State Budget Notes

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Funding for Public Education: The Recent Impact of Increased MPSERS Contributions

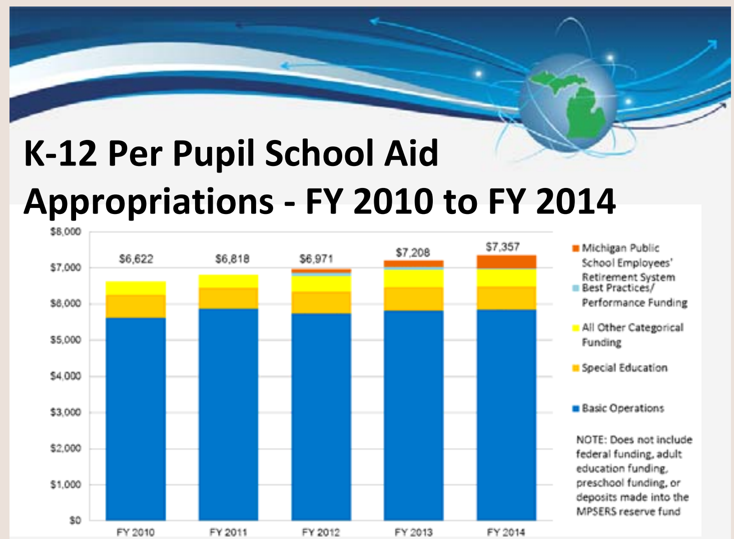
Debates over adequate funding for public education are nothing new. Advocates for increased K-12 funding have insisted that more dollars are needed in the classroom to ensure a quality education for students. Others have disagreed, arguing that K-12 funding in Michigan has generally been at or above national norms. More recently, however, debate has moved beyond the typical question of 'How much is needed?' to the question of 'How much was received?' This latter question is normally well-defined, but recent developments have added confusion to the issue and resulted in arguments as to whether K-12 funding has been increased or cut in recent years.

When the Governor's budget recommendation was released in February, it contained a 2.2 percent overall increase in FY2014 appropriations for K-12 schools within the School Aid budget. During his budget presentation to the joint House and Senate Appropriations Committee, Governor Snyder touted recent increases in per-pupil state appropriations for K-12 schools. A presentation slide (see **Figure 1**) showed per-pupil appropriations from state sources increasing from $6,622 in FY2010 to $7,357 in his proposed FY2014 budget, which reflects an average annual growth of 2.7 percent over that time period.[1] These funds included appropriations that support the state foundation allowance paid to districts, special categorical grants and performance-based funding, special education funds to school districts, as well as new funding initiated in FY2012 to assist districts with meeting ever-growing costs related to the Michigan Public School Employees Retirement System (MPSERS).

However, approximately a week later, the organization Michigan Parents for Schools presented testimony to the House Appropriations Subcommittee on School Aid suggesting that state appropriated per-pupil funding for K-12 education, when adjusted for inflation, had actually declined by almost nine percent since FY2002.[2] In terms of FY2014, the analysis suggested districts could expect declines of between $2 and $32 per pupil under the Governor's proposal. Is there a way to synthesize these two seemingly conflicting assertions?

This budget note examines recent trends in funding for K-12 education in order to shed light on this policy question. It takes a broad-based look at total revenues available to K-12 schools from state, local, and federal sources. In particular, the analysis examines two important factors that have affected recent K-12 revenues and costs: 1) the role

Figure 1
School Aid Appropriations Slide



Source: Governor Rick Snyder, Lt. Governor Brian Calley, and Budget Director John Nixon, Moving Michigan Forward: Continuing Our Comeback, February 7, 2013

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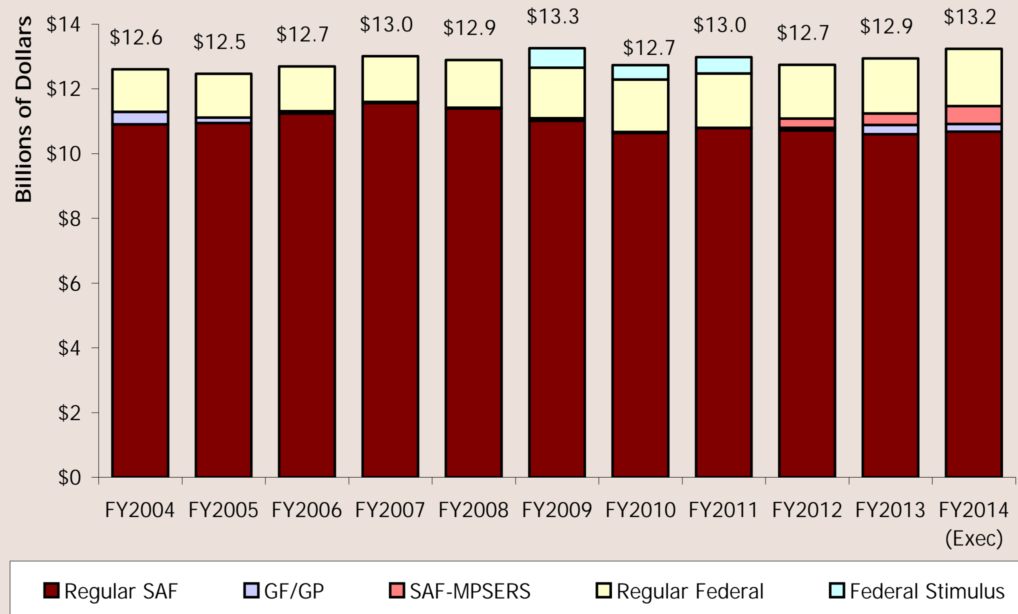
of federal stimulus funding in stabilizing K-12 revenues during the period starting in FY2009 through FY2011; and 2) the growing portion of K-12 revenues that have been needed to meet a trend of escalating MPSERS retirement costs that began around FY2004.

A 2004 report from the Citizens Research Council first explored the potential for large unfunded liabilities related to MPSERS and concluded that growth in these costs could crowd out spending elsewhere in school budgets.[3] MPSERS costs have indeed escalated in recent years, and the state has responded with new appropriations to assist in meeting these costs, as well as with legislative reforms aimed at mitigating their growth. This report further examines this cost factor and analyzes how total revenues available for basic education operations have changed since FY2004 after controlling for both MPSERS cost growth and general inflation.

Summary of Recent School Aid Appropriations

As background for the discussion, **Chart 1** shows final School Aid appropriations from FY2004 through FY2013, as well as the Governor's recommendation for FY2014. Total gross appropriations for K-12 education in Michigan have increased at an average annual rate of 0.3 percent over the ten-year period ending with current FY2013. In fact, the FY2013 year-to-date gross appropriation of $12.94 billion is just 2.6 percent higher than the final FY2004 appropriation of $12.61 billion. While overall appropriations were relatively stable during this period, the proportion financed with state versus federal revenue changed markedly due to the addition, and then the eventual phase-out, of federal stimulus funding (See the light green regions in **Chart 1**). In addition, a very significant component of recent additions to state-financed appropriations has included funding to specifically address growing retirement liability costs within the MPSERS system (See the orange regions in **Chart 1**).

Chart 1
Appropriations for K-12 Education, FY2004-FY2012



Source: Senate Fiscal Agency and House Fiscal Agency reports

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Impact of Federal Stimulus

The severe economic downturn beginning in 2008 led to the enactment of the federal American Recovery and Reinvestment Act (ARRA) – an economic stimulus package aimed at boosting government spending in an effort to offset weakness in the private sector's economic activity.

