State Notes
TOPICS OF LEGISLATIVE INTEREST
July/August 2006

Revenue Changes and Retirement Costs in the Public School Employees' Retirement System
By Kirk Sanderson, Fiscal Analyst

Introduction

Retirement costs for Michigan's public school employees are becoming a growing concern across the State. Decreases or small increases in school district revenue in recent years are forcing an increasing percentage of district budgets to fund pension and health insurance benefits for retirees under the Michigan Public School Employees' Retirement System (MPSERS), which is one of four State-administered retirement plans for public sector workers.

A defined benefit retirement system that covers retirees' health and pension costs, MPSERS includes all of Michigan's public school districts, community colleges, and district libraries, and is available to public school academies. Seven of the State's 15 public universities also are covered under the system. These universities are: Central Michigan, Eastern Michigan, Ferris State, Lake Superior State, Michigan Tech, Northern Michigan, and Western Michigan.

Two factors have been causing retirement obligations to rise since fiscal year (FY) 1999-2000. First, active membership (i.e., current working employees) has declined slightly over the last two years in response to tightening budgets, while retired membership continues to grow. Since FY 1999-2000, active membership has increased by only 8,358 members, or 2.7%. During the same time, retired membership has increased by 25,591, or 20.3%.

In addition to changes in membership, exogenous factors such as poor stock market performance and rising health costs have negative impacts on MPSERS. Taken together, these changes have been requiring Michigan's school districts to pay larger portions of their total operating revenue to fund their MPSERS obligations every year since FY 1999-2000.

This article looks specifically at how contributions to MPSERS have grown relative to operating revenue for Michigan's school districts from FY 1999-2000 through FY 2005-06, and looks ahead using projections for FY 2006-07. In addition, it breaks down numbers on a per-pupil basis to analyze what increases in the foundation allowance are needed to keep up with increases in MPSERS contributions.

MPSERS Expenditure and School District Revenue

Members of MPSERS are enrolled in one of two plans, the Basic Plan or the Member Investment Plan (MIP). The Basic Plan covers employees who were hired before 1987 and did not choose the option of becoming part of MIP. Beginning in 1990, all new hires were required to join MIP. The two major differences between the plans include the way pension payments are determined and the requirement that MIP members make contributions toward their plan based on their salary.

Since MPSERS is a defined benefit plan, employees receive a monthly pension benefit that is calculated according to a formula that includes years of service and final average compensation. Members become vested in the program based on criteria including age and years of service, depending on whether they are members of MIP or the Basic Plan. Basic Plan members may retire starting at age 55, while MIP members may retire as young as 46 with a certain number of years of service.

To determine each school district's contribution to MPSERS, a contribution rate determined by the State is applied to wages paid. The total rate is composed of two different rates. The first part is the pension rate, which funds monthly pension payments to retirees. The second component of the total rate is the health insurance rate, which pays for health coverage for retirees. These rates are determined by the Office of Retirement Services, and in FY 2005-06 were 6.55% for health benefits and 9.97% for pensions for a total contribution of 16.34% of wages paid. The rates and contributions from FY 1999-2000 to FY 2005-06 are shown in Table 1. As the table indicates, the total contribution has increased every year since FY 1999-2000, from just under $1.0 billion to about $1.6 billion.[1]

Table 1

MSPERS Contribution Rates and Total K-12 Contributions*
(Dollars in Millions)

	FY 1999-2000	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06
Health Rate	4.60%	5.55%	6.05%	6.05%	6.05%	6.55%	6.55%
Pension Rate	7.06%	6.61%	6.12%	6.94%	6.94%	8.32%	9.79%
Total Rate	11.66%	12.16%	12.17%	12.99%	12.99%	14.87%	16.34%
Wages	$8,093.9	$8,281.1	$8,627.7	$8,842.9	$8,932.4	$8,748.3	$8,887.3**
Total Contribution	$943.8	$1,007.0	$1,050.0	$1,148.7	$1,160.3	$1,300.8	$1,452.2**

* MPSERS contribution figures only include payments from school districts and public school academies.
** Estimated.

Source: Office of Retirement Services

As shown in Table 1, MPSERS contributions have increased by almost 60.0% since FY 1999-2000. Growing costs for health and pension benefits have resulted in rising contribution rates. The health rate has been relatively stable since FY 2000-01, only increasing one percentage point over that time, from 5.55% in FY 2000-01 to 6.55% in FY 2005-06. This account, created in 1997, used overfunding from previous years to offset increases in health costs in FY 2003-04 through FY 2005-06.

The pension contribution rate has risen in recent years after strong investment returns in the late 1990s allowed the rate to decrease to a low of 6.12% in FY 2001-02. Since then, poor stock market performance, increasing numbers of retirees, and rising costs have forced the rate to increase steadily. The pension rate is 9.79% in FY 2005-06, and will increase to 11.19% in FY 2006-07. That is an increase of nearly 83.0% over the FY 2001-02 level.

