforward, simple answers to questions about school funding. Today,

accurate and comprehensive responses to questions about school funding require additional explanation, much more than may have been required in the past.

This Memorandum answers three fundamental questions surrounding the issue of school funding. 1) Is school funding up or down compared to four years ago? 2) Over this period, has funding gone up as much as it could have? 3) Are individual school districts better off today than they were four years ago?

Is Funding Up or Down?

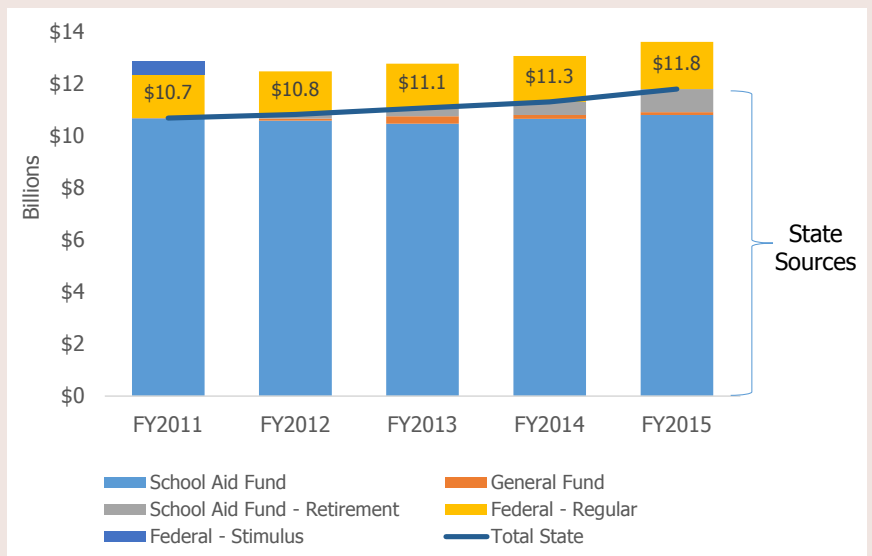
The answer to this basic question is an unequivocal "up" when just the raw numbers are considered. However, providing this simple answer requires additional explanation to understand the larger fiscal picture facing schools, including where the additional funding is being directed and how the money is being used.

State education appropriations are financed almost exclusively by the School Aid Fund (SAF) with the General Fund responsible for a couple line items.

Chart 1 shows the most recent five-year total appropriations history, by major fund source, for

Public schools receive operating funding from federal, state, and local sources; however, it is state lawmakers, not local school boards, that have sole control over funding decisions involving state funds – including the amount of funding available for public education and the per-pupil dollar amounts allocated to each school district. State dollars have financed the majority of local school district budgets since the adoption of Proposal A in the mid-1990s when state taxes replaced local property taxes as the primary revenue source for public schools. Most of a district's general operations are financed from a combination general state aid (e.g., foundation allowance) and categorical grants (e.g., at-risk student funds) allocated through the state budget.

Chart 1
Total K-12 Education Funding by Major Source: FY2011 to FY2015



Source: Senate Fiscal Agency and House Fiscal Agency reports

K-12 education (excludes adult education and early childhood funding).

Total appropriations increased from \$12.9 billion in FY2011 to \$13.6 billion for the current fiscal year (FY2015), with annual increases in every year since FY2012. The decline from FY2011 to FY2012 was the result of the phase-out of temporary federal education dollars (i.e., stimulus funding); in FY2011, Michigan received about \$500 million from federal sources to maintain state spending. With the end of the federal stimulus dollars, state lawmakers chose to reduce appropriations rather than replace the funds with state dollars.

In terms of K-12 resources that lawmakers control directly, state-source appropriations rose from \$10.7 billion to \$11.8 billion over the five-year period, a total increase of \$1.1 billion or about 2.5 percent per year. Much of the increase, beginning in FY2012, was used for SAF-financed appropriations specifically to address public schools' legacy costs associated with the state-administered Michigan Public School Employees Retirement System (MPSERS). School districts' unfunded retirement liabilities are up significantly because of the financial market downturn in 2008 and the decision by state lawmakers to begin prefunding retiree health care benefits. Even with the increase in funding, the total unfunded accrued liability increased from \$12 billion in 2009 to \$25 billion in 2013.