As part of the package, states received allocations to a State Fiscal Stabilization Fund (SFSF), which could be used to directly offset state funding in the wake of significant declines in state revenues that came with the depressed economic conditions. Michigan appropriated $600 million in SFSF revenue to offset state revenue used to make foundation grant payments to local school districts in FY2009 – a fund shift from state to federal sources equivalent to around $370 per pupil. The foundation allowance for K-12 schools was also increased in FY2009, with the minimum allowance rising from $7,204 to $7,316 (an increase of $112 per pupil) and the maximum allowance rising from $8,433 to $8,489 (an increase of $56 per pupil).

The ARRA fund shift was phased out over the next two fiscal years. In FY2010, $450 million in SFSF revenue was appropriated as an offset to state revenue (equivalent to around $282 per pupil). In addition, a $154 per-pupil reduction was implemented for FY2010 in order to address both revenue declines within the School Aid Fund that came with the economic downturn and the reduction in appropriated ARRA revenue per pupil. In FY2011, the final $184.3 million in SFSF revenue was appropriated ($117 per pupil), and the per-pupil reduction was increased slightly to $170 per pupil. FY2011 appropriations, however, were further supplemented with $316 million in additional stimulus funding arising from the federal Education Jobs Fund Act. This funding was meant to supplement, rather than supplant, existing state and local funding; thus state revenues were not offset by this newest inflow of federal stimulus dollars.

This federal stimulus support ended in FY2012, leaving the state with a choice to replace federal stimulus funds with state support or to implement reductions to make up for the loss. Michigan chose to make significant changes to School Aid funding for that fiscal year by not only retaining the $170 existing per-pupil reduction but also by adding a $300 per-pupil cut. The total $470 per pupil reduction was built into the minimum and maximum foundation allowances for FY2012. The savings from this action allowed for the utilization of $398.1 million in School Aid Fund revenue to support the Higher Education and Community Colleges budgets in order to offset state general fund/general purpose revenue needs. The action helped balance the state's GF/GP budget for that fiscal year, and the SAF allocation for higher education and community colleges remains in place in FY2013 and in the Governor's FY2014 recommendation.

State Revenue Dedicated to MPSERS Costs

Another driver of the recent growth in state-funded appropriations to public schools has been an increase in allocations for the purpose of covering MPSERS employer contributions. **Table 1**

Table 1
Appropriations to Address MSPERS Retirement Costs, FY2012-FY2014
(Dollars in Millions)

	FY2012	FY2013	FY2014 Executive Budget
Appropriations to Cover Direct MPSERS Costs			
MPSERS Cost Offset Funding to Districts (Sec. 147a)	$155.0	$155.0	$155.0
State Funding - Contribution Above Employer Cap (Sec. 147c)		$160.5	$403.3*
Appropriations to Cover Future Reform Costs			
Deposits into MPSERS Reserve Fund (Sec. 147b)	$133.0	$ 41.0	$ 0.0
Total MPSERS-related appropriations	$288.0	$356.5	$558.3

* FY2014 appropriation includes $150.0 million from Reserve Fund balance

reviews these appropriations that began in FY2012.

In recognition of the growing MPSERS cost burden, the FY2012 budget included a $155.0 million MPSERS cost offset. The funding was distributed to local school districts to assist them in meeting their growing employer contributions towards MPSERS. The cost offset funding for districts has been maintained in the FY2013 budget as well as the FY2014 Executive Budget recommendation.

In addition, new appropriations were established to create a MPSERS Reserve Fund to help address the upfront costs of system reforms aimed at mitigating retirement system liabilities in future years. In FY2012, $133.0 million in School Aid revenue was appropriated into the reserve fund. This was followed by another $41.0 million appropriated in FY2013 – bringing the reserve fund's balance to $174.0 million.

Finally, the largest component of the recent MPSERS-related allocations was the direct result of MPSERS reform legislation passed in 2012[4] that capped employer contribution rates for unfunded accrued liabilities at 20.96 percent of payroll. Any costs for these liabilities that exceeded the cap would come directly from the State through an "off-the-top" School Aid Fund appropriation. With the state funding, growth in MPSERS contributions that are above the employer cap would no longer be incurred by school district employers from their own state and local revenue base. To cover the state's share of employer contributions over the capped amount, $160.5 million was added to the FY2013 budget and $403.3 million was included in the Governor's FY2014 budget proposal (with $150.0 million of the FY2014 amount coming from the existing balance in the MPSERS Reserve Fund).

Recent Changes in State Funding for K-12 Schools

Table 2 examines recent changes in K-12 appropriations when both the federal stimulus revenue and recent MPSERS-related funding are taken into account by looking at changes in appropriations from state sources on a per-pupil basis starting in FY2008 – one year before ARRA distributions began. The table shows adjustments to total state-funded appropriations related to both ARRA and MPSERS. Direct ARRA savings are added back to per-pupil revenue since state-funded appropriations would have needed to be higher to provide the same level of support without the additional ARRA stimulus. Funding specifically related to MPSERS costs is subtracted from total per-pupil state funding as the funds are allocated to directly offset increased MPSERS employer contributions and therefore do not reflect new revenue available for general school operations. So essentially, these adjusted revenues serve as a proxy for state-funded appropriations that would have been necessary to provide the same level of overall support in the absence of the ARRA stimulus and the added costs related to MPSERS.

Total School Aid appropriations from state sources were equal to about $6,912 per pupil in FY2008, but then fell to a low of $6,690 per pupil in FY2010 – partly in response to both the availability of federal ARRA stimulus dollars and other budget reductions. Under the Governor's FY2014 proposal, state funding per pupil would grow to $7,487 in FY2014, increasing at an average annual rate of 2.9 percent from FY2010

Table 2
State-Funded Per-Pupil Appropriations for K-12 Schools, FY2008-FY2014

	Base FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014 Executive Budget
Total Per-Pupil Revenue	$6,912	$6,852	$6,690	$6,884	$7,144	$7,313	$7,487
ARRA offset savings		$370	$282	$117			
MPSERS-related funding					($186)	($232)	($364)
Adjusted Per-Pupil Revenue	$6,912	$7,222	$6,972	$7,001	$6,958	$7,081	$7,123

– very comparable to the 2.7 percent figure cited in the Governor's budget presentation, which excluded state funding for adult education, preschool, and the original MPSERS reserve fund appropriations.

However, the trajectory changes when these state revenues are adjusted for the ARRA savings and the more recent increases provided to help offset MPSERS employer contributions. The adjusted revenues increase at a more modest rate of 0.5 percent over the same FY2010 to FY2014 time period, again assuming the Governor's proposal is implemented. As a result, state funding to public education has indeed increased since its low point in FY2010, but that growth is largely driven by new revenues needed to replace federal ARRA funding and to meet increasing MPSERS liabilities.

