State Notes

TOPICS OF LEGISLATIVE INTEREST

March/April 2007

Department of Information Technology: Appropriations and Expenditures
By Stephanie Yu, Fiscal Analyst

The Department of Information Technology (DIT) was created by Executive Order 2001-3 by then Governor Engler in October 2001. No additional funding was provided to support DIT. Instead, funds from existing appropriations within State departments and agencies were shifted to DIT as a series of interdepartmental grants. Each department has a line item in its budget for information technology services and projects, the sum of which constitutes DIT's total appropriation. That structure remains in place, and overall changes to DIT's budget are generally spread across departments, although certain projects can be targeted.

The Department of Information Technology is responsible for the information technology needs of the Executive Branch and its departments and agencies. These include 55,000 computers, 2,300 servers, and 25,000 telephone lines. The Department is also responsible for the security of the entire system and faces the threat of 8,400 e-mail viruses daily. In its short history, the total budget for DIT has varied from over $500.0 million to $360.0 million.

Since the creation of DIT, the amounts DIT has charged to other departments and agencies for information technology (IT) services have exceeded the amounts appropriated to DIT by considerable margins. Individual departments retain considerable control over the funds marked in their budgets for DIT, and a number of projects and services are not included in DIT's appropriation. The discrepancy between amounts appropriated and funds spent is explained in the final section of the article, "Appropriations vs. Expenditures".

Budget History

Fiscal Year (FY) 2002-03 was the first year DIT was included in the General Government appropriation bill. The total appropriation for the Department was $503,086,800. The initial appropriation for FY 2003-04 was $360,239,300. A supplemental appropriation brought the total to $371,269,300. The initial appropriation for FY 2004-05 was $360,738,600. A supplemental appropriation increased the interdepartmental grant (IDG) from the Department of State Police by $1,304,100. Executive Order 2005-7 required $4.34 million in reductions of user fees and service charges to other departments, as well as $2.06 million in savings through expenditure reductions under the Master Computing Contract. Total savings of $10,876,800 were achieved.

For FY 2005-06, $365,194,400 was appropriated to DIT. Public Act 153 of 2006 made adjustments totaling $19.5 million to the DIT budget to align the appropriation with the departmental authorizations, for a year-end total appropriation of $384.7 million. In FY 2006-07, the DIT budget began the fiscal year at $378,222,000, but Executive Order 2007-3 reduced it to approximately $369.0 million. Reductions to DIT included statewide cuts of $47,000 and retirement savings of $5.8 million, as well as $75,000 in administrative efficiencies in the Michigan Administrative Information Network (MAIN) and delayed projects in the Department of Human Services. Table 1 shows the gross appropriation by year, and Table 2 shows the total appropriation by department. The inconsistency between the two tables reflects the discrepancy in appropriations to DIT and IT appropriations in other departments.

Table 1

Gross Appropriations to the Department Of Information Technology					
Year	**Enacted Budget**	**Supplementals**	**Transfers**	**Reductions**	**YTD Total**
2002-03	$424,006,800	$41,588,700	$37,491,300		$503,086,800
2003-04	360,239,300	11,030,000			371,269,300
2004-05	360,738,600	3,996,600		(10,876,800)[a]	353,858,400
2005-06	365,194,400	19,512,300			384,706,700
2006-07	378,222,000			(3,171,400)[b]	375,050,000

[a] EO 2005-7 required reductions to the DIT budget. Total savings of $10,876,800 were achieved.
[b] EO 2007-3 contained reductions to IT in various departments.

Table 2

Year-To-Date Gross Appropriations to the Department of Information Technology by Department

Department	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07
Agriculture	$1,884,100	$1,515,700	$823,200	$1,469,600	$1,536,600
Attorney General	859,400	773,600	773,600	701,900	738,100
Career Development	6,492,700	---	---	---	---
Civil Rights	1,082,000	786,200	786,200	754,600	779,800
Civil Service	3,317,600	3,827,000	3,827,000	3,788,400	3,817,800
Community Health	35,173,100	29,751,900	29,751,900	30,468,800	31,424,400
Consumer & Industry Services	26,067,300	---	---	---	---
Corrections	15,524,700	13,822,000	13,822,000	14,076,000	16,612,700
Education	3,183,200	2,489,800	2,489,800	2,532,900	2,611,400
Environmental Quality	7,200,200	6,632,500	6,632,500	6,607,700	6,809,700
Gaming Control Board	---	1,100,600	1,100,600	1,143,500	1,286,000
History, Arts, & Libraries	1,166,100	926,300	926,300	790,700	945,700
Human Services[b]	226,719,000	128,618,300	122,922,300	151,396,600	132,706,100
Labor & Economic Growth	---	42,159,400	42,159,400	42,486,200	43,188,500
Lottery	---	4,236,700	4,236,700	4,397,000	4,421,500
Management & Budget	27,816,200	24,433,200	24,433,200	27,268,900	28,433,600
Military & Veterans Affairs	1,230,800	1,159,400	1,159,400	1,119,200	1,161,100
Natural Resources	15,492,200	8,557,700	8,557,700	8,704,200	9,001,500
State	20,928,600	21,885,300	21,885,300	22,188,500	23,626,900
State Police	22,067,800	21,999,000	21,999,000	21,529,100	21,026,500
Transportation	26,396,400	26,827,300	26,827,300	27,000,000	27,826,500
Treasury	23,102,400	16,052,500	16,052,500	16,282,900	16,720,600
Total	**$465,703,800**	**$353,858,400**	**$351,165,900**	**$384,706,700**	**$374,675,000**[a]

a) This total does not reflect $5.8 million in retirement savings in Executive Order 2007-3, since the distribution across departments is unknown. That adjusted total would be $368.9 million.
b) Formerly named Family Independence Agency.

Required Reporting

As required in previous years, Section 578 of the Omnibus appropriation bill (Public Act 345 of 2006) requires DIT to submit a report by March 1 for the preceding fiscal year to the General Government subcommittees of both houses. The report must include:

> (a) the total amount of funding appropriated for information technology services and projects, by funding source, for all principal executive departments and agencies;
> (b) a listing of the expenditures made from the amounts received by the Department of Information Technology, as reported in subdivision (a).