To address these growing liabilities and provide districts with more predictability in financial planning, the state enacted reforms to the retirement system in 2012 to cap the schools' contributions for unfunded retirement liabilities to 20.96 percent of payroll. Under the law, required retirement payments above the cap are satisfied by the state from a separate School Aid Fund appropriation (\$675 million in FY2015). In addition to this direct state funding, an additional \$100 million appropriation is allocated to help individual districts meet their annual retirement contributions. Combined, total MPSERS-specific funding increased more than five-fold from \$155 million in FY2012 to \$883 million in FY2015.

While it is the case that state-sourced funding to K-12 education increased in recent years, this growth has funded appropriations intended to address schools' retirement obligations, specifically the unfunded liabilities resulting from past years' underfunding. These retirement payments are mandatory and have to be satisfied one way or another, either through direct state appropriations or via the state aid provided to individual school districts through their foundation allowances. While districts continue to finance the majority of their unfunded retirement liabilities from a portion of the foundation allowance they receive, under the current arrangement, the state budget is providing specific funding to help finance a share of these liabilities. In both cases, retirement contributions are funded with SAF dollars.

Is Funding Up As Much As It Could Have Been?

Public education funding trends are directly influenced by other state policy decisions, including tax policy changes affecting the School Aid Fund revenues and budget decisions regarding the allocation of the School Aid Fund. Recent major tax and budget policy decisions have stretched the School Aid Fund and cannot be ignored in the current debate surrounding education funding.

Michigan made significant changes to its overall tax structure with legislation enacted in 2011. An over-

haul of the individual income tax and business taxes took effect in 2012 and was fully phased in over two fiscal years. Key provisions of the reforms included eliminating the Michigan Business Tax, imposing a new Corporate Income Tax, expanding the base of the Personal Income Tax, and freezing a scheduled Personal Income Tax rate reduction. The changes in expected revenues that resulted from the tax reforms had to be incorporated in the state spending plan beginning in FY2012.

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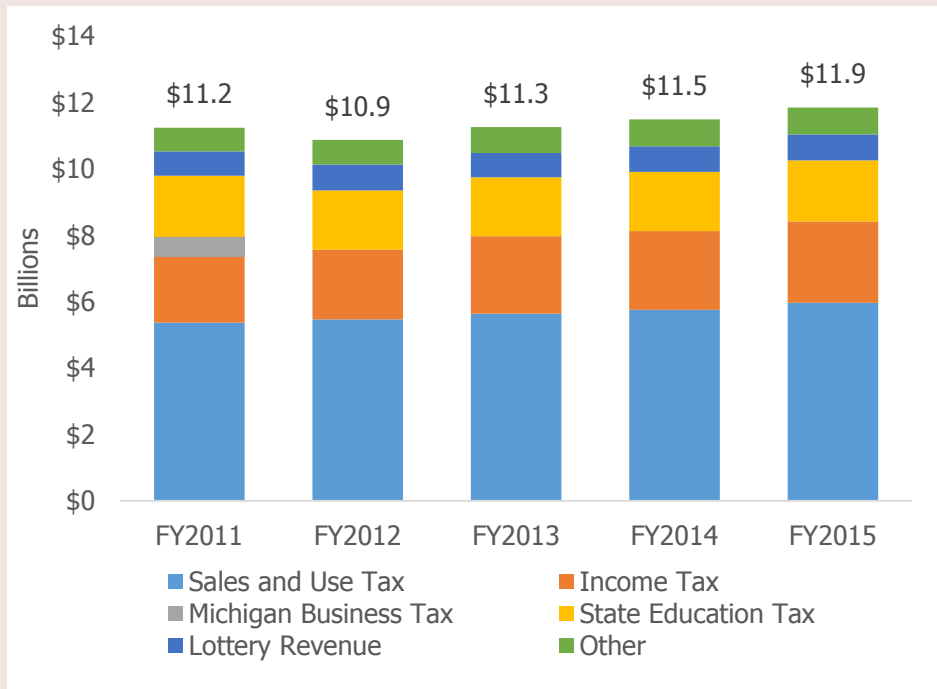
Overall, the School Aid Fund shouldered a significant amount of the net \$1.8 billion business tax cut portion of the tax reform package. The School Aid Fund picked up some additional revenue through the changes made to the Personal Income Tax, but not enough to offset the revenue lost because of the Michigan Business Tax elimination. The Senate Fiscal Agency estimates that the School Aid Fund will experience a net revenue decline of \$688 million from the tax changes and that the General Fund will net an additional \$714 million in FY2015.