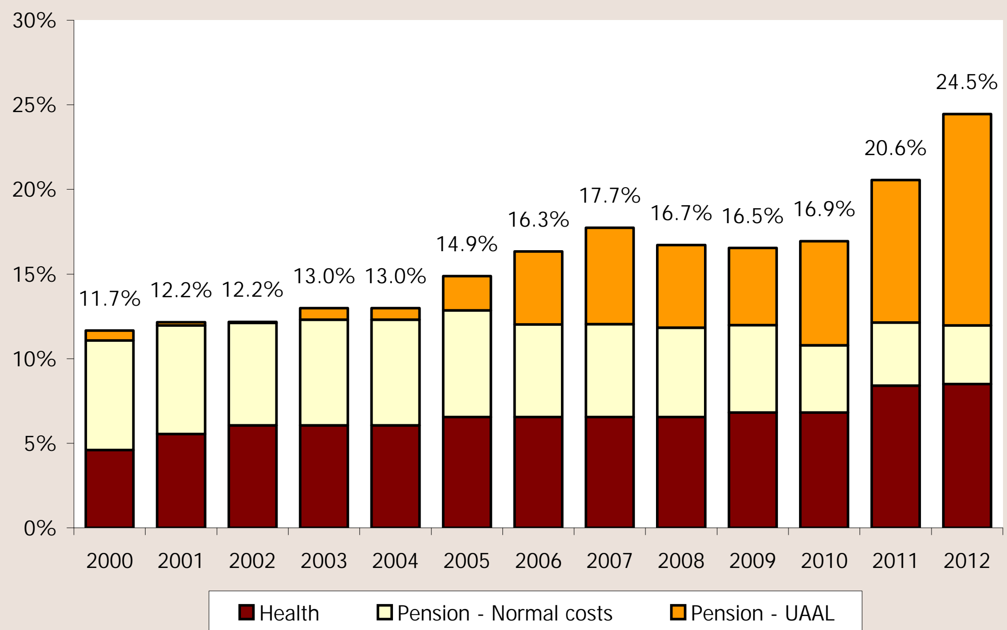
The Impact of Escalating MPSERS Retirement Costs

The Michigan Public School Employee Retirement System provides retirement benefits for covered employees of Michigan public school districts (both local K-12 districts and intermediate school districts) and community colleges, as well as certain public school academies, state universities, and public libraries.[5] MPSERS benefits include both a financial pension benefit (including disability and survivor benefits), as well as subsidized health, dental, and vision insurance benefits at the option of eligible retirees.[6] The cost of providing these benefits is shared by employers and employees that participate in the system.

Employer contributions to meet estimated retirement costs are determined by the Michigan Office of Retirement Services on the basis of an annual actuarial valuation of the retirement system's assets and accrued liabilities. The estimated cost is then charged to employers as a percentage of payroll for employees covered under the system. Historical employer contribution rates for school districts are outlined in **Chart 2**.[7] MPSERS participation is mandatory for all traditional public school districts, making the established contribution rates are applicable to all districts. On the other hand, public school academies (PSAs) have the option to participate in the MPSERS system. Michigan Department of Education data indicate 256 PSA districts existed as of May 2012.[8] The 2012 MPSERS Comprehensive Annual Financial Report lists 59 participating PSA employers. Thus, the MPSERS contribution rates apply to less than one-quarter of PSA districts.

Chart 2 displays the total contribution rate for districts and also classifies the rate into three components that illustrate the underlying costs being covered by the contributions. The rate covers three major cost categories for

Chart 2
MPSERS School District Contribution Rates, 2000-2012



Source: Michigan Office of Retirement Services

school districts: 1) pension normal costs; 2) retiree health care; and 3) unfunded actuarially accrued liabilities.

Pension normal costs: The normal cost of an individual's future pension benefits is essentially the present value of those benefits spread over the estimated working life of the individual. In other words, based on the underlying assumptions (e.g. investment returns on contributions, number of years worked, future salary growth, and age at death) used in the actuarial model, it is the amount that needs to be set aside (from both the employer and employee) today to ensure that sufficient funds are available to pay the earned pension benefits when the individual retires.

As shown in **Chart 2**, the employer contribution for normal costs has actually fallen in recent years. It hovered between 6.0 and 6.5 percent during the period between FY2000 and FY2005, but it fell to 3.74 percent in FY2011 and to 3.47 percent in FY2012. Much of the drop is related to legislative changes to the MPSERS system that have increased employee contribution rates and thus reduced the need for employer contributions. It should be noted, however, that the recent early retirement incentive provided to school employees will add to these costs in future years. Current FY2013 rates include a new 1.36 percent surcharge to cover the added pension system costs related to the incentives.

Retiree Health Care Benefits: In addition to the pension benefit, MPSERS retirees hired into the system before September 4, 2012, are eligible for a premium subsidy on health insurance (medical, dental, and vision) upon retirement. Until recently, these costs were covered on a pay-as-you-go basis, with employer contributions set to cover the current costs of health insurance for retirees in the same year. Contribution rate increases from FY2000 through FY2010 largely reflect increased numbers of retirees with insurance. Retirement incentives offered as part of 2010 MPSERS reform legislation have contributed to more recent overall increases in retiree health care costs.

That same 2010 legislation, however, required that covered employees begin to make three percent contributions toward retiree health care benefits beginning in July 2010.[9] The three percent contribution, however, is the subject of ongoing litigation with the state Court of Appeals ruling in August 2012 that the required contribution was unconstitutional. The case is pending before the state Supreme Court and funding collected through the contribution is currently being held in escrow.[10] As a result, a three percent surcharge was added to employer contribution rates for FY 2011 and FY2012 to make up for the employee contribution. Without the surcharge, employer contributions for health care would have been 5.50 percent.

Note that employer contributions for normal pension costs and retiree health costs combined have stayed remarkably stable over the period, with the increases for health coverage roughly offsetting the reductions in normal costs that came with increased employee contributions. Combined the normal cost and health contribution rates in FY2004 were 12.31 percent, while the combined rates in FY2012 were 11.97 percent, which includes the three percent surcharge related to the pending litigation on the three percent employee contribution.

Pension unfunded actuarially accrued liabilities: The amounts collected to cover the normal costs of an individual's pension benefit will be sufficient to cover that person's pension benefit, but only if other assumptions made under the actuarial model are also met. When those assumptions are not met, unfunded actuarially accrued liabilities (UAAL) result for the system. Since employee contributions are fixed in statute, these unfunded liabilities must be covered through additional employer contributions.

Unfunded liabilities can accrue for various reasons. Typically, the primary driver is lower-than-anticipated investment returns. Until recently, the MPSERS actuarial model assumed an eight percent return on all pension fund assets.[11] In years where actual returns fall short of expectations, the system's UAAL increase because fund assets now cover a smaller portion of accrued pension benefit liabilities than previously assumed. Increases in UAAL can also be triggered by factors related to pension liabili-

ties. For instance, if individuals live longer than expected during their retirement years or have salary increases greater than expected under the actuarial model, the UAAL level will also climb.

Chart 2 shows that virtually all of the growth in MPSERS employer contributions between FY2004 and FY2012 is attributable to charges to cover growth in UAAL. To determine the underlying cause of the increased contributions to cover the increased UAAL, one must look at the specific ways in which actuarial assumptions were not met and how those departures from assumptions affected UAAL growth to the system. This information is reported annually within an analysis of the system's experience gain or loss. By statute, this analysis is included in each annual actuarial valuation of the system. The primary factors that have led to changes in the system's UAAL (and thus to the contribution rates needed to cover those unfunded liabilities) can be determined by examining the annual analyses and then looking at the cumulative experience gain/loss of the system over a defined period. To illustrate, **Table 3** outlines the experience gain/loss analysis for MPSERS plan year 2011.

