Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:

DISCUSSION ITEM

For Meeting of March 29, 2012

UPDATE ON THE UNIVERSITY'S 2012-13 BUDGET AND PROPOSED STATEWIDE TAX INITIATIVES

EXECUTIVE SUMMARY

The University of California is at a crossroads. UC's State support has eroded dramatically over time; the reduction in State support for 2011-12 alone totals $750 million in permanent reductions. However, there are developments that offer hope for some degree of fiscal stability.

This item summarizes the dire fiscal situation the University faces and describes the provisions in the Governor's proposed 2012-13 budget. At the March Board meeting, the Board also will be updated on potential revenue-enhancing November ballot initiatives in circulation. The context around these statewide proposals was in flux at the time this item was prepared.

BACKGROUND

The State of the University of California in 2012

In the storied 143-year history of the University of California, incoming students have never faced a situation quite like the one they will confront in the fall of 2012:

- At UC Riverside, they will walk onto a campus where enrollment has grown in the last three years by nearly 3,000 students – many of them the first in their families ever to attend college – while at the same time the number of faculty has been reduced by five percent. The result: class sizes have grown by 33 percent. Introductory physics classes that used to average 95 students have exploded in size in three years to 573 students.
- At UC Davis, students will find an acclaimed medical center that has eliminated all State supplemental support for clinical care. Just as the campus' athletic program had begun to mature, four sports had to be eliminated to help meet the need to make $106.5 million in cuts in four years.
- At UC Santa Cruz, students will be provided with 84 fewer course offerings and their class sizes will have spiked 33 percent. The student-faculty ratio has exploded by nearly 15 percent, and the campus lacks funding for 125 faculty FTE – 14 percent of its faculty positions. Yet for all the cuts, the campus still faces a daunting $38 million budget gap.

- UC Santa Barbara has over 1,000 more students than it did three years ago, but the number of staff has declined by 450 (nearly 11 percent) during that time, and the faculty has remained the same size. The results are fewer student services, larger classes and discussion sections, and reductions and eliminations in many programs.
- At UC Berkeley, despite its more mature capacity to raise private funds and attract non-resident students, the campus forecasts that – even with stable fee increases – it could face at least a $200 million budget gap within six years due to exploding pension contribution costs.
- And across the system, pension costs alone will rise to $1.8 billion annually in the next five years – an expense that campuses did not have to shoulder as recently as three years ago. If there is no increase in either State funds or tuition during this time, campuses will have to find the equivalent of funding for 7,000 staff or 3,900 faculty to fund this expense alone.

Similar conditions exist on every other UC campus – from UCLA and San Diego to Merced, Irvine and Santa Barbara. The University faces an unprecedented threat to academic quality.

Pillars of Support

The strength and quality of the University rest on four pillars:

- A stable funding relationship with the State of California;
- Wise stewardship of the University's financial resources, including maximizing efficiencies from the power of a system unrivaled anywhere in the world by its size and academic influence;
- Leveraging the other strengths of the University, including its medical centers and research enterprise; and
- Predictable funding from other financial sources, including, since 1968, fees from student enrollment.

Yet the University of California of 2012, despite its current strengths and contributions, is at a crossroads, with two of its four pillars proving increasingly unable to sustain the University's mission and the continuing quality of its education and research.

The Fraying Relationship with the State of California

The first pillar – State support – has eroded in ways unimaginable to previous generations of Californians. If the narrative of the middle part of the 20th century was California building the best public research university in the world under Governor Pat Brown, the narrative of the early part of the 21st century is California's disinvestment in public higher education.

While the University has been historically buffeted by the ebbs and flows of California's economic and fiscal fortunes, a more steady and consistent decline began after passage of Proposition 13 and accelerated in the early 1990s. After an uptick in the University's fortunes with the infusion of one-time State monies in the late 1990s, the State's growing structural deficit and its mounting obligations to fund corrections, health and welfare, debt service, and rising pension and post-employment benefit costs have cemented the State's unreliability as a funding partner.