Chart 2 highlights the recent revenue history of the School Aid Fund by major source (excludes General Fund deposit).

The loss of the Michigan Business Tax earmark (\$662 million) is clearly visible in the change from FY2011 to FY2012 in total School Aid Fund. Total revenue declined from \$11.2 billion in FY2011 to \$10.9 billion in FY2012. Since that time, total revenue increased to \$11.9 billion in FY2015.

Budgetary decisions to shift more funding responsibilities from the General Fund created additional strain on the School Aid Fund. Most significantly, as part of the FY2012 budget, \$460 million in School Aid Fund resources were used to support the Higher Education and Community Colleges budgets, offsetting an equal amount of General Fund appropriation reductions. Prior to this change, the School Aid Fund resources were reserved almost exclusively to finance K-12 education.¹ This fiscal policy change helped lawmakers balance the FY2012 General Fund budget. Since that time, the School Aid Fund has been responsible for financing about \$400 million of combined university/college state appropriations each fiscal year.² This has had the effect of reducing

Chart 2
Total School Aid Fund Revenue by Major Source: FY2011 to FY2015



Source: Senate Fiscal Agency reports

the amount of resources available for K-12 education each year.

The recent increase in state support for early childhood programming was another important policy decision affecting K-12 education funding. The Great Start Readiness Program provides preschool services to needy four year olds. State lawmakers expanded the program in the last two years by more than doubling its School Aid Fund allocation from \$120 million in FY2013 to \$250 million in FY2015. The annual \$65 million bumps in funding each of the last

¹ In FY2010, the School Aid Fund financed \$208 million of state appropriations to Michigan community colleges in an effort to address a projected General Fund budget deficit. At the time, this appropriation was viewed as one-time in nature.

² The constitutional language establishing the School Aid Fund allows the fund to be used to provide aid to higher education institutions. Specifically, Article IX, Section 11 of the 1963 Constitution states that the fund "shall be used exclusively for aid to school districts, *higher education*, and school employees' retirement systems, as provided by law (emphasis added)."

two years meant that fewer resources were available for K-12 education.

At the same time that the School Aid Fund’s responsibilities have expanded, state General Fund support

for K-12 education has dwindled. In FY2015, the state General Fund budget allocates \$115 million for K-12 education, down from \$282 million in FY2013.

Are Individual Districts Better Off?

It is a little more difficult to provide a definitive answer to this question because the factors influencing a school district’s total funding vary across districts. Total operational funding is primarily a function of a district’s per-pupil foundation allowance and the number of students it enrolls. At the individual district level, each of these components is influenced differently by state policy decisions as well as circumstances unique to a district.