The UAAL carried in from the 2010 plan year valuation was just over $17.6 billion. Even if all actuarial assumptions were met, the UAAL would be expected to increase to $18.4 billion by the end of plan year 2011. That increase would be caused by interest losses on the UAAL charged at the eight percent discount rate. Since plan assets are not available to cover these liabilities, the plan loses interest earnings that would otherwise have been accrued if the liabilities were fully funded. At the same time, employer contributions applied to the UAAL and interest earnings on all new contributions (both employee and employer contributions) help to offset some of this loss.

For 2011, the expected UAAL at the end of the year was $18.4 billion. That expected UAAL is then compared to the actuarially calculated UAAL under the new valuation. For 2011, the plan experienced an unanticipated loss of nearly $4.0 billion. This is the amount that will need to be added to the prior year UAAL amortization and will result in increased employer contribution rates. The experience analysis then looks at the specific factors that led to the loss. Again for 2011, the predominant factor was investment income failing to meet the assumed eight percent rate of return. Investment gains or losses are smoothed over a five-year period to help prevent dramatic year-to-year changes in employer contribution. After factoring in the five-year investment experience (which included significant market losses from 2008 and 2009), the resulting actuarial value of MPSERS assets declined by just over $3.1 billion. The remaining experience loss resulted from deviations from actuarial assumptions on the liability side of MPSERS, with the largest factors being longer life spans after retirement ($707 million) and greater pay increases than assumed by the model ($255 million).

As noted, this experience is part of each annual actuarial valuation

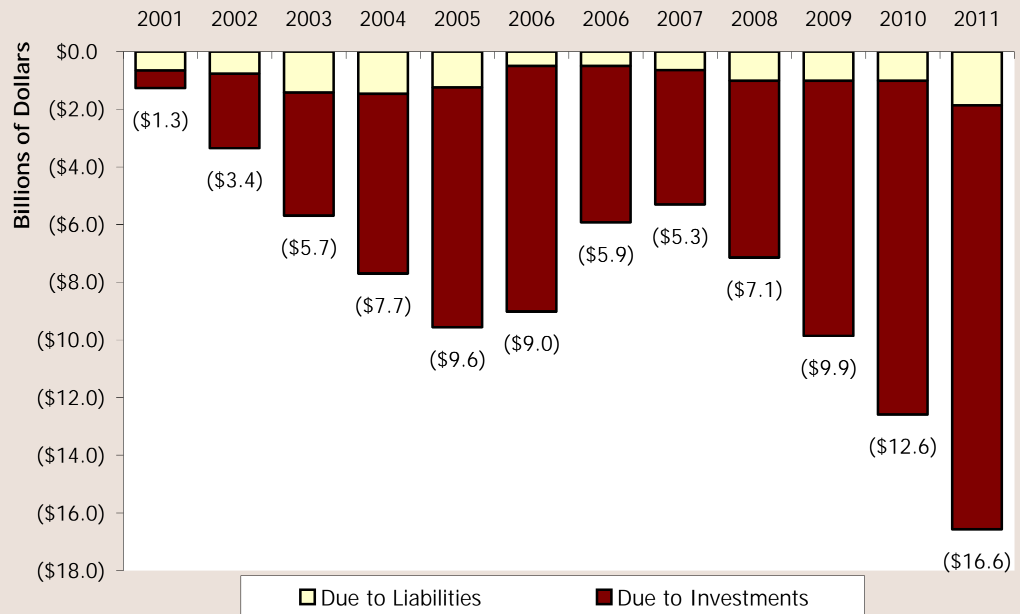
Table 3
MPSERS 2011 Experience Loss

Item	Amount
UAAL - previous valuation	$17,633,360,664
a. Interest on UAAL (8%)	$1,410,668,853
b. Contributions toward UAAL	($611,111,939)
c. Interest on all contributions (4%)	($24,570,043)
UAAL - expected	$18,408,347,535
UAAL - actual	$22,388,860,544
Experience loss	**($3,980,513,009)**
Factors Behind Loss:	
Investment income below assumptions	($3,129,071,573)
Longer life spans after retirement	($707,397,766)
Greater pay increases than assumed	($255,369,513)
New entrants and rehire into system	($74,608,220)
Other factors	$185,934,063

Source: 2011 MPSERS Annual Actuarial Valuation report.

report. To determine the underlying factors behind the increased MPSERS employer contribution related to the UAAL over the long term, **Chart 3** examines the cumulative MPSERS experience loss since 2000. Since the 2003 valuation would have been the last valuation available before development of the FY2005 budgeted employer contribution rate, the experience losses of plan years 2003 and later are the changes most relevant to the contribution rate increases since FY2004.

Chart 3
MPSERS Cumulative Actuarial Experience Gain/(Loss) Since 2000



Source: MPSERS Annual Actuarial Valuation reports

Chart 3 shows that, of the cumulative $16.6 billion actuarial loss experienced by the MPSERS system since FY2001, around $14.7 billion (almost 89 percent) of the loss is attributable to the investment gains that have fallen short of the actuarially-assumed eight percent annual rate of return. The market losses in 2008 and 2009 arising from the financial crisis are the major factors in this loss. Thus, the sharp increase in MPSERS employer costs to cover unfunded actuarial liabilities is largely due to this recent poor market performance.

Total Revenues for K-12 Districts and the Impact of MPSERS Costs

Increased MPSERS employer contributions have had a significant financial impact on public schools, with an increasing proportion of available resources being needed to meet these costs.

Table 4 provides a recent history of total operating revenues for public education. The table breaks out revenue to intermediate school districts, traditional K-12 school districts, and public school academies (PSAs). For traditional districts and PSAs, total revenues include all general fund revenues from federal, state, and local sources. For intermediate school districts, revenues include both general fund and Special Education Fund revenues from these sources, given the significant role of ISDs in providing special education services. In order to avoid duplication, revenue received by a public school from another public school entity is excluded from the figures.[12] It should also be noted that revenue data for FY2012 is preliminary.

These data are used to evaluate the changing per-pupil revenue conditions for public education from FY2004 to FY2012. In the analysis, state revenue is broken out into state unrestricted revenue (e.g. foundation allowance

Table 4
Total Operating Revenue to Public Education by Entity, FY2004-FY2012
(Dollars in Millions)

Year	Intermediate School Districts	Traditional K-12 School Districts	Public School Academies	Total Revenue	Statewide Pupils
FY2004	$1,647.3	$13,368.6	$587.4	$15,603.4	1,714,402
FY2005	$1,788.2	$13,376.1	$661.7	$15,826.0	1,707,780
FY2006	$1,922.9	$13,587.8	$745.2	$16,256.0	1,697,534
FY2007	$2,026.3	$13,869.9	$828.0	$16,724.2	1,681,062
FY2008	$2,121.1	$13,681.8	$863.1	$16,666.1	1,652,555
FY2009	$2,132.8	$13,583.8	$911.8	$16,628.3	1,619,744
FY2010	$2,315.3	$13,210.2	$989.2	$16,514.7	1,595,722
FY2011	$2,269.6	$13,382.2	$1,013.0	$16,664.8	1,569,436
FY2012*	$2,179.3	$12,667.1	$1,039.0	$15,885.3	1,552,100