The result is that over the past 20 years, UC has had 11 years of cuts from the State, including seven in the last decade.

The impact has been dramatic:

- The State's contribution to UC, on a per-student basis, has declined by 60 percent in inflation-adjusted dollars since 1990. As a result, *for the first time in our history, the amount the University raises from tuition and fees exceeds the amount it receives from the State.* Students now bear roughly 49 percent of the cost of education, whereas 20 years ago, their share was only about 13 percent.
- UC today relies on the same absolute level of funding as in 1997-98, *even though today it educates 73,000 more students, operates one additional undergraduate campus, and offers scores of new programs and degrees.*
- The overall amount spent per student from UC's core sources of funding – student fees, UC general funds and State General Funds – has declined by nearly 20 percent in the past 20 years. So, while tuition has increased as the State has disinvested, *the rate of increase has not kept pace with the decline in State spending.*

The current year vividly demonstrates this trend. For fiscal year 2011-12, the State cut funding for the University of California by $750 million – $650 million in the budget act, and $100 million in a mid-year cut – which represents a 25 percent reduction in our State allocation in one year. In addition to this, UC faces over $300 million in mandatory cost increases, over one-half of which represent contributions to the UC retirement system, an expense that the State directly covers for the California State University and community college employees, but not UC employees.

This disinvestment by the State comes in the face of dramatically rising mandatory costs to fund UC's pension system and other benefits. Even after cutting the costs of these programs prospectively, the employer costs of contributions will rise by at least $180 million annually over the next six years, rising to close to $1.8 billion in annual costs by 2016-17. These are expenses that the University did not have to bear just two years ago, and they pose increased burdens on UC campuses and medical centers.

Working Smarter With Less

At critical moments, all great public institutions are asked to do more with less. Even in times of generous State support, UC has managed only by strong and smart fiscal stewardship.

Currently, the University is engaged in the Working Smarter initiative, which is designed to use the power of UC's size to fundamentally change the way the University does business through a wide range of administrative efficiency projects.

Most of these efforts are focused on our campuses; in addition, many innovative regional initiatives are taking place where campuses are combining services for economies of scale. For instance:

- Berkeley has a comprehensive program – entitled Operational Excellence – to look at service improvement and cost savings across a spectrum ranging from procurement practices to energy efficiency efforts to organizational restructuring.
- Most campuses have similar efforts under way, although several are further along, driven by financial necessity years ago. Santa Cruz, for example, went to one common service center for human resources, finance and other business transactions nearly ten years ago.
- UCLA provides the financial system for Merced and for the Office of the President.
- Berkeley and San Francisco recently consolidated their procurement offices, and a consortium of our campuses is working towards a common human resources system as well.

There are also systemwide efforts, which involve all the campuses and are coordinated at the Office of the President. The University combines these under the general rubric of the Working Smarter initiative, for which UC has set an ambitious target of $500 million in positive fiscal impact over five years.

There are close to 40 different initiatives, but they can be grouped under several broad categories:

- *Financial management:* UC has already launched new investment portfolios to enhance its asset management and it is moving towards a centralized capital bank on the debt side that should offer tens of millions of dollars in either reduced costs or higher earnings.
- *Risk management/insurance:* UC has several opportunities to pool its risk and insurance programs more effectively, yielding better coverage and lower costs. One example last year is the initiation of one common student health insurance program for all undergraduates and graduate students in the University, a program that will save $8 million in premiums this year and provide a higher level of benefits for UC students.
- *Energy strategies:* All UC campuses are taking advantage of partnerships with the investor-owned utility companies to retrofit buildings on campus for energy savings, but the University is also looking at large-scale opportunities to become either a wholesale energy provider or develop large-scale alternative energy projects. These efforts will enable UC to control its costs more directly and also meet the ambitious climate change goals every campus has adopted.
- *Enterprise systems:* UC has set as a broad goal that the whole University would share one common administrative platform in the next eight to ten years. The University's first effort in this direction is in payroll – namely, to develop one common payroll system to replace the 11 that currently exist for all our campuses and medical centers. UC just last year signed contracts and is in the phase of developing common business practices and definitions to dovetail with the common technology platform.