Fiscal Year 2002-03

The report for FY 2002-03 indicated that DIT invoiced other departments a total of $494,458,416.07. The total amount appropriated at fiscal year-end was $465,703,800, a difference of $28,754,616. Table 3 shows that difference by department.

Table 3
Department of Information Technology Appropriations and Amounts Invoiced FY 2002-03

Department	FY 2002-03 YTD Appropriation	Total Expenditures	Difference
Agriculture	$1,884,100	$2,765,743	$881,643
Attorney General	859,400	916,320	56,920
Career Development	6,492,700	6,033,944	(458,756)
Civil Rights	1,082,000	831,714	(250,286)
Civil Service	3,317,600	1,775,836	(1,541,764)
Community Health	35,173,100	45,232,181	10,059,081
Consumer & Industry Services	26,067,300	45,441,797	19,374,497
Corrections	15,524,700	19,827,582	4,302,882
Education	3,183,200	5,514,576	2,331,376
Environmental Quality	7,200,200	8,784,531	1,584,331
Family Independence Agency	226,719,000	218,036,815	(8,682,185)
History, Arts, & Libraries	1,166,100	970,575	(195,525)
Management & Budget	27,816,200	27,265,807	(550,393)
Military & Veterans Affairs	1,230,800	1,009,171	(221,629)
Natural Resources	15,492,200	17,144,594	1,652,394
State	20,928,600	18,630,012	(2,298,588)
State Police	22,067,800	23,996,437	1,928,637
Transportation	26,396,400	23,511,395	(2,885,005)
Treasury	23,102,400	26,769,385	3,666,985
Total	**$465,703,800**	**$494,458,416**	**$28,754,616**

Fiscal Year 2003-04

For FY 2003-04, the Department modified its report to show total expenditures by category and department. Total expenditures exceeded total appropriations of $353,858,400 for the year by $131,894,980. Table 4 shows that comparison by department. The Department of Information Technology spent less than the amount appropriated for the Departments of Civil Service, Military and Veterans Affairs, and State. Department of Information Technology expenditures for all remaining departments exceeded those appropriations.

Table 4
Department of Information Technology
Expenditures and Appropriations
FY 2003-04

Agency	YTD Appropriations	Total Expenditures	Difference
Agriculture	$1,515,700	$3,352,124	$1,836,424
Attorney General	773,600	2,031,559	1,257,959
Civil Rights	786,200	865,017	78,817
Civil Service	3,827,000	3,061,176	(765,824)
Community Health	29,751,900	45,501,662	15,749,762
Corrections	13,822,000	20,107,250	6,285,250
Education	2,489,800	7,542,813	5,053,013
Environmental Quality	6,632,500	9,766,070	3,133,570
Family Independence Agency	128,618,300	142,169,824	13,551,524
Gaming Control Board	1,100,600	2,499,095	1,398,495
History, Arts, & Libraries	926,300	1,247,666	321,366
Labor & Economic Growth	42,159,400	52,890,422	10,731,022
Lottery	4,236,700	39,020,550	34,783,850
Management & Budget	24,433,200	30,747,935	6,314,735
Military & Veterans Affairs	1,159,400	1,118,102	(41,298)
Natural Resources	8,557,700	19,189,302	10,631,602
State	21,885,300	20,557,182	(1,328,118)
State Police	21,999,000	31,451,386	9,452,386
Transportation	26,827,300	30,955,203	4,127,903
Treasury	16,052,500	21,679,042	5,626,542
Total	**$353,858,400**	**$485,753,380**	**$131,894,980**

Fiscal Year 2004-05

The Department of Information Technology's expenditures for FY 2004-05 totaled $441,608,516. The Department's total appropriation for the year was $351,165,900, a difference of $90,442,616, as detailed by department in Table 5. The Departments of Civil Service and Human Services did not exceed their appropriations; the remaining departments did.

Table 5

Department of Information Technology Expenditures and Appropriations FY 2004-05			
Agency	**YTD Appropriations**	**Total Expenditures**	**Difference**
Agriculture	$823,200	$2,964,872	$2,141,672
Attorney General	773,600	2,118,930	1,345,330
Civil Rights	786,200	837,352	51,152
Civil Service	3,827,000	3,081,748	(745,252)
Community Health	29,751,900	37,652,140	7,900,240
Corrections	13,822,000	18,498,727	4,676,727
Education	2,489,800	4,656,938	2,167,138
Environmental Quality	6,632,500	8,850,611	2,218,111
Gaming Control Board	1,100,600	2,041,829	941,229
History, Arts, & Libraries	926,300	1,163,898	237,598
Human Services	122,922,300	116,935,680	(5,986,620)
Labor & Economic Growth	42,159,400	52,135,540	9,976,140
Lottery	4,236,700	41,360,563	37,123,863
Management & Budget	24,433,200	26,980,301	2,547,101
Military & Veterans Affairs	1,159,400	1,259,817	100,417
Natural Resources	8,557,700	16,419,158	7,861,458
State	21,885,300	22,573,530	688,230
State Police	21,999,000	32,643,673	10,644,673
Transportation	26,827,300	28,776,580	1,949,280
Treasury	16,052,500	20,656,629	4,604,129
Total	**$351,165,900**	**$441,608,516**	**$90,442,616**

Fiscal Year 2005-06

Department of Information Technology expenditures for FY 2005-06 totaled $494,804,483. Amounts appropriated in the DIT budget totaled $384,706,700. Table 6 shows the difference by department. The Department reported an additional $66.0 million appropriated in other departments' non-IT line items, as well as $36.4 million in prior-year funds. Departments can use authorization in other line items to pay DIT user fees, but do not have to specify which line items.