* Preliminary data

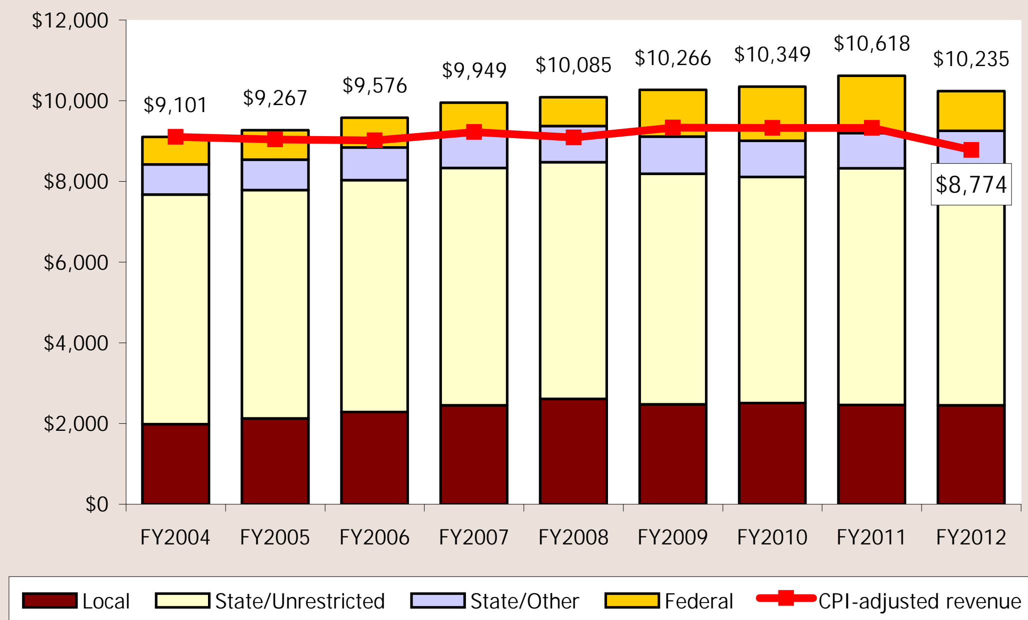
Source: Michigan Department of Education, Financial Information Database

and other unrestricted grants) and other state revenue (e.g. state funding restricted by purpose, including the MPSERS cost offset funding appropriated in FY2012). Federal revenue includes all federal revenue sources, including the federal stimulus revenue from ARRA and the Education Jobs Act discussed earlier. Local revenues are primarily local property tax revenues dedicated to education purposes – the largest component being the locally-financed portion of district foundation grants. Local revenues also include smaller amounts of locally-generated revenue through sources such as sales, donations, and fees.

Overall Per-Pupil Revenue Growth

Chart 4 provides an overview of these revenues on a per-pupil basis by fund source. For the period between FY2004 and FY2008, per-pupil revenue growth averaged 2.0 percent, rising from $9,901 per pupil in FY2004 to $10,085 in FY2008. The growth was driven largely by moderate, but consistent, growth

Chart 4
Total Per-Pupil Revenues for K-12 Education, FY2004-FY2012



from state and local sources. That changed in FY2009. While overall growth continued in FY2009 (1.8 percent over FY2008), it was largely driven by growth in federal revenues that were received as part of federal stimulus efforts under the American Recovery and Reinvestment Act (ARRA) and the later Education Jobs Fund Act. Federal revenue per-pupil increased to $1,152 in FY2009 after averaging about $720 during the previous five years. Federal funding further increased to $1,341 per pupil in FY2010 and to a peak of $1,422 per pupil in FY2011.

At the same time, state and local revenue per pupil reversed course because of the reduction in state funding that accompanied the availability of federal ARRA and the budgeted per-pupil reductions of $154 in FY2010 and $170 in FY2011 for local school districts. State and local revenue per pupil fell from $9,371 in FY2008 to $9,114 in FY2009 and then to $9,009 in FY2010 before growth resumed with the phase-out of the federal ARRA stimulus.

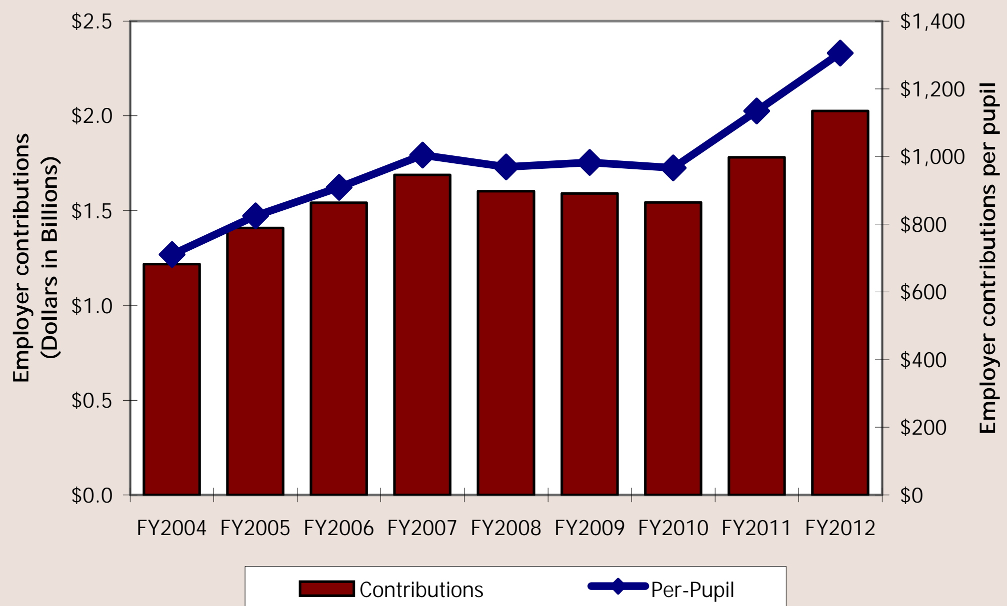
The outlier in **Chart 4** is clearly FY2012, where total revenues per pupil fell sharply by 3.6 percent from the FY2011 peak. While state and local revenues per pupil increased in FY2012, their effect was more than offset by the loss of federal stimulus funding.

The red line in **Chart 4** adjusts these per-pupil revenue figures for changes in inflation, as measured by the Consumer Price Index for Detroit in constant FY2004 dollars. Between FY2004 and FY2011, growth in total per-pupil revenues largely tracked with the inflation rate. Inflation-adjusted revenues per-pupil reached a low in FY2008 of $9,089 (virtually the same as FY2004) before rebounding to a high of $9,335 the following year in FY2009 (a 2.4 percent increase since FY2004). The decline in FY2012, however, has brought inflation-adjusted revenues per pupil to $8,774, a 3.6 percent decline from FY2004.

Per-Pupil Revenue Growth and the Impact of MPSERS Costs

The analysis in **Chart 4**, however, does not take into account the increased role of MPSERS costs to the public school system. From a school district's perspective, the increased contributions into the MPSERS retirement system essentially mean less revenue available for other educational and administrative purposes. The MPSERS cost increases effectively crowd out spending in these other areas. **Chart 5** reviews the upward trend in MPSERS employer contributions on a total dollar and per-pupil basis since FY2004. In FY2004, total employer contributions to MPSERS (from traditional K-12 districts, ISDs, and participating public school academies)

Chart 5
MPSERS Employer Contributions, FY2004-FY2012



Source: Contributions data from Michigan Office of Retirement Services

Recent Reforms to the MPSERS Retirement System

As a result of the growing costs of MPSERS retirement liabilities to public schools and other participating employers, legislation aimed at mitigating some of the upward cost pressure was enacted in 2007, 2010 and again in 2012. These reforms primarily rely on increased employee contributions, reductions in retiree health insurance subsidies, and/or reductions in the level of pension benefits to offset the need for employer contributions to cover estimated liabilities.