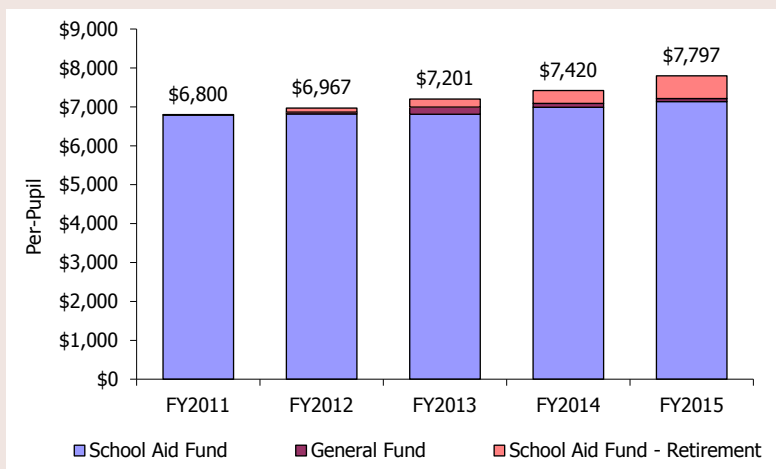
Chart 3 examines recent changes in total state-sourced K-12 appropriations on a per-pupil basis, again excluding allocations for adult education and preschool. The story here is clear and consistent with that of **Chart 1**; funding increases each year.

Total per-pupil funding (both general and categorical aid) rose nearly \$1,000 per pupil, from \$6,800 in FY2011 to \$7,797 in FY2015. While the amount of total state per-pupil funding has grown, much of

the increase is earmarked for specific purposes (e.g., retirement obligations) as opposed to unrestricted state aid. Similarly, state lawmakers have used some of the additional state funds to incent school districts to adopt certain practices or engage in specific behaviors as a condition of receiving state aid (e.g., adopt best practices, improve student performance). Previously, these funds would have been provided to schools through the foundation allowance without any strings attached.

Historically, the foundation allowance has been used as the measuring stick when discussing per-pupil funding in Michigan because it is the largest funding source supporting each district’s general fund budget. Also, since the adoption of Proposal A, the foundation allowance has been used to finance a school district’s share of required retirement costs related to MPSERS.

Chart 3
State-Funded Per-Pupil Appropriations for K-12 Education: FY2011 to FY2015*

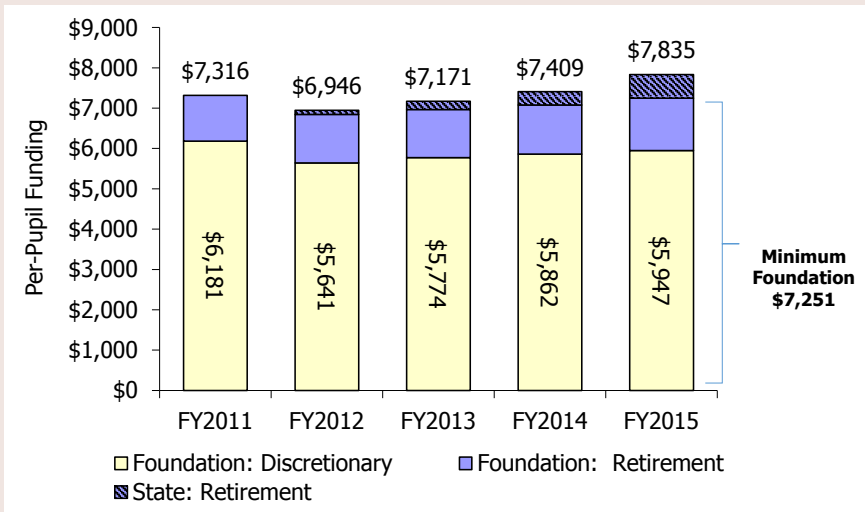


* Excludes early childhood and adult education funding.

Source: Senate Fiscal Agency and House Fiscal Agency reports

Chart 4 shows the effects of total MPSERS retirement costs on the minimum foundation allowance from FY2011 to FY2015. On average, a district receiving the minimum foundation grant in FY2011 (\$7,316 per pupil) was required to use \$1,135 per pupil (16 percent) of the grant to satisfy retirement obligations, effectively leaving \$6,181 per pupil for other general fund expenses (e.g., salaries, other benefits, supplies, utilities, etc.). The growth of these obligations, along with reductions made to the foundation allowance in FY2012, have resulted in fewer resources available to school districts to meet other, non-retirement expenses. In FY2015, the minimum foundation grant is set at \$7,251 per pupil, but approximately \$1,304 per pupil (18 percent) must be used to meet retirement obligations. This leaves \$5,947 per pupil for all other educational spending, about \$234 less compared to FY2011.