Table 6

Department of Information Technology Expenditures and Appropriations Fiscal Year 2005-06			
Agency	**YTD DIT Appropriations**	**Total Expenditures**	**Difference**
Agriculture	$1,469,600	$2,695,252	$1,225,652
Attorney General	701,900	2,825,143	2,123,243
Civil Rights	754,600	851,923	97,323
Civil Service	3,788,400	3,464,258	(324,142)
Community Health	30,468,800	40,155,605	9,686,805
Corrections	14,076,000	21,114,035	7,038,035
Education	2,532,900	6,159,684	3,626,784
Environmental Quality	6,607,700	8,873,238	2,265,538
Gaming Control Board	1,143,500	1,996,080	852,580
History, Arts, & Libraries	790,700	1,134,546	343,846
Human Services	151,396,600	142,911,056	(8,485,544)
Labor & Economic Growth	42,486,200	56,480,737	13,994,537
Lottery	4,397,000	43,891,534	39,494,534
Management & Budget	27,268,900	28,648,202	1,379,302
Military & Veterans Affairs	1,119,200	1,287,295	168,095
Natural Resources	8,704,200	16,654,605	7,950,405
State	22,188,500	31,086,635	8,898,135
State Police	21,529,100	31,476,397	9,947,297
Transportation	27,000,000	30,954,863	3,954,863
Treasury	16,282,900	22,143,394	5,860,494
Total	**$384,706,700**	**$494,804,482**	**$110,097,782**

Fiscal Year 2005-06 Overexpenditures

In fiscal year 2005-06, the Departments of Corrections and State Police had net overexpenditures in their budgets. Both departments overspent their information technology line items, the Department of Corrections by $2.2 million, and State Police by $1.7 million. Public Act 3 of 2007 made supplemental appropriations to cover the shortfall In March 2007. The structure of DIT funding allows individual departments to transfer to and from the information technology line item with or without the agreement of DIT, although DIT was aware of the shortfall in these departments before the end of the fiscal year.

Appropriations vs Expenditures

Since the creation of DIT in 2001, the amounts charged to other departments and agencies have exceeded the amounts appropriated to DIT by considerable margins, though FY 2005-06 was the first year departments officially overspent their IT line items. The Department of

Information Technology provides information with its invoices that explains the breakdown of the various charges and reviews those charges monthly with the departments or agencies. Throughout the budget planning process and the fiscal year, DIT works with the departments to provide the services requested and to provide advice on information technology (IT) needs. Despite these efforts at cooperation, departments can adjust their IT line items, and often do, without similar adjustments made to the DIT appropriations. As a result, the DIT appropriations and the line items in individual departments often do not match at the end of the fiscal year, and as in FY 2005-06, this fluidity in what is included in the line item can lead to significant and unpredictable discrepancies in what is appropriated and what is spent.

The Department of Information Technology states that a portion of the discrepancy between appropriations and expenditures stems from the fact that telecommunications services are not included in the IT appropriations but are managed by the Department, although that is not consistent across departments. The Department of Management and Budget (DMB) maintained telecommunications services as an internal service fund until 2001, when it was transferred to DIT. It remains an internal service fund, charging each department for usage. Also, it varies whether the authorization for many other DIT services appears in the DIT budget.

Beginning with fiscal year 2005-06, DIT's expenditure report has included appropriation funds that are not included in the IT line items. The Department reported an additional $66.0 million that was appropriated for DIT services in other line items, but the Department does not receive any detail regarding the individual fund sources, although it does track Federal and State spending broadly. The Department of Information Technology and the departments or agencies being served work together to develop individual IT plans, but this is not reflected in the way DIT is appropriated. Since FY 2003-04, the difference between what is appropriated in the DIT budget and what is spent by the Department has ranged from $90.0 million to $130.0 million. These expenditures constitute a significant portion of total expenditures, between 20.0% and 30.0% per year. The departments, along with DIT, track the funds that are not included in the IT line items, but those amounts are rolled up in other line items and not transparent in the appropriations process.

The structure of DIT funding is complicated, and there are a number of projects and services that are not included in DIT's appropriations. The ability of departments to transfer to and from that line item, thus affecting the DIT budget, adds an additional layer of complexity. As demonstrated in the FY 2005-06 overexpenditures, individual departments retain considerable control over funds marked for DIT. The number of services that DIT provides outside its appropriation distorts the true picture of DIT expenditures, which significantly exceed that appropriation.

State Notes

TOPICS OF LEGISLATIVE INTEREST

March/April 2007

Per-Pupil Funding Gaps and Equity in School Aid
By Kathryn Summers-Coty, Chief Analyst

Questions arise in Michigan and nationwide regarding per-pupil funding in schools. Are there differences among districts? Should there be differences? What is an equitable level of disparity? This article examines the status of per-pupil funding in Michigan's school districts before Proposal A's passage in 1994, the immediate impact of Proposal A on that funding, and how the per-pupil dollars have changed over time.

Before Proposal A

In fiscal year (FY) 1993-94, the year before the implementation of Proposal A, school districts received a combination of State and local money supporting their operations. The local operational money received by a school was entirely dictated by the conditions within that school district. Some schools had very high local millage revenue, due to high property tax values or voter passage of high millage rates or some combination of both; other schools had less local millage revenue because of lower property tax values, low millage rates, or some combination of the two.

The unrestricted operational funding a district received from the State was based on a funding equalization formula known as District Power Equalizing. District Power Equalizing guaranteed each district a minimum return per pupil for each mill of property tax levied. Districts were allowed to tax themselves at whatever rate the voters approved, within the 50-mill limit of Article IX, Section 3 of the Michigan Constitution. If a district's revenue from the levied tax rate was less than the State guaranteed revenue from that tax rate, the State paid the district the difference in the form of State formula aid payments.

The State and local funding received by a school district during FY 1993-94 was crucial to the impact of Proposal A. In most cases, the State and local funding received in that year on a per-pupil basis became the platform, or "base revenue", on which the new "foundation allowance" funding was based. In a few situations, the amount received in FY 1993-94 on a per-pupil basis was less than what was received in FY 1992-93, and an average of the two years was used as the base revenue per pupil.

Since local funding varied dramatically in these years, there was substantial per-pupil funding disparity among the 557 school districts. In fact, the lowest base per-pupil funding received by a school district in FY 1993-94 was $2,762; the district was Sigel Township 3F in Huron County with 33 pupils. At the other end of the spectrum, the highest base per-pupil funding received was $13,734 in the Bois Blanc district. However, this district had only four pupils, so the small population led to a high per-pupil figure. The highest base per-student funding received by a district with more than 50 pupils was Bloomfield Hills (5,559 pupils) at $10,294. If this figure is compared with Sigel Township's figure, the funding gap in FY 1993-94 was $7,532, or a gap of almost 4 to 1.