Public Acts 110 and 111 of 2007

The legislation made changes to both employee contributions and retiree health care premium subsidies affecting new employees hired on or after July 2008. For these employees, employee contributions toward pension benefits paid on salary above $15,000 was increased from 4.3 percent to 6.4 percent of that marginal income. Further, upon retirement after 10 years of service, MPSERS would cover only 30 percent of their health care premium costs, with an additional four percent subsidy for each additional year of service up to a maximum of 90 percent (which would be earned after 25 years of service). Before the legislation, these employees would have received the full 90 percent subsidy after vesting at 10 years of service. Employees hired before July 2008 were not affected by these provisions.

Public Act 75 of 2010

The enacted legislation made further reforms to the MPSERS retirement benefit and also provided an early retirement incentive for eligible employees. A key feature of the reforms was the creation of a new "Pension Plus" retirement plan, which combined the traditional defined benefit pension with an additional defined contribution benefit. The new plan replaced the traditional 100 percent defined benefit plan for employees hired on or after July 2010. For these employees, the changes included: limited the availability of pension benefits to retirees who are 60 years old with 10 years of service (employees hired before July 2010 can choose to receive benefits at any age with 30 years of service); calculated final average compensation (the basis for the pension benefit) on a five-year (rather than three-year) average; and eliminated annual cost of living adjustments for the pension benefit.

Under the defined contribution component of the plan, employees that contribute up to two percent of their salary to the plan would receive a 50 percent employer match on those contributions. MPSERS employers and their employees are also allowed to negotiate to apply the 50 percent employer match to additional employee contributions up to a total of six percent of salary.

Another significant change was the creation of a new three percent employee contribution towards retiree health care benefits. The employee contribution was expected to offset $3.5 billion in employer contributions over ten years. However, the contribution was challenged in the courts by school employee organizations, and the Court of Appeals ruled in August 2012 that the contribution requirement was unconstitutional. These funds are being held in escrow pending a ruling on the issue by the state Supreme Court.

Public Act 300 of 2012

The most extensive reforms to the MPSERS system were enacted in 2012 with the passage of Senate Bill 1040. This legislation made significant changes to MPSERS affecting active employees as well as both current and future retirees. These changes included:

- **Current Employee Retirement Benefit:** Employees were required to choose to: (a) accept an increase in employee contributions (four percent for traditional plan and a flat seven percent for Pension Plus); (b) accept a reduced pension benefit through a lower benefit multiplier applied to future years of service; or (c) move into a defined contribution plan with a fixed four percent employer contribution rate.

Recent Reforms (continued)

- **New Employee Retirement Benefit:** Employees hired on or after September 4, 2012 would have the option of enrolling in the Pension Plus plan or a defined contribution plan with a 50 percent employer match on employee contributions up to three percent of salary.
- **Health Insurance Subsidy for Current and Future Retirees:** Required that both current retirees and future retirees pay at least 20 percent of their health insurance premium costs, except that current retirees who were at least 65 years old as of January 1, 2013 would maintain their lower 10 percent contribution.
- **Retiree Health for New Employees:** New employees (hired on or after September 4, 2012) will no longer be eligible for subsidized retiree health care coverage and will instead be placed in a Personal Healthcare Fund with employer-matched contributions deposited into a health savings account and a credit at termination into a Health Reimbursement Account.
- **Pre-Funding of Retiree Health Care:** The legislation maintained the three percent employee contribution towards retiree health care established in Public Act 75 of 2010 but guarantees an individual's contributions and applies those contributions towards pre-funding the retiree health care benefit. Employees not wishing to make the 3 percent contribution may instead move to a Personal Healthcare Fund in the same manner as new employees.
- **Capped Employer Contribution Rates:** Finally, the legislation caps MPSERS employer contributions towards unfunded actuarially accrued liabilities at 20.96 percent of covered payroll. Any amount needed to fund contributions in excess of the employer cap would be paid directly by the state from School Aid Fund revenues.

Without the legislation, the required employer contribution to cover MPSERS liabilities would have continued to rise significantly in the short run as a result of the continuing phased-in recognition of the significant 2008 and 2009 market losses under the smoothing model, the costs of the 2010 early retirement incentives, and the pre-funding of retiree health care. The reforms help to mitigate these cost increases and cap the required contribution that will come directly from public school resources. According to a recent House Fiscal Agency report, without the legislation, the MPSERS employer contribution would have risen to 31.7 percent in FY2014 and reached a peak of 36.4 percent by FY2017.[a] The reforms cut these required contributions to 29.4 percent and 33.1 percent in those years, respectively. Further, the employer cap provision is expected to limit MPSERS contributions coming directly from public school employers at 25.8 percent with the state covering any contribution needs above the cap using School Aid Fund revenues.

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[a] Kyle I. Jen and Bethany Wicksall, *The Michigan Public School Employees Retirement System*, Michigan House Fiscal Agency, April 2013.

equated to around $710 per pupil. By FY2007, they had reached $1,004 per pupil (41.4 percent above their FY2004 levels) and rose further to $1,305 per pupil for FY2012, an increase of 83.7 percent from FY2004 on a per-pupil basis.

Chart 6

Total Per-Pupil Revenues to Public Education: Impact of MPSERS Costs, FY2004-FY2012