Chart 4
Effect of MPSERS Costs on Minimum Foundation: FY2011 to FY2015



Source: Senate Fiscal Agency and House Fiscal Agency Reports; Office of Retirement Services

Fewer students effectively allows the amount of state funds to be stretched and permits per-pupil funding to increase at a faster annual clip (3.5 percent) than total state funding (2.5 percent).

For many districts, declining enrollment has been a permanent fixture of their fiscal planning for a number of years. The causes of declining enrollment are many and each school district is affected differently by each cause. One important, over-arching contributor is statewide enrollment, which has been on a downward trend since the early 2000s and does not show signs of changing course in the immediate future. Also, districts' enrollments are affected by the increased competition for students (and foundation allowance dollars) that has grown with the expansion

of school choice options in their communities, including charter schools and inter-district choice options.

Table 1 shows the enrollment experience among traditional public school districts and charter schools over the most recent five-year period. Generally speaking, traditional public school districts saw enrollment declines, while charter schools experienced

As a result of the MPSERS reforms in 2012 (discussed above), the state now meets a portion of a district's unfunded retirement liabilities. For all intents and purposes, this state funding, absent the reforms, would have been distributed to districts via the foundation allowance and paid from that source. For this reason, the state share of the retirement costs are included in **Chart 4**. It is clear that MPSERS costs, in the aggregate, have grown significantly over the five-year period and that the share of the foundation allowance available for other typical classroom expenses has increased very modestly, but has not kept up with general inflation.

The amount of per-pupil funding a school district receives is only one part of the equation that determines the overall funding available to a district each year. The other key factor is enrollment. Statewide enrollment dropped 3.7 percent from 2011 to 2014.

Table 1
Enrollment Changes in Traditional Public School Districts and Charter Schools, 2009-10 to 2013-14*

Enrollment Change: <u>2009-10 to 2013-14</u>	<u>Traditional Public School Districts</u>		<u>Charter Schools</u>	
	<u>Number</u>	<u>Share of Total</u>	<u>Number</u>	<u>Share of Total</u>
Enrollment Gain	153	28%	126	63%
Enrollment Loss				
Greater than 50%	1	0	5	3
25% to 50%	16	3	13	7
10% to 25%	137	25	27	14
0 to 10%	235	43	28	14

* Enrollment data is total full-time equivalency (FTE) K-12 student count in fall of each year.

Source: Center for Educational Performance and Information

increases. Two-thirds of all traditional public school districts (360 of 543 districts) saw their enrollment decline from 2012-13 to 2013-14. Looking at the five-year period reveals that over 70 percent of all districts saw some amount of enrollment decline and over one-quarter of all districts had declines of 10 percent or more (about 2.6 percent annual decline).

As enrollment declines, school districts are left with fewer resources in total. Managing in an environment of declining resources, at least in the short term, can be difficult, especially when the funding reduction is sizeable. All schools face some fixed (or semi-fixed) costs for building operations (i.e., lighting, heating), employing teachers, and staffing various non-instructional positions. When students leave a district, many of these costs remain with the district. The reality is that the relationship between enrollment and district costs is not completely linear, at least in the near term.

Over time, districts are able to “right size” their budget to accommodate a significantly smaller student body, for instance, by closing buildings or reducing staff. But, in the short run, declining enrollment can increase fiscal stress associated with meeting the “sticky” fixed/semi-fixed costs. The bottom line is that declining enrollment will continue to be a challenge requiring affected districts to think long term to effectively manage their resources without incurring undue fiscal stress.

Despite the challenges associated with managing down, there is evidence, both statewide and at the individual district level, that schools are making changes in their operations to meet financial realities.