Immediate Impact of Proposal A on Per-Pupil Funding

In FY 1994-95, school districts experienced a major change in determining their revenue, moving from the equalization formula driven by property taxes to the foundation allowance system. The foundation allowance is a per-pupil revenue amount that a district may receive, and it changed the focus of school funding from the property tax to the number of students enrolled in the district. In the initial calculation of the foundation allowance, the starting point was the base revenue that a district received in FY 1993-94 (or an average of revenue received in FY 1992-93 and FY 1993-94, if that yielded a larger result), adjusted by the following formulas to determine the FY 1994-95 foundation allowance:

Formula 1: If the base revenue per pupil was less than $4,200:

1994-95 Foundation Allowance Per Pupil = $4,200

Formula 2: If the base revenue per pupil was greater than $4,200 and not more than $6,500:

1994-95 Foundation Allowance Per Pupil	=	Base Revenue Per Pupil + $250 - {$90 X [(Base Revenue Per Pupil - $4,200)/$2,300]}

Formula 3: If the base revenue per pupil was greater than $6,500:

1994-95 Foundation Allowance Per Pupil = Base Revenue Per Pupil + $160.

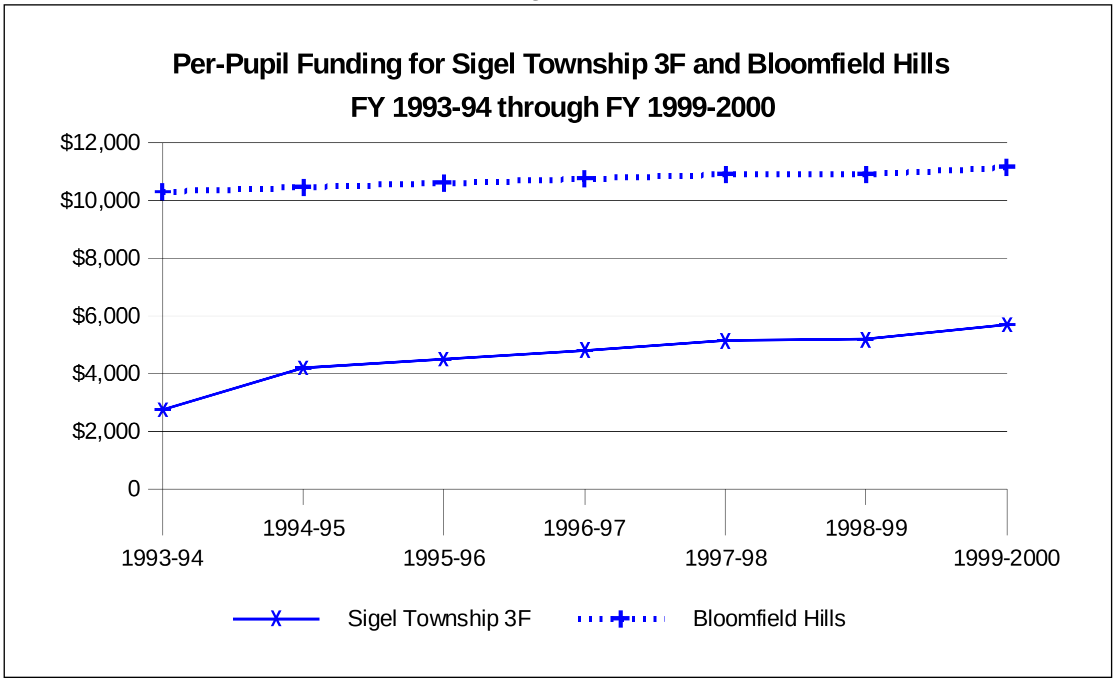
The immediate impact of Proposal A was to increase the operational funding of Sigel Township (and any district with base funding below $4,200 per pupil) to $4,200 per pupil in FY 1994-95. At the same time, Bloomfield Hills saw an increase of $160 per pupil above its base, bringing its FY 1994-95 foundation allowance to $10,454. The funding gap between these two districts shrunk to $6,254, or a ratio of 2.5 to 1.

The use of widely disparate base revenue per pupil as the platform for determining foundation allowances meant that funding gaps that existed before Proposal A would carry forward once Proposal A was implemented. However, with the inclusion of funding formulas in the School Aid Act, the gaps would grow smaller over time until the minimally funded districts achieved the targeted "basic" funding.

What Has Happened Since FY 1994-95

From FY 1995-96 through FY 1999-2000 (except for FY 1998-99), formulas were written into the School Aid Act to provide larger per-pupil dollar increases to lower-funded districts. Any district below the "basic foundation allowance" (defined as $5,000 in FY 1994-95 and growing to $5,700 in FY 1999-2000; currently at $7,085 in FY 2006-07) benefited from the "catch-up" funding formulas in place each of these years. Once all districts began receiving at least the basic amount per pupil in FY 1999-2000, the gap closed to $5,454, or a ratio of just under 2 to 1. This gap resulted from the lowest-funded district's receiving $5,700 in FY 1999-2000 and the highest receiving $11,154. In the space of seven years, funding for Sigel Township 3F doubled, while Bloomfield Hills's funding increased slightly more than 8.0%. In this manner, the equity gap was narrowed. Figure 1 illustrates the growth in Sigel Township 3F's per-pupil funding over this time period compared with that of Bloomfield Hills.

Figure 1



Since FY 1999-2000, when all districts "caught up" to the basic foundation allowance, there have been only two instances in which extra funding was provided to districts at the lower end of the per-pupil funding scale. The first time this occurred was in FY 2001-02, when a $200 per-pupil "equity" payment was given to all districts below $6,500. The second time is in the current year, FY 2006-07, when a $23 equity payment is being provided. Combining these two equity payments, the equity gap has been narrowed by a further $223, meaning that the gap between the lowest-funded district (now at $7,108) and the highest (now at $12,339) stands at $5,231. Table 1 illustrates the growth, since FY 1993-94, in the minimum, basic, and maximum per-pupil funding.