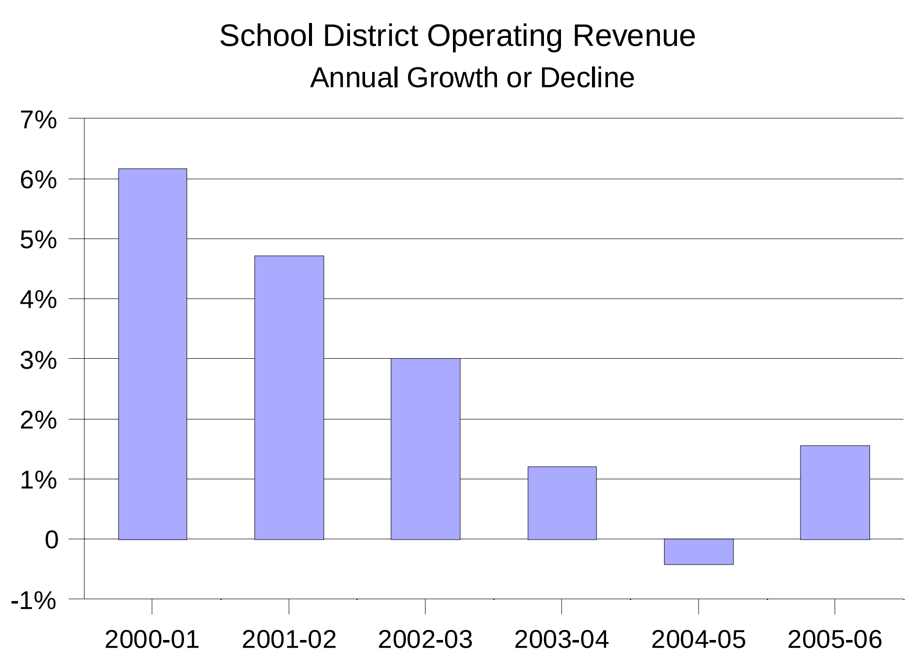
[1] For a more detailed description of how MPSERS works, see http://www.senate.michigan.gov/sfa/Publications/Notes/2005Notes/notesmarapr05jc.pdf.

Funding MPSERS Obligations

Michigan's public school districts fund MPSERS obligations with money from their operating revenue. Districts receive this revenue from two sources: State aid payments and local revenue through property taxes. First, under Section 22a of the State School Aid Act (which provides for districts' foundation allowance), a district receives an amount equal to its FY 1994-95 total State and per-pupil revenue as outlined in Proposal A (the constitutional amendment approved by the voters in March 1994). The remainder of a district's State revenue is granted as discretionary payments pursuant to Section 22b. The net result is that districts receive the same amount of State funding under the new system as they would have when there was a single payment.

In most cases, local contributions are generated through an 18-mill nonhomestead property tax that each district keeps for its own revenue. (This is not to be confused with the State education tax, which levies six mills on all property and contributes to the State School Aid Fund.) Figure 1 illustrates the changes in total operating revenue of Michigan school districts from FY 1999-2000 to FY 2005-06, defined here as the sum of State foundation allowance payments, (appropriated in Sections 22a and 22b of the State School Aid Act of 1979), plus local revenue. One can note the decline in the rate of growth of total funding from FY 2000-01 to FY 2004-05, with a slight decline in funding in FY 2004-05, and an estimated 1.5% growth in FY 2005-06.

Figure 1



Source: Michigan Department of Education, State Aid Status Reports

District Budgets and Rising MPSERS Contributions

Increasing MPSERS obligations come during a period when school district operating revenue either has been declining or is seeing only meager growth, as illustrated in Figure 1. Revenue from the State education tax has steadily increased on the strength of the real estate market in recent years. State budget problems, however, have limited funding increases from the State. Budget shortfalls forced the State to prorate some school funds in FY 2002-03 and FY 2003-04, and total unrestricted operational funding actually decreased in FY 2004-05. The decrease in funding that year was the result of an unchanged foundation allowance and a decline in enrollment.

As a result of increasing MPSERS contributions combined with stagnating revenue, a greater portion of a school's budget is used for MPSERS. This can become problematic for a district as these funds are diverted from other areas of its budget. As Table 2 shows, in FY 1999-2000 MPSERS contributions constituted 9.13% of Michigan school districts' operating revenue. By FY 2003-04, that percentage had increased to 9.69%. Large increases in contribution obligations in the last two years have pushed the percentage up to an estimated 11.99%.

Table 2

Percent of Operating Revenue Needed to Fund K-12 MPSERS Obligations*
(Dollars in Millions)

	FY 1999-2000	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06
MPSERS Contributions	$943.80	$1,007.00	$1,050.00	$1,148.70	$1,160.30	$1,300.8	1,452.2**
Operating Revenue	$10,312.8	$10,973.6	$11,490.0	$11,476.4	$11,586.1	$11,495.3	$11,636.3
% Required to Pay MPSERS	9.13%	9.18%	9.14%	9.71%	9.69%	10.90%	11.99%

* MPSERS contribution figures only include payments from school districts and public school academies.
** Estimated.