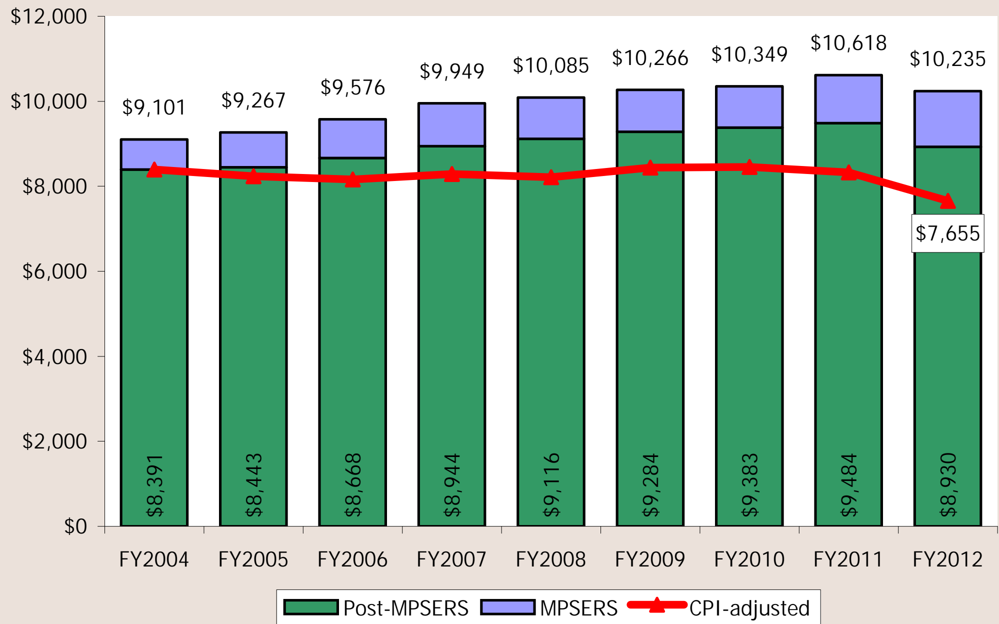


Chart 6 analyzes the financial implications of these growing MPSERS contributions. The chart separates per-pupil revenues into two components: 1) revenues needed to meet MPSERS employer contributions; and 2) remaining revenues to meet other spending priorities. The green segments in **Chart 5** highlight these remaining per-pupil revenues for public education, while the blue segments display MPSERS employer contribution needs. Remaining per-pupil revenues were $8,391 in FY2004 with the MPSERS contribution equated to roughly 8.7 percent of total per-pupil revenue. That figure rose slowly to $9,484 per pupil in FY2011 with $1,134 per pupil needed to cover MPSERS contributions. However, the per-pupil revenue decline experienced in FY2012 pushed the remaining revenues down to $8,930 per pupil, about 6.4 percent above the FY2004 level in nominal terms. By FY2012, MPSERS contributions accounted for almost 14.8 percent of overall per-pupil revenues. Once again, the red line in the chart looks at the remaining revenue after MPSERS figures on an inflation-adjusted basis. Adjusted for Detroit CPI inflation and the significant increase in MPSERS contribution rates that occurred over the period, FY2012 revenues remaining after MPSERS costs equate to $7,655 in constant 2004 dollars, a reduction of 8.8 percent from the level in FY2004.

The data suggest that the combination of increased MPSERS employer contributions and the phase-out of federal stimulus revenue have left public schools in a more financially constrained situation, particularly in FY2012. With more revenue needed to meet MPSERS obligations, less revenue remains available to cover other budget needs (e.g. teacher and staff salaries, fringe benefit costs, books and supplies, and maintenance) within the education system when inflation is taken into account.

The situation is particularly difficult for traditional K-12 school

districts. As shown in **Table 5**, traditional K-12 districts have seen pupil membership fall by 208,729 students from FY2004 to FY2012, a 12.7 percent decrease. This declining enrollment and the recent reductions in per-pupil funding have added to the challenge of meeting MPSERS obligations. Further, since traditional K-12 districts are required to participate in MPSERS, the impact of MPSERS costs outlined above is more significant to them than it is for public school academies, where MPSERS participation is optional.

Table 5
Pupil Membership History, FY2004-FY2012

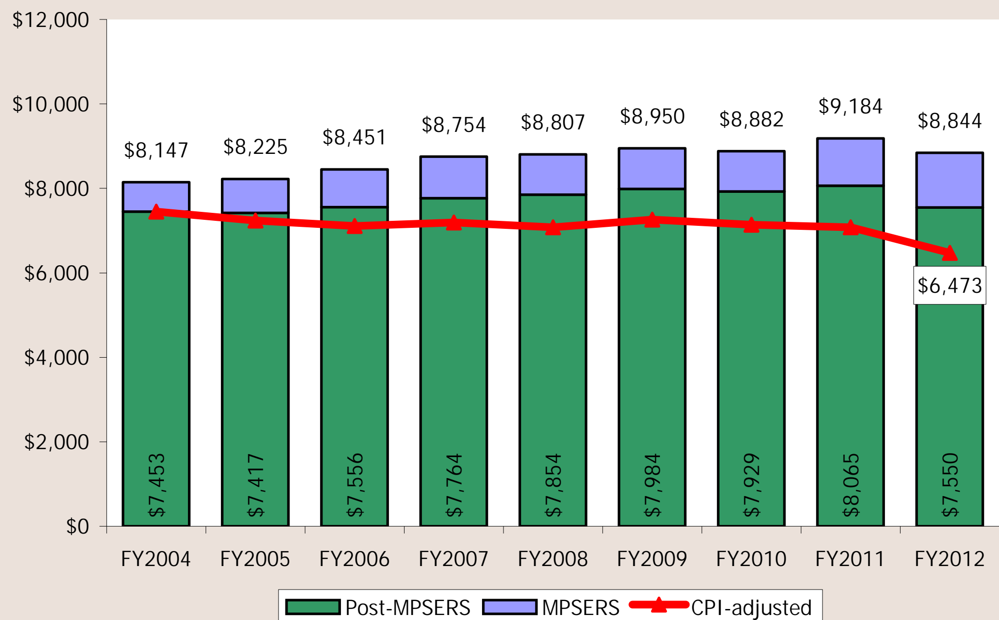
Fiscal Year	Traditional K-12 Districts	Public School Academies	Total
2004	1,640,929	73,473	1,714,402
2005	1,626,289	81,491	1,707,780
2006	1,607,880	89,654	1,697,534
2007	1,584,435	96,627	1,681,062
2008	1,553,568	98,987	1,652,555
2009	1,517,714	102,030	1,619,744
2010	1,487,297	108,425	1,595,722
2011	1,457,160	112,276	1,569,436
2012	1,432,200	119,900	1,552,100

Source: Senate Fiscal Agency

Chart 7 recreates **Chart 6** but focuses exclusively on traditional K-12 school district revenues and their related MPSERS costs. These revenues are adjusted by pupil membership counts for students in traditional K-12 districts and, thus, do not include pupils enrolled in public school academies. While post-MPSERS per-pupil revenues for the public education system overall in FY2012 were up by 6.4 percent from FY2004 before adjusting for inflation, the same per-pupil revenues for traditional K-12 districts alone were up by only 1.3 percent from $7,453 in FY2004 to $7,550 in FY2012. Adjusting for Detroit CPI inflation, remaining per-pupil revenues after MPSERS obligations declines to $6,473 in FY2004 constant dollars, a 13.1 percent decline from FY2004 – significantly greater than the 8.8 percent inflation-adjusted decline experienced by all public education entities as a whole.

Furthermore, it appears these revenue trends may get worse before they get better. **Table 6** shows how total K-12 appropriations per pupil would change under the Governor's FY2014 and FY2015 budget proposals. Over-

Chart 7
Total Per-Pupil Revenues to Traditional K-12 Districts: Impact of MPSERS Costs, FY2004-FY2012



all, growth in per-pupil appropriations appears healthy, with funding increasing from $8,213 per pupil in FY2012 to a proposed $8,840 in FY2015 – which represents an average annual growth of almost 2.5 percent. However, a substantial portion of appropriations growth is driven by funding to cover MPSERS cost increases, with MPSERS-related appropriations reaching the equivalent of $527 per pupil in the proposed FY2015 budget. Another significant growth factor is the proposed increase in pre-school funding within the Great Start Readiness Program. Factoring out the growth in these two allocations, remaining K-12 appropriations per pupil grow by almost 2.0 percent under the FY2013 budget (which included a $120 per pupil boost to the minimum foundation allowance to $6,966) before growth slows to 0.6 percent in FY2014 and then declines by 0.1 percent in FY2015. Adjusted for inflation, appropriations per pupil increase by 0.1 percent in FY2013 and then fall in both FY2014 and FY2015 by 1.3 percent and 2.0 percent, respectively. The per-pupil appropriation in FY2015 is 3.2 percent below FY2012 in inflation-adjusted dollars. In short, without the receipt of additional revenues that stretch beyond the levels necessary to meet increasing MPSERS cost obligations, public schools will continue to see per-pupil revenue growth lag behind the general inflation rate over the coming years.