Table 1

Foundation Allowance Changes Since Proposal A
FY 1993-94 through FY 2006-07

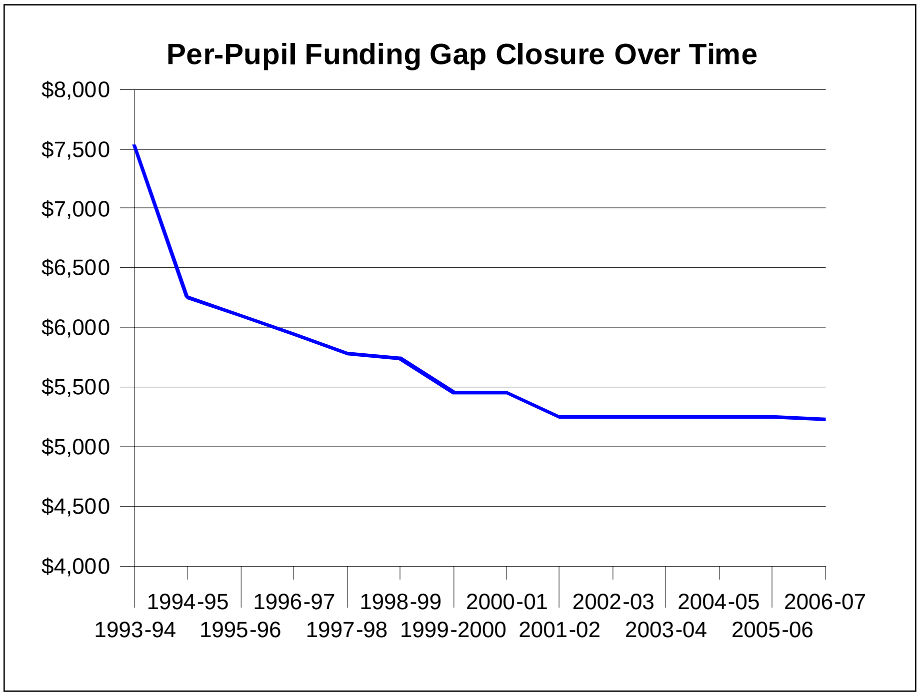
Fiscal Year	Minimum	Basic	Growth in Basic	Maximum[1)]	Equity Gap
1993-94	$2,762	n/a	n/a	$10,294	$7,532
1994-95	4,200	$5,000	n/a	10,454	6,254
1995-96	4,506	5,153	$153	10,607	6,101
1996-97	4,816	5,308	155	10,762	5,946
1997-98	5,124	5,462	154	10,916	5,792
1998-99	5,170	5,462	0	10,916	5,746
1999-2000	5,700	5,700	238	11,154	5,454
2000-01	6,000	6,000	300	11,454	5,454
2001-02	6,500	6,500[2)]	500	11,754	5,254
2002-03[3)]	6,700	6,700	200	11,954	5,254
2003-04[3)]	6,700	6,700	0	11,954	5,254
2004-05	6,700	6,700	0	11,954	5,254
2005-06	6,875	6,875	175	12,129	5,254
2006-07[4)]	7,108	7,108	233	12,339	5,231

1) This maximum is for Bloomfield Hills, the highest per-pupil funded district with a standard-sized pupil population. (Two districts with fewer than 10 pupils have higher per-pupil allowances.)
2) For FY 2001-02, the Basic Foundation Allowance was actually $6,300. However, a $200 per pupil Equity Payment was subsequently built into the base for that year.
3) For FY 2003-04 and FY 2004-05, proration occurred, which did not statutorily reduce the foundation allowance, but which reduced per-pupil funding by approximately $74 each year.
4) For FY 2006-07, the Basic Foundation Allowance is actually $7,085, but a $23 per-pupil equity payment is appropriated, which, by FY 2007-08, is proposed to be built into the base and shrink the gap by $23.

In the Future

Without new equity payments or the adoption of a new funding formula, the funding gap between the highest and lowest foundation allowance districts will not change. Nevertheless, this issue is one that keeps garnering attention. On April 4, 2007, the House Appropriations Subcommittee on School Aid adopted a budget bill for FY 2007-08 that proposes a $100 equity payment for those districts whose per-pupil funding would be less than $7,669. This payment would be on top of a $100 increase proposed in the foundation allowance for all districts. If the equity payment proposal is enacted, it will narrow the equity gap by $100. The Governor has not proposed additional closing of the equity gap, and instead would put more funding ($178 per pupil) into all districts' foundation allowances for FY 2007-08. The timetable for Senate action on the K-12 budget provides for a bill to be reported out of subcommittee in the latter part of May. Whether dollars ultimately will be put toward closing the funding gap depends upon available revenue and the demand on that revenue for other purposes. Figure 2 illustrates the closing of the gap over time, from FY 1993-94 through FY 2006-07, and shows that while the gap started out at $7,532 per pupil, it has closed by $2,301 and, as mentioned above, now stands at $5,231.

Figure 2


Per-Pupil Funding Gap Closure Over Time
$8,000
$7,500
$7,000
$6,500
$6,000
$5,500
$5,000
$4,500
$4,000
1993-94
1994-95
1995-96
1996-97
1997-98
1998-99
1999-2000
2000-01
2001-02
2002-03
2003-04
2004-05
2005-06
2006-07

State Notes

TOPICS OF LEGISLATIVE INTEREST

March/April 2007

Budgetary Savings from State Retirement Systems for FY 2006-07
By Kirk Sanderson, Fiscal Analyst

Introduction

Many changes have been proposed to address the General Fund and School Aid Fund revenue shortfalls in the current fiscal year's budget. One area where there have been efforts to find savings is the State's retirement systems. The State manages four retirement systems on behalf of public employees: the State Employees' Retirement System (SERS), the Michigan Public School Employees' Retirement System (MPSERS), the State Police Retirement System (SPRS), and the Michigan Judges Retirement System. Some changes already have been passed while others are currently under consideration. This article describes the plans that are being implemented and proposed, their impact on the current year's budget situation, and some potential long-term implications.

