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Office of the President

TO MEMBERS OF THE FINANCE AND CAPITAL STRATEGIES COMMITTEE:

DISCUSSION ITEM

For Meeting of September 13, 2017

PRELIMINARY DISCUSSION OF THE UNIVERSITY'S 2018-19 BUDGET

EXECUTIVE SUMMARY

Executive Vice President Brostrom will provide a preliminary overview of the development of the University's 2018-19 budget. The budget will be developed within the context of the long-term funding framework agreed upon by the Governor and the University, which has served as the foundation for University-wide budget plans in recent years; the unprecedented levels of enrollment growth among California resident undergraduates over the past two years; and provisions of the Budget Act of 2017.

The budget plan will address expenditures for mandatory cost increases, enrollment growth, and other high-priority areas, such as sustaining the University's investments in academic quality and deferred maintenance.

It is expected that UC will receive an increase of between three and four percent in State support for the University's base budget. The University is exploring additional funding options, including new revenue associated with asset management strategies, increases in unrestricted gift revenue, student tuition and fees, and other possible sources of revenue, consistent with the long-term funding framework.

A comprehensive budget plan for 2018-19 will be presented to the Board for approval at the November 2017 meeting.

BACKGROUND

The University's core funds budget – the funds used to support its basic educational mission – consists of State General Funds, revenue from mandatory systemwide tuition and fees, and UC General Funds (which include Nonresident Supplemental Tuition, portions of indirect cost recovery, application fee revenue, and a variety of other revenue sources). Totaling over $8 billion in 2017-18, core funds comprise only about one-fourth of the University's overall expenditures; however, they support the operational infrastructure needed for the success of other programs in the $33 billion enterprise, such as medical centers and organized research.

Development of the 2018-19 budget plan will take into account various factors that affect the University's ability to continue to provide extraordinary levels of access, affordability, and excellence to future generations of students. Specifically, the plan will reflect elements of the long-term funding framework agreed upon by the Governor and the University; the opportunities and challenges created by the unprecedented growth in California resident undergraduate enrollment that has occurred over the past two years, resulting in the all-time high enrollment of California undergraduates at every UC campus; and the Budget Act of 2017, which contains provisions that modify the University's internal allocation of resources, sets expectations regarding enrollment growth in 2018-19, and calls upon the University to fund that enrollment growth using current resources. Each of these considerations is described in greater detail below.

The Long-Term Funding Framework between the Governor and UC

The long-term funding framework established between the Governor and the University, which was endorsed by the Regents in May 2015, has provided welcome stability in State support for UC students. Key elements of the framework include the following:

- State support for the University's permanent base budget will increase by four percent annually over the term of the agreement through 2018-19.

- The University will receive Proposition 2 debt repayment funds of $436 million in one-time funding over three years to help address the unfunded liability associated with the University of California Retirement Plan (UCRP).

- The Student Services Fee may increase by five percent annually, with one-half of the new revenue (net of financial aid) to be used to provide enhanced student mental health services.

- The framework permits moderate increases in Nonresident Supplemental Tuition.

- Any tuition adjustment proposed for 2017-18 or later years would be generally pegged to economic indicators that reflect cost increases in the broader economy.

Under the framework, the University committed to a number of reforms that have the potential, over time, to improve student success, expand the University's capacity to serve students, and reduce elements of the University's cost structure. These include:

- an enhanced commitment to the transfer function, reflected in both enrollment goals and efforts to clarify and streamline the transfer function;

- innovations to support student progress and improve time-to-degree, such as reviewing the number of undergraduate major units required for graduation across the system, identifying three-year degree pathways, and piloting alternative pricing models in summer sessions;

- continued development of online undergraduate courses, with funding priority for bottleneck courses;

- supporting the innovative use of data to identify students at risk, to better assess costs of instruction, and to support student learning; and

- developing new options for benefits under UCRP for future hires that incorporate the pensionable salary cap reflected in State's Public Employees' Pension Reform Act (PEPRA).

The stable funding provided by the framework agreement has allowed UC to meet its most pressing budgetary needs and has provided campuses with greater predictability in their funding projections. Many reforms called for under the framework will improve students' educational opportunities and improve student success.

Three aspects of the framework have a direct bearing on the University's budget plan for 2018-19.

- *Adjustment to the University's base budget.* The Governor's May Revise budget proposal indicated that maintaining the base budget adjustment of four percent for the University in 2018-19 may not be possible in light of State revenue projections and other funding commitments. The proposal suggested that base budget adjustments for both UC and the California State University could be as low as three percent. For UC, the difference between a three percent adjustment and a four percent adjustment is approximately $34 million for 2018-19.