Source: Office of Retirement Services, Michigan Department of Education, and Senate Fiscal Agency estimates.

Another way to look at increases in MPSERS contributions is to determine how much of the yearly foundation allowance increase is needed to match the contribution increases. The foundation allowance is the annual per-pupil payment from the State. In all but two years during the period covered in this paper, the foundation allowance increased. In FY 2003-04 and FY 2004-05, there was no increase.

The percentage of the foundation allowance needed for MPSERS contributions fell in the early 2000s as contribution rates remained low and foundation allowance increases were high. As Table 3 shows, the rate dropped to a low of 5.0% in FY 2001-02. This changed the next year when $58 of the $200 foundation increase, or 29.0%, was needed to cover MPSERS increases.

In FY 2003-04, MPSERS rates remained unchanged, with only a $7 per-pupil increase in contributions due to rising district payroll. This mitigated the effect of having no foundation allowance increase in FY 2003-04 and having some funding prorated due to revenue shortfalls at the State level.

Table 3

Per-Pupil Increases in K-12 MPSERS Contributions and Basic Foundation Allowance Payments*							
	FY 1999-2000	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06
Foundation Allowance Increase	$530	$300	$500	$200	$0	$0	$175
MPSERS Contribution Increase	$75	$37	$25	$58	$7	$82	$89
% Needed to Cover MPSERS Increase	14.2%	12.3%	5.0%	29.0%	N/A	N/A	51.0%

* MPSERS contribution figures only include payments from school districts and public school academies.

Source: Office of Retirement Services, Michigan Department of Education, and Senate Fiscal Agency estimates.

There was no increase in the foundation allowance again in FY 2004-05, though funding prorated in FY 2003-04 was restored. Nevertheless, the contribution rates for health and pension benefits increased by 0.5 and 1.6 percentage points, respectively. These increases, combined with a slight decline in the total number of pupils, caused MPSERS contributions to increase by $82 per pupil.

The foundation allowance increased by $175 in FY 2005-06, but as in the previous year, declining enrollment and an increase in the total contribution rate caused MPSERS contributions to increase by $89 per pupil. That represents 51.0% of the total foundation allowance increase. When the last three years are taken together, however, it looks much worse for districts. Over that time, MPSERS contributions have increased by $178 per pupil, while foundation allowances increased by $175.

Looking Ahead to FY 2006-07

Several of the trends that have emerged in the last two years should continue in FY 2006-07. Despite modest rate increases, estimates indicate that MPSERS contributions will continue to require a larger portion of total operating revenue for districts, and that those costs will be spread over fewer students, resulting in increased requirements on a per-pupil basis.

These projections use MPSERS contribution rates released by the Office of Retirement Services, and are based on assumptions about payroll data, local revenue contributions, and the number of pupils. Projections for local revenue and payroll were based on previous years' growth rates. This averaging may lead to an overstatement of local contributions, as growth rates for local contributions have slowed in recent years.

The MPSERS contribution rate will increase to 17.74% in FY 2006-07, according to the Office of Retirement Services. The pension rate will increase 1.4 points to 11.19%. Changes in the Medicare system will provide some savings to MPSERS, allowing the health rate to remain at 6.55% for FY 2006-07. Combined with the payroll estimates, total MPSERS contributions are likely to increase by nearly 10.0% in the next fiscal year.

To help partially offset the rise in MPSERS obligations, total operating revenue for school districts should see the biggest increase in five years. The foundation allowance will be $210 more than in FY 2005-06 and the discretionary payment has been increased by more than 10.0% from the current year. Despite these increases, MPSERS obligations will account for an estimated 12.95% of total revenue, up from 11.99% in FY 2005-06.

Declining enrollment and rising retirement costs push MPSERS obligations even higher in FY 2006-07 when measured on a per-pupil basis. An estimate of the FY 2006-07 pupil count shows a decrease of 0.42%, or roughly 7,060 students. Along with the increasing contributions described above, MPSERS funding will likely cost around $1,040 per pupil. This is the highest level yet and an increase of 77% over the FY 1999-2000 level.

Conclusion

Several of the factors mentioned in this paper will put growing strains on the ability to Michigan school districts to fund their MPSERS obligations in the coming years. Some of the primary challenges include:

- Growth in the number of retired members likely will outpace any growth in active membership as large numbers of teachers approach retirement age.
- Slow or negative growth in active membership will result in a smaller base over which to spread costs, forcing contribution rates to increase if districts are to meet MPSERS obligations, particularly for the pay-as-you-go health benefit system.
- These higher rates will continue to divert from instructional uses a larger portion of total operating revenue as well as foundation allowance increases.

The demographic trends and rising costs that have begun to cause concern for school districts in recent years show no indication of reversing in the near future. Pressure on Michigan school districts to fund obligations to their employees while increasing student instruction and achievement will become greater as MPSERS consumes an ever-larger portion of district revenue. Proposals such as the K-16 ballot initiative are attempting to address the issue, but any potential solution must carefully weigh both the long-term benefits and drawbacks of changes to the current structure.