Mark-to-Market

Five-Year Smoothing Mechanism

The first approach to saving money in the retirement systems is called Mark-to-Market. It is included in Executive Order 2007-3 for SERS and SPRS and is part of a proposal passed by the Senate to create savings in MPSERS for the School Aid Fund. The mark-to-market proposal will revalue a retirement system's assets according to their actual market value as of September 30, 2006, for the purpose of determining the required amount of employer contributions. This is a change from the current method of using a "five-year smoothing" when determining the value of assets.

Under the present system, the annual return on investments is assumed at 8.0%. The difference between that assumed amount and the actual investment return gets spread over a five-year period, i.e., one-fifth of the gain or loss is accounted for in each of the next five fiscal years. The goal of this smoothing process is to reduce volatility in the value of assets and, in turn, the employer contribution rate. It helps protect the rate from the natural fluctuations in the stock market. Another effect is that the smoothed valuation does not reflect the actual value of a system's assets. For example, it produces a value that is lower after a string of years in which returns have been increasing, or that includes one or two previous years of negative returns.

Fiscal Impact of Revaluation

Revaluing a retirement system's assets to their market value as of September 30, 2006, will allow the system to realize gains in the stock market in the time leading up to the end of the last fiscal year. It also eliminates the inclusion of a portion of the negative returns experienced in 2002. This higher value allows for a lower contribution rate required of employers, i.e., the rate needed to raise a certain amount of dollars gets smaller as the value of the assets gets larger.

Mark-to-market was included in Executive Order 2007-3 for SERS, SPRS, and for all community colleges and the seven public universities that participate in MPSERS. These savings, combined with the deferral of certain payments described in the following section, resulted in savings of $99.2 million in General Fund dollars. A similar plan for school districts has passed the Senate and is awaiting action in the House. The mark-to-market portion of the Senate-passed plan would save an estimated $175.6 million for the School Aid Fund.

In addition to the revaluation, this plan resets the five-year smoothing period. Therefore, for the next fiscal year, only one-fifth of any gain or loss from investments this fiscal year will be built into that next year's contribution rate. The rest will be accounted for in each of the following four years, along with a portion of any gains or losses from those years.

Deferred Pension Payments

Overview of Current Contribution Rate Breakdown

The second part of the proposed solution involves postponing a portion of the payments made to the retirement funds. The total rate of contributions paid into each retirement system is the sum of four different rates. This section outlines each of these payments and then describes the payment deferral in Executive Order 2007-3 and the budget plan passed by the Senate.

The first portion of the total contribution rate is called the normal pension cost. This portion of the rate funds the cost of the present value of the projected benefits of each individual included in the actuarial valuation. It is allocated on a level basis over the service of the individual between entry age and assumed exit age. In fiscal year (FY) 2006-07, this rate for the State Employees' Retirement System is 7.67%, out of an original total rate of 30.30%.

The second portion of the contribution is the unfunded accrued liability (UAL) payment. The UAL is the difference between each system's assets and liabilities. The unfunded liability is amortized over a 29-year period for FY 2006-07. This rate includes contributions for payments both on the UAL itself and on accumulated interest. This rate was 7.80% before the changes in Executive Order 2007-3.

The third portion of the payment is the pension reconciliation payment. Employer contributions to each system are in part determined using actuarial assumptions, such as the 8.0% investment return noted earlier. The contribution required to meet these assumptions may end up being more or less than is actually needed to fund the system. As a result, any amount that is greater or less than the assumed level is smoothed over a five-year period in a manner similar to the investment income smoothing. Before Executive Order 2007-03, this reconciliation payment was 2.63%.

The final portion of the contribution rate funds retiree health benefits. This portion of the rate determines employer contributions to cover health benefits for current retirees that are funded on a pay-as-you-go basis during the fiscal year in which the costs are incurred. This rate is 12.20% in FY 2006-07. These four payments add up to the 30.30% total contribution rate, as summarized in Table 1.

Table 1

Original FY 2006-07 Contribution Rates State Employee Retirement System (SERS)	
	Original FY 2006-07 Rate
Normal Cost	7.67%
UAL	7.80%
Reconciliation	2.63%
Insurance	12.20%
Total	30.30%

Deferral of Part of the Contribution Payments

Executive Order 2007-3 calls for a one-time change for FY 2006-07 for SERS and SPRS. It requires payments only for the pension normal cost and the interest payments on the UAL, suspending the remaining payments for the current fiscal year only. As stated above, the payment deferral and the mark-to-market combined will save the General Fund an estimated $99.2 million. The health benefit payments are unaffected.

This deferral will have a small effect on future contribution rates to compensate for the lack of payment this fiscal year. For SERS, beginning in FY 2008-09 the contribution rate will be approximately 0.06 percentage point higher than it would have been if not for the deferral. The system's funded ratio (liabilities divided by assets) also will be approximately 0.2 point lower than it would have been beginning in FY 2007-08.

The Senate has passed a similar proposal that would affect the Michigan Public School Employees' Retirement System. The estimated savings for the School Aid Fund from making an interest-only payment on the UAL for that system are $86.4 million in FY 2006-07. Effects on future contribution rates are likely similar to those in the SERS plan.

Health Sub-Account Savings

Background

The third piece of the General Fund reduction in the Executive Order involves closing the Health Advance Funding Sub-Account (HAFS). The HAFS is an account set up in 2002 to prefund health benefits for members of SERS, and includes a combination of General Fund dollars, State restricted revenue, and Federal funds. During FY 2002-03, however, $58.2 million from the account was transferred to the State's General Fund as part of Executive Order 2002-22 to help offset that fiscal year's revenue shortfall.

The U.S. Department of Health and Human Services (HHS) has objected to the transfer, specifically the use of Federal money for purposes other than retiree benefits. The Federal portion of the transferred money must be repaid. The original amount plus interest totals $15.2 million. According to the repayment request from HHS, repaying the money using General Fund/General Purpose (GF/GP) funds will allow a lower interest rate to be charged than if a different fund source were used. Using General Fund dollars to get this lower rate will save the State $6.8 million.