Table 6
Per-Pupil Appropriations for K-12 Schools, FY2012-FY2014

	FY2012	FY2013	FY2014 (Exec)	FY2015 (Exec)
Total Appropriations per Pupil	$8,213	$8,420	$8,639	$8,840
Less: MPSERS-Related Appropriations per Pupil	*$186*	*$232*	*$364*	*$527*
Less: Great Start Readiness Appropriations per Pupil	*$67*	*$71*	*$114*	*$157*
Remaining Appropriations per Pupil	$7,960	$8,117	$8,161	$8,156
Growth from prior year		1.97%	0.55%	(0.06%)
Remaining Appropriations per Pupil (CPI-adjusted)	$7,960	$7,971	$7,865	$7,704
Inflation-adjusted growth from prior year		0.14%	(1.33%)	(2.04%)

Source: Detroit CPI-U data estimates for FY2013, FY2014, and FY2015 taken from January 2013 Consensus Revenue Estimating Conference forecast

Conclusions: MPSERS Costs and Implications Going Forward

Much of the recent confusion and debate regarding K-12 funding trends center on two important factors that have had significant impacts on state funding to public education – 1) the emergence and eventual phase-out of federal stimulus funding used for K-12 education and 2) the growing significance of Michigan Public School Employee Retirement System costs on school districts. While state funding has risen significantly since FY2010, most of the increase in state-sourced funding has been related to restoring funds that had been saved with the availability of the temporary federal stimulus revenue and to meeting growing unfunded retirement liabilities that largely arose as the result of the financial market turbulence in 2008 and 2009.

When adjusting for both inflation and the resulting growth in MPSERS contributions, remaining per-pupil revenue available to meet other basic instructional and non-instructional needs has declined by 8.8 percent for all public education entities and by 13.1 percent for traditional K-12 school districts since FY2004. Escalating MPSERS costs have played an important role in the decline with districts' contributions to the pension system increasing from 8.7 percent of per-pupil revenues in FY2004 to almost 14.8 percent of those revenues in FY2012 when public school employers contributed over $2.0 billion to cover their MPSERS liabilities.

How this translates into the public debate about the adequacy of K-12 funding for public schools depends on one's perspective as to the adequacy of funding prior to the escalation of MPSERS costs. According to data from the National Center for Education Statistics, total revenue per pupil in Michigan for school year 2003-04 was 7.8 percent higher than the U.S. average. By school year 2009-10, per-pupil revenue in Michigan had fallen to a level 2.9 percent below the national average.[13] This suggests that K-12 revenues in Michigan have fallen relative to those in other states, but whether that is good (more value per dollar invested) or bad (financial constraints harm educational outcomes) is an open debate.

Regardless of one's perspective, what is clear is that the rapid growth in public school employer costs related to MPSERS has had a substantial impact in crowding out revenues available for other educational purposes and that this impact has left public schools more financially constrained than they were a decade ago. While increased state funding to mitigate any additional impact of MPSERS costs for districts helps avoid further crowding-out of their base revenues, it does not undo the financial stress incurred by districts to date. And since that additional funding is coming from the state's School Aid Fund, the MPSERS-related funding does not prevent further crowding-out of the growth in those base revenues. If not for the MPSERS contribution burden, those same revenues could instead be utilized to boost the foundation allowance or other grant funding for schools and lead to more actual dollars for educational purposes.

Recent legislative changes to the MPSERS system should help contain and eventually reduce future contribution costs (see the box "Recent Reforms to the MPSERS Retirement System" for a review of these changes). Further, the recent poor-market performance responsible for much of the increased UAAL will eventually work itself through the system's five-year smoothing process, which would at least stabilize the employer contribution arising from these unfunded liabilities.

However, in the near term, the crowding-out effects of increased MPSERS contributions will remain and state policymakers will need to continue to decide whether additional support is warranted to reverse some of their negative impacts on public schools.

Endnotes

[1] Moving Michigan Forward: Continuing Our Comeback, February 7, 2013 available at http://michigan.gov/documents/dtmb/presentation_410869_7.pdf

[2] Michigan Parents for Schools, Testimony on the FY 2014 School Aid Executive Budget Proposal, February 19, 2013 available at www.miparentsforschools.org/files/MI edu_funding_backgr_w_testimony Feb2013a.pdf

[3] Citizens Research Council of Michigan, Report 337, *Financing Michigan Retired Teacher Pension and Health Care Benefits*, September 2004, www.crcmich.org/PUBLICAT/2000s/2004/rpt337.pdf.

[4] Public Act 300 of 2012 capped the employer contribution rate for unfunded actuarially accrued liabilities at 20.96 percent, but also made significant changes to MPSERS pension benefits, requiring covered employees generally to choose between increased employee contributions to the pension fund, a reduced pension benefit multiplier, or a switch to defined contribution plan. For more information on recent reforms, see the section below on "Recent Reforms to the MPSERS Retirement System" as well as House Fiscal Agency, *The Michigan Public School Employees' Retirement System* available at http://house.mi.gov/hfa/PDFs/MPSERS%20report%20Apr2013.pdf

[5] According to its 2012 Comprehensive Annual Financial Report, the MPSERS system covered 711 employers: 549 local K-12 school districts, 57 intermediate school districts, 28 community colleges, 59 public school academies, 7 state universities, and 11 public libraries.

[6] Retiree health care reforms in Public Act 300 of 2012 ended subsidized retiree health care coverage for new employees hired on or after September 4, 2012. New employees will instead be placed in a Personal Healthcare Fund with employer-matched contributions deposited into a health savings account and a credit at termination into a Health Reimbursement Account. Employees hired prior to that date were given the option of participating in the Personal Healthcare Fund in place of their subsidized premium benefit and the related 3% employee contribution.

[7] Contribution rates reflect rates paid for employees who first worked before July 1, 2010. Rates for employees who began work after this date are slightly lower as a result of recent MPSERS reforms.

[8] Data on PSA districts taken from MI School Data website at https://www.mischooldata.org/DistrictSchoolProfiles/EntitySummary/Summary.aspx

[9] These changes were implemented by Public Act 75 of 2010. For more information, see the section on "Recent Reforms to the MPSERS Retirement System" and the enacted legislative analyses available at www.legislature.mi.gov/documents/2009-2010/billanalysis/House/pdf/2009-HLA-1227-7.pdf and www.legislature.mi.gov/documents/2009-2010/billanalysis/Senate/pdf/2009-SFA-1227-E.pdf

[10] More recently, Public Act 300 of 2012 modified the three percent contribution, guaranteeing an individual's contribution toward his or her own retirement health care. As a result, revenue collected under the new three percent employee contribution is no longer being placed in escrow.

[11] MPSERS reforms contained in Public Act 75 of 2010 created a new hybrid Pension Plus retirement plan which combines the typical defined benefit pension with a defined contribution component. The statute establishes that the expected rate of return on contributions for the Pension Plus system shall be 7 percent, rather than 8 percent.

[12] Specifically, the exclusions include revenues with revenue major class codes 317, 318, 417, and 418 within the FID coding structure.

[13] U.S. Department of Education, National Center for Education Statistics, Common Core of Data available at http://nces.ed.gov/ccd/elsi/quickFacts.aspx