Leveraging the Strength of the University's Total Enterprise

The University enjoys a huge advantage in that its overall $22 billion enterprise remains as strong as it is diverse.

The research enterprise, for example, brings in $4.9 billion in revenues and in 2009 spawned 1,500 new inventions and 47 startup companies, which continue to drive the California economy.

The UC Commission on the Future, established jointly by the Chairman of the Board and the President to identify additional sources of revenue, identified numerous initiatives to take advantage of the University's size and resources.

One opportunity to increase revenues from research is to increase research cost recovery, where UC currently is at a disadvantage relative to its private university competitors. The University's goal is to increase the costs it recovers from the federal government by $30 million annually through a two-pronged approach – first, by increasing recovery on campuses through the granting of fewer waivers and more direct charges; and second, by increasing the negotiated rates with the federal government to a level consistent with that which the private universities already receive.

Another potential source of additional research revenue is the acceleration of technology transfer, which currently represents about one percent of UC's total revenue for research and teaching. While a potentially long and risky strategy, technology transfer licensing practices have the potential of creating a stable and expanding royalty base.

Another area of strength is in private philanthropy. In the last fiscal year, UC campuses raised over $1.6 billion in private support – the 11th straight year over $1 billion. The University is investing new resources in expanding its fundraising efforts, particularly in programs focused on increasing privately-funded scholarships.

Historically, private support to UC has been predominantly for current use (versus endowments) and often restricted for fairly specific purposes. This was due, in part, to the State of California providing strong ongoing core support similar to an endowment at a private University. As State funding has declined, the model for philanthropic support needs to change to provide greater flexibility as well as funding for areas that traditionally did not rely on gift funds.

The University has the ability to raise more flexible support and has proven models that both honor the intent of donors and alleviate core budget needs. The Hewlett chairs at Berkeley are the best example of this, but there are other opportunities to support faculty, graduate students, and undergraduate students.

Other efforts, such as increasing the number of nonresident students and developing more self-supporting academic programs, are already yielding new revenues for our campuses. A final area of growth and strength has been in UC medical centers and their clinical practices. Revenues from the medical centers are already a major source of revenue for medical education in the UC system – over $400 million. In fact, UC medical centers provide more revenue for medical education than does the State of California.

Student Fees: The Fourth Pillar

But even with wise stewardship of the University's financial resources and the strength of its other enterprises, the University must rely on a fourth pillar – student fees. Historically, the University adhered to the Master Plan idea of a tuition-free research institution; it long resisted reliance on this pillar, and has done so only because it has run out of other options.

The long-term decline and volatility of State funding has created similar uncertainty and volatility in the University's implementation of fee increases.

The whipsaw has been wrenching for our students and their families. Over the last 20 years UC students witnessed:

- eight years with no tuition increase or actually a tuition decrease;
- eight years where the increase was ten percent or higher; and
- only four years where it fell between five and eight percent, which, after adjusting for return-to-aid, represents the approximate average rate of inflation for higher education.

Depending on when a student started at one of the UC campuses, he or she could have had flat tuition for four years or have seen it doubled during a separate four-year period.

The University has worked hard to cushion these blows to maintain financial accessibility for students at all income levels. It is remarkable that about 40 percent of all UC undergraduates receive Pell Grants, whose recipients come from families with an annual household income of $50,000 or less. To contextualize this percentage, consider this: four UC campuses – Berkeley, Davis, UCLA and San Diego – each enroll more Pell Grant recipients than the entire Ivy League combined. This track record in providing access to low-income students would not be possible without the combination of a strong State Cal Grant program and the University's practice of using a portion of all fee increase revenue for aid to financially needy students.