Impact on FY 2006-07 Budgets

In order to use GF/GP money for the repayment, Executive Order 2007-3 directs $24.0 million from the HAFS to replace an equal amount of GF/GP funding in each department's FY 2006-07 budget. The money will be applied toward the department's contribution into SERS. The $24.0 million will be used almost exclusively for repayments to the Federal government and the State restricted funds that originally paid in the money. The net savings to the General Fund will be much lower. Of the $24.0 million General Fund being taken out of the FY 2006-07 budget, $15.2 million is being used to repay the Federal government. A net $7.1 million is being paid back to the State restricted revenue. As a result, the closing of the HAFS will save $1.7 million in the General Fund for FY 2006-07.

Potential Long-Term Impacts

The changes to the retirement systems described above are intended as one-time fixes to address revenue shortfalls in the current year's budget. If these plans are all enacted as described, they could produce savings of $100.9 million for the General Fund and $262.0 million for the School Aid Fund. The impacts of these changes on future contribution rates should be minimal.

Revaluing the assets will cause contribution rates to be lower in the short term than they otherwise would have been. This is because the actual value of each system's assets is higher than their five-year average. Revaluing the assets allows for the use of each system's true value instead of the "smoothed" value, which may better reflect the ability to pay out benefits in the future. Absent the revaluation, the rate necessary to get the required amount of contributions would be based on a value of assets that is *less* than what it actually is.

As described above, the impact of the interest-only payments on each system's UAL also will have minimal impact on future rates. Because the deferred payment can be spread over a number of years, the increase each year is expected to be less than 0.1 percentage point.

State Notes

TOPICS OF LEGISLATIVE INTEREST

March/April 2007

Tagging Cattle: Mandatory RFID Tags in Michigan
By Curtis Walker, Legislative Analyst

Introduction

On March 1, 2007, new State cattle tagging regulations went into effect, requiring cattle owners in Michigan to place radio frequency identification (RFID) tags on all cattle before they leave their place of origin. The required tags bear a unique 15-digit identification number, which can be read by electronic readers at close range. The program is similar to certain Federal guidelines issued under the National Animal Identification System, and is part of the State's ongoing bovine tuberculosis (TB) eradication project. Supporters of the program also hope that the identification system will inspire greater confidence in Michigan beef and reopen lucrative export markets in Japan and elsewhere. Many farmers, on the other hand, have complained vigorously that the requirement is an invasion of their privacy and an unnecessary expense, and will be no more effective in reducing the threat of disease or food-borne illness than current policies are. This article explores the history of and the debate over the new cattle tagging requirements in Michigan.

Tagging Requirement

The Animal Industry Act authorizes the Michigan Department of Agriculture (MDA) Director to develop, implement, and enforce scientifically based movement restrictions and other requirements, including official identification of animals for movement between or within zones established to control the spread of bovine TB in the State (MCL 287.709(8)). Before these requirements are issued, the MDA must follow certain procedures, which include publishing the proposed requirements in newspapers, and placing them on the Agriculture Commission agenda. Pursuant to this process, in December 2005, the Agriculture Commission approved a proposed zoning order to require, among other things, that all cattle be identified with an official RFID ear tag before being moved from premises in Michigan, unless exempted by the MDA director. The order was approved by the MDA Director on February 9, 2007.

Historically, cattle in Michigan have been marked with ear tags that allow farmers to identify individual animals and to distinguish their animals from those owned by others. The traditional ear tags are plastic or metal, bearing an identification number or sequence of letters that can be read visually. The new requirement replaces those tags with RFID tags that can be read by a radio frequency scanner. The scanners are effective from a maximum distance of about six feet, depending on the equipment used.

The cost is about $2 per tag, according to the MDA, and a hand applicator costs about $20. (The MDA notes that the applicators previously used to attach tags may not be used for the new RFID tags, because the new tags have a smaller pin, and the older applicators will destroy the tamper-evident features of the tag.)

In order to obtain the RFID tags, a livestock facility must register with the MDA and receive a premises number. Once registered, the owner may purchase tags through the MDA or authorized suppliers. Each tag is assigned a 15-digit identification number, which contains a three-digit country code and is tied to the premises identification number, allowing it to be traced quickly to the animal's place of origin. Previously, RFID tags were issued in a portion of the State (as discussed below). These tags had a different numbering system, which was not standardized among the various suppliers. The new tagging system is designed to eliminate confusion and ease the establishment of a comprehensive database of registered animals in Michigan.

The information in the database will allow officials, if an animal is found to be infected with a virulent disease or is determined to be the source of a food-borne illness, to isolate the source quickly and effectively, potentially saving lives and limiting the spread of the disease. A rapid response also may limit the economic damage of an outbreak. In these ways, proponents of the new requirements say that the program will protect cattle owners and strengthen the cattle industry in the State.

The program will have other benefits as well, according to proponents. These include the ability of cattle owners to track their herds efficiently and easily, with a high degree of accuracy. The RFID scanners may be set up on the side of a cattle chute so that the ID numbers are recorded as the cattle move through, and that information can be downloaded directly into the producer's computer, with the proper equipment and software. The recorded information can be used to track immunizations or other particulars for each animal.

The ability to scan the numbers electronically also will prevent input errors and save labor. For small operations, less expensive handheld readers that perform similar functions are available, or the tags can be read visually if the owner prefers.

Although organizations such as the Michigan Cattlemen's Association and the Michigan Milk Producer's Association have expressed support for the program, many farmers have strong objections, for a number of reasons. Some have expressed distrust of governmental intervention and fear the consequences of a statewide database that could track all of the cattle statewide. These individuals claim that the program is an invasion of their privacy and an infringement on their right to conduct business and raise cattle as they see fit.

Others may fear the potentially devastating consequences if an infected animal is traced back to their herd, possibly requiring the destruction of a large number of animals and bringing significant financial hardship.

In addition, many small farmers have voiced concern that the program will benefit only large producers, while placing significant burdens on those who own smaller herds. They point out that the price of implementing the program could be extensive, far beyond the $2 per cow required to purchase the tag. Factoring in the cost of electronic readers, tag installers, software, and labor required to install the tags, collect data, and manage the information being collected, the program could be very expensive, particularly for small farmers. Some believe that the added expense and inconvenience could drive some small operators out of business.