Table 2
Enrollment Changes and Staffing Changes in Traditional Public School Districts, 2009-10 to 2013-14*

	<u>Enrollment</u>		<u>Teachers</u>		<u>Total Staff</u>		<u>Memo: Student/Teacher Ratio</u>
	<u>Students</u>	<u>Annual Change</u>	<u>FTE</u>	<u>Annual Change</u>	<u>FTE</u>	<u>Annual Change</u>	
2009-10	1,487,297		79,956		176,277		18.6
2010-11	1,457,160	(2.0%)	75,951	(5.0%)	166,766	(5.4%)	19.2
2011-12	1,432,200	(1.7%)	74,323	(2.1%)	159,342	(4.5%)	19.3
2012-13	1,405,599	(1.9%)	72,921	(1.9%)	157,484	(1.2%)	19.3
2013-14	1,374,800	(2.2%)	72,014	(1.2%)	154,293	(2.0%)	19.1
Change:							
2009-10 to 2013-14	(112,497)	(7.6%)	(7,942)	(9.9%)	(21,984)	(12.5%)	

* Staffing data is total full-time equivalency (FTE) positions.

Source: Center for Educational Performance and Information

The general effect of declining enrollment means less demand for educational personnel, including instructional and non-instructional staff. Declining student enrollment in traditional public school districts was matched by a corresponding contraction in the school workforce from 2009-10 to 2013-14 (see **Table 2**).

A common metric used to analyze staffing levels in the public school setting over time is student/teacher ratio. This ratio describes the average number of students per teacher at a given point in time for a specific educational setting (e.g., state, district, school). In general, an increasing ratio indicates that the average class size is growing, while a decreasing number suggests class size is declining. From a statewide perspective, the average student/teacher

Table 3
Student/Teacher Ratios in Traditional Public School Districts, 2009-10 to 2013-14

<u>Change in Student/Teacher Ratio</u>	<u>Number of Districts</u>	<u>Share of Total</u>
Ratio <i>increase</i> of:		
0 to 2	275	50.8%
2 to 5	84	15.5
Greater than 5	9	1.7
Ratio <i>decrease</i> of:		
0 to -2	145	26.8
-2 to -5	24	4.4
Less than -5	4	0.7

Source: Center for Educational Performance and Information

ratio increased from 18.6 students in 2009-10 to 19.1 students in 2013-14. A total of 368 districts, more than two-thirds of all districts, saw their student/teacher ratio increase between 2009-10 and 2013-14 (see **Table 3**). The student/teacher ratio increases

suggest that districts reduced the number of classroom teachers employed in greater proportions than the declines in student enrollment during the five-year period. More than one-half of all districts had a ratio increase of less than 2.0 students.

Final Assessment

Making sense of school funding is never an easy task. Because of changes made to the way state funding is shared with public schools in recent years, the task has been made slightly more difficult. Also, because school funding has taken a front-row seat in the current political debate, there has been a flurry of claims and counter-claims about changes in state funding for K-12 education. As a result, citizens are left scratching their heads about what to believe. To help clear up some of the confusion surrounding this important public policy issue, the Citizens Research Council of Michigan set out to answer three fundamental questions.

As to the first question, "Is school funding up or down compared to four years ago?" the answer is an unequivocal "up". While total state funding is up over \$1 billion from FY2011 to FY2015, the increase is almost exclusively earmarked to satisfy school employee retirement costs, specifically legacy costs arising from the financial market downturn and state retirement system reforms.

With respect to the second question, "Has education funding gone up as much as it could have?"

the answer is "no". State tax policy and budget decisions effectively stretched the School Aid Fund, leaving fewer dollars available for distribution to K-12 schools. The personal income tax and business tax reforms of 2012 substantially reduced the amount of state tax revenue deposited in the School Aid Fund. Also, policymakers decided to fund certain state higher education appropriations from the School Aid Fund. Combined, these decisions have effectively reduced the amount of state resources schools receive.

Finally, the answer to the third question, "Are individual school districts better off today than they were four years ago?" is less definitive. While the amount of per-pupil funding is up, districts are paying higher retirement bills. This leaves fewer resources for other school expenses. Also, total funding at the district level is greatly influenced by the number of students enrolled. Because declining enrollment is a pervasive issue across the state, the vast majority of traditional public school districts must manage the fiscal effects of having less non-retirement funding to operate.

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