To provide affordability for UC's middle-income families, UC has maintained in-state tuition and fees at a level that puts UC near the middle of its major public comparator institutions. In addition, UC's Blue and Gold Opportunity Plan ensures that 100 percent of in-state tuition and fees is covered by scholarship or grant for eligible financially needy California students who come from a family with an annual household income of $80,000 or less. These students do not pay one dollar in systemwide tuition or fees. UC also covered the 2011-12 fee increase of $1,890 for needy families earning up to $120,000 per year. In fact, overall, the University estimates that the most recent tuition increase was covered for 55 percent of all UC students and that net tuition per student last year was only $4,400 – among the lowest of its comparator institutions.

Nonetheless, the volatility in fees is not fair to anyone – not to students, not to their families, and not to campuses, which are trying to engage in long-term planning during times of steadily increasing fixed costs.

The University of California Cannot Rest on Only Two Pillars

For UC to remain true to President Daniel Coit Gilman's promise in the 1800s to be the "University of this State" – to help fuel its economy and provide opportunities for its continually changing population and its needs – the University must strengthen its pillars of support.

First, the University needs a consistent and reliable funding agreement with the State. The Governor's proposal for a multi-year funding plan offers real promise, both in providing the University a predictable source of funding for its pension costs and also in giving it flexibility in restructuring its debt and, thus, in meeting its other obligations.

Second, it needs a student tuition plan that provides the campuses with money they need both to begin the rebuilding process so necessary to prevent a deterioration in quality, as well as to begin planning for the future. As crucially, the plan must provide predictability for families who suffer more from the volatility in fees than they do from modest and predictable increases for which they can plan.

THE UNIVERSITY'S 2012-13 BUDGET

The ongoing structural deficit at the State level caused major budget reductions during the first three years of the 2000s, and, along with the worldwide recession, has caused far more draconian reductions over the last four years. As noted earlier, the reduction in UC's State support for 2011-12 alone totals $750 million in permanent reductions; in addition, the University faces $362.5 million in unfunded mandatory cost increases, which include contributions to the University's retirement program. Between unfunded mandatory cost increases and massive reductions in State funding, in 2011-12 the University is struggling to resolve a budget gap of more than $1 billion. This is in addition to several years of budget reductions and unfunded cost increases prior to 2011-12.

The University has been forced to rely on student tuition and fees to partially fill this budget gap. In November 2010, the Regents approved an eight percent increase in mandatory systemwide charges for implementation in 2011-12. After the State reduced UC's funding by the additional $150 million in June 2011, the Regents approved an additional 9.6 percent increase in mandatory systemwide charges, effective beginning fall quarter/semester 2011, to backfill for the lost $150 million.

However, these tuition and fee increases have made up only a portion – $265.8 million, or 24 percent – of UC's budget gap of approximately $1.1 billion. Massive budget reductions over multiple years have severely destabilized campus budgets. The $750 million budget reduction within a single year is unprecedented and will take several years for campuses to address on a permanent basis.

Campuses have reached a point where further deterioration in UC's support base will require dismantling of critical programs that are fundamental to the character of this great public research university. It has taken decades of investment to build one of the greatest universities in the world, public or private. Once lost, however, excellence is not easily regained. As Chancellor Drake noted in an earlier budget discussion, a redwood tree cannot grow back overnight. The campuses cannot absorb additional budget reductions, and they cannot sustain the current severely diminished funding levels without sacrificing academic quality.

While the 2011-12 fiscal year is perhaps the worst in the University's history, there are promising developments. In his budget for 2012-13, Governor Brown proposed several changes that, if implemented, would positively affect UC, both in 2012-13 and beyond. On the downside, the Governor also proposed a change to the Cal Grant program that would result in a loss of revenue to UC undergraduates. Information about the Governor's proposals and how they would affect UC is shown in Display 1.