National Animal Identification System

Despite the concerns expressed by some cattle owners, the MDA has gone ahead with the program, which is similar to the guidelines released in November 2006 for the implementation of the National Animal Identification System, or NAIS. The Federal program is voluntary, but establishes standards for identifying and tracking cattle from their place of origin to the processing plant. The stated purpose of NAIS is to allow public health officials to respond quickly to a disease outbreak or other emergency linked to livestock in the United States. The system has three components: facilities registration, animal identification, and traceability through a centralized database. The Michigan animal ID program follows a similar structure, although it is more limited in scope: NAIS includes guidelines for tracking all livestock and poultry, while the Michigan requirements are restricted to cattle. To date, Michigan is the only state to require RFID tags for cattle, although some other states require premises registration for livestock owners.

Bovine Tuberculosis Eradication

According to the MDA, the decision to implement the RFID requirement was driven in part by Michigan's ongoing effort to eradicate bovine tuberculosis in the State. Bovine TB is a virulent disease that is transferable to most mammals, including humans (although the risk of a human contracting bovine TB is extremely low). The United States Department of Agriculture has made eradication of the disease its policy, through the National Bovine Tuberculosis Eradication Program. Michigan is one of only three states in the country (along with Texas and New Mexico) that have failed to achieve bovine TB-free status under the national program.

Although the disease was present in Michigan cattle going back to the mid-1900s, it was thought to have been eliminated from the 1970s until 1996, when a white-tailed deer shot by a hunter was found to be infected with the disease. Since that time, additional deer, as well as cattle, have tested positive for bovine TB.

The infected animals have been confined to several counties in the northeastern part of the Lower Peninsula. Since the infection was limited to that portion of the State, Michigan applied for and was granted split-state status, designating the area where the infection was found as a Modified Accredited Zone, or MAZ (meaning that bovine TB is present at a rate of less than 0.1%). Under the bovine TB eradication program, cattle in the MAZ are subject to movement restrictions, and may not be sold or transferred without a whole herd test for bovine TB.

The split-state status allows cattle in other parts of the State to be transported more freely without movement permits or whole herd testing. Since this status was granted, the Upper Peninsula has been certified as bovine TB-free, and the rest of the Lower Peninsula is designated as Modified Accredited Advanced (meaning that bovine TB is present at a rate of less than 0.01%).

The MDA has made RFID tags available to cattle owners since November 2001, as part of a pilot program to help contain the disease. Those tags previously were supplied by the MDA free of charge, and the State was responsible for verifying that owners complied with the required testing and obtained appropriate permits before moving animals within or out of the MAZ. Proponents of the statewide mandatory RFID cattle tagging program believe that it will enable better tracking of the disease, allowing Michigan to eliminate the TB problem and gain TB-free status throughout the State.

Those opposed to the new regulations complain that the cattle owners now will be required to pay for the cost of the tags. Critics also have said that because bovine TB exists in the wild deer herd, the program will do little to eradicate the disease, which may be reintroduced to cattle from infected deer.

Concerns of Owners

Of the 15,000 cattle facilities in Michigan, about two thirds of those have fewer than 50 head of cattle, according to data from the MDA. Many of the outspoken critics of the RFID program are small farmers who fear that the new requirement will make them uncompetitive with large-scale operations, which can better absorb the costs associated with purchasing the tags, readers, software, and other equipment needed to implement the electronic identification system. The MDA and others have said that a producer is required to install only the tags, not readers or other equipment. The identification number is printed on each tag and may be read visually, eliminating the need for expensive equipment. Those who have religious objections to the use of electronic tags could take a similar approach, installing and reading the tags in the same manner as the visual ear tags are installed and read. Alternatively, since the requirement applies to cattle only when they leave their place of origin, producers can opt to have their cattle tagged immediately before being sold or being transported to the processing facility.

Some cattle owners, including members of the Amish community, have expressed objections not only to the electronic ID tags, but to the prospect of having their premises tracked in a national database, particularly a computer database. Although not opposed to the concept of eradicating bovine TB, they feel that they should not be compelled to comply with a program that would violate their religious beliefs. It has been suggested that the State could make some accommodation, such as allowing cattle to be tagged at the processing facility. That would enable the farmer to remove himself or herself from the process, although it is unclear whether this approach would resolve the issue entirely, since it would not eliminate the requirement for each facility to be assigned a premises identification number.

Another frequent complaint is that the RFID program could be expanded to include other animals such as swine or poultry. Chicken or turkey farms tend to have many more animals than a typical dairy or beef cattle operation does, and the cost and inconvenience of tagging a large number of animals could have significant negative impacts on the industry. Currently, the program is limited to cattle, because of the great concern about bovine TB, mad cow disease, and other ailments that could infect herds in the United States. Avian flu, however, is an equal concern among poultry farmers, and could have similar devastating effects if it took hold in chicken farms in this country. Therefore, critics suggest, there will inevitably be efforts to extend the program to all domesticated animals.

Ultimately, farmers warn, the costs will have to be passed on to consumers who will end up paying higher prices for their beef. They argue that limiting the RFID requirement to beef will place cattle producers at a competitive disadvantage to poultry or other meat producers. If the program is expanded to include other animals, the cost of meat in general is likely to rise to cover the cost of complying with the requirement.

Conclusion

As part of Michigan's continuing effort to eradicate bovine TB, the new RFID regulations will provide more complete and accurate information on cattle herds throughout the State, allowing a rapid response in case of an emergency. A centralized, searchable database will enable investigators to identify other animals that may be contaminated, potentially limiting the extent of the damage. The program could improve the safety of Michigan beef, and allow the entire State to attain free certified status, opening up new markets and easing the transportation requirements that currently apply to farmers in the MAZ.

Those benefits come with a cost, according to critics. The RFID tags are more expensive than the traditional ear tags, and may not be reused. Additional equipment such as radio frequency readers and software could drive the price up even further. Critics also believe that the program is an invasion of privacy, amounting to an unprecedented governmental intrusion into the affairs of cattle ranchers, in order to implement a program that may or may not prove to be effective. Others say that the privacy concerns are overblown, and that the costs of implementation will not be as great as some fear.

In short, the debate is about whether the potential benefits outweigh the costs of the program. If the program is effective at preventing disease and improving the efficiency of animal traceability in the State, it could be worth the cost. Since Michigan is the first state in the country to implement an RFID requirement, many other states likely will be watching closely to determine the effectiveness of the program.