DISPLAY 1: Features of Governor's Proposed Budget for 2012-13

Adjustments to UC's Base Budget	• The Governor proposes no further cuts to UC in 2012-13. • The Governor's Budget also includes an augmentation of $90 million toward the State's share of employer contributions to the University's retirement program. This is a major step forward in terms of securing the State's participation in employer contributions for UC employees – support which is fully and automatically provided for employees of California's other two higher education segments. • The Budget also proposes to remove various set-asides for specific programs and purposes, e.g., the Drew Medical Program, to provide UC with greater flexibility to manage its 2011-12 budget reduction. • The Budget proposes to shift appropriations for general obligation and lease revenue debt service for capital improvement projects into UC's budget.
Long-Term Plan	• The Budget describes the Administration's desire to establish a long-term plan for higher education with several components, such as moderate tuition and fee increases. • Also under the plan as described in the Governor's Budget, the State would increase its General Fund contribution to UC (and CSU) by a minimum amount each year from 2013-14 through 2015-16, contingent on the passage of the Governor's tax initiative. • General Fund augmentations would be contingent on UC meeting accountability metrics related to student success (e.g., graduation rates, time to completion, etc.).
Ballot Initiative	• The Governor's Budget assumes the passage of the Governor's proposed tax initiative at the November election. More information on the various ballot initiatives will be provided at the March Board meeting.
Trigger Cut	• If the Governor's tax initiative does not pass in November, the Governor proposes $5.4 billion in cuts affecting education and public safety. • The trigger cut for UC would total $200 million, effective during the 2012-13 budget year.
Changes to Cal Grant Program	• The Governor's Budget proposes to raise the program's minimum grade point average (GPA) requirements for all applicants – i.e., raising the Cal Grant A GPA requirement from 3.0 to 3.25 and the Cal Grant B GPA requirement from 2.0 to 2.75. • These proposed increases would result in an estimated loss of about $20 million for UC undergraduates in 2012-13, growing to $25 million per year over time as more cohorts are affected.

UC leadership has been engaged in discussions with both the Governor and the Department of Finance on the terms of the multi-year funding agreement proposed by the Governor. *An update about these discussions will be provided to the Regents at the March Board meeting.*

It is important to note that success of any multi-year funding agreement would require legislative endorsement of the agreement as well.

The Governor has indicated that a multi-year funding agreement would be contingent on the passage of the Governor's revenue-enhancing initiative on the 2012 ballot. And if the Governor's initiative does not pass, UC is slated to receive a mid-year cut of $200 million in 2012-13.

REVENUE INITIATIVES

The combined effects of the State's ongoing structural deficit and the "great recession" have crippled California's ability to address pressing financial needs of the State, including those of the University of California. The Legislature has failed in several attempts to enact tax increases to address the imbalance between revenues and funding need; therefore, several ballot initiatives have been proposed that would allow the voters to decide the issue in the November general election. Some of these initiatives would generate revenues that could potentially benefit the University but would not be guaranteed for higher education.

Several statewide ballot initiatives seeking to increase State revenues to help fund State programs have been cleared for circulation by the Attorney General, and, if certified, may appear on the November 2012 general election ballot. Two are of particular interest to UC:

- *The Schools and Local Public Safety Protection Act of 2012 – version 2 (Secretary of State no. 1554, Attorney General no. 12-0001),* hereafter referred to as "Governor Brown's Initiative"; and
- *The California Funding Restoration Act of 2012 (Secretary of State no. 1565, Attorney General no. 11-0091),* hereafter referred to as the "Millionaires Tax Initiative."[1]

Please note that at the time this item was written, a new revenue-enhancing ballot initiative representing agreement on a compromise between Governor Brown's Initiative and the Millionaires Tax Initiative had just been reached. The new initiative has not been cleared for circulation by the Attorney General nor was its language available at the time this item was written. At the March Board meeting, the Regents will be presented with the most up-to-date information available at that time.

[1] The Attorney General's official title for the measure is "Tax to Fund Education, Preschools, and Child Care."