- *Funding for UCRP.* The $436 million of one-time State support for UCRP allowed the University to make critical progress towards addressing the funded status of the plan beyond what would have been possible through employer and employee contributions alone. The framework does not, however, provide State funding for UCRP beyond 2017-18. As part of the University's long-term effort to continuously improve the plan's funded status, the Regents approved an increase in the employer contribution rate from 14 percent to 15 percent in 2018-19. Covering this increase is expected to require additional contributions in excess of $30 million from core funds in 2018-19.

- *Progress on programmatic aspects of the framework.* The University has fully implemented nearly all of the programmatic reforms specified by the framework. The State's desire for greater progress in some areas is reflected in a provision of the Budget Act of 2017 that makes $50 million of the University's 2017-18 State appropriation contingent on certain outcomes. These are discussed more completely under *The Budget Act of 2017*, below.

Recent California Resident Enrollment Growth

The University, with the support of the State, has achieved an extraordinary level of enrollment growth in recent years. The growth in total enrollment of California resident undergraduates between fall 2015 and fall 2016, for example, was the largest one-year increase since the end of the Second World War. This expanded access has benefited both California high school graduates and California Community College students, who applied to – and enrolled at – the University in record numbers.

This growth, while a boon to California students seeking to enroll at UC, has created challenges for campuses. The challenges have resulted in part because actual enrollment growth far exceeded the funded enrollment growth targets specified in the Budget Acts of 2015 and 2016. Respectively, those acts provided State support for enrollment growth of 5,000 students in 2016-17 over 2014-15 levels, and enrollment growth of 2,500 additional students in 2017-18 compared to 2016-17.

Both Budget Acts provided funding on an all-or-nothing basis: UC was to receive no enrollment growth funding if it fell short of the specified goal, yet would receive no additional funding for enrolling students in excess of the goal. In order to avoid the prospect of receiving no State funds for enrollment growth, campuses made the rational decision to err high when trying to achieve their enrollment growth targets. This tendency, combined with the inherently unpredictable nature of enrollment management, resulted in estimated enrollment growth of approximately 10,400 students between 2014-15 and 2017-18, or 2,900 more than the 7,500 students for which funding was provided in the Budget Acts of 2015 and 2016. In lieu of State support to subsidize the cost of educating these students, campuses must instead divert funds from other pressing budgetary needs to accommodate the larger-than-expected enrollment of California resident undergraduates.

The Budget Act of 2017

Funding provided to the University under the Budget Act of 2017 was generally consistent with the long-term funding framework between the Governor and UC. Three provisions of the Act warrant special mention because of their potential implications for the development of the University's budget plan for 2018-19.

- *Funding is contingent upon meeting certain requirements.* Under the Act, $50 million of the University's 2017-18 State General Fund appropriation is contingent upon the University demonstrating a good-faith effort to satisfy five requirements: completing pilot programs of activity-based costing at three campuses by May 2018; attaining a freshman-to-transfer ratio of 2:1 systemwide and at every campus except Merced by 2018-19; implementing recommendations made by the California State Auditor in its recent audit of the Office of the President by April 2018; eliminating supplemental retirement payments for Senior Management Group employees hired after May 2018; and disclosing information about revenues, expenditures, and carryover funds for systemwide and presidential initiatives. The University expects to meet the requirements set forth in the Act; ultimately, however, the State Director of Finance is responsible for making the determination of whether these requirements have been met.

- *Enrollment growth expectations for 2018-19.* The Act calls upon the University to enroll at least 1,500 more California resident undergraduates in 2018-19 compared to 2017-18. In a departure from previous Budget Acts, however, the Act provides no assurance of incremental State General Funds to support that enrollment growth. Instead, the Act suggests that this enrollment growth should be funded, at least in part, by reallocating existing resources from other parts of the University's budget. The Act directs the University to consult with the Legislature and the Department of Finance to identify possible areas where funding could be redirected towards enrollment growth.

- *Direct State appropriation for the Office of the President.* In a significant departure from past Budget Acts, the Budget Act of 2017 allocates $348.8 million of State General Funds to support the Office of the President and UCPath and requires the University to eliminate the general campus and UCPath assessments that would have otherwise funded those programs and activities. Although intended to be revenue-neutral to the University as a whole, the provision has far-reaching implications for the State's involvement in University governance; for the extent to which State funds should be used to subsidize centralized administrative functions (rather than to directly benefit students at UC campuses); and for how campuses that are particularly dependent on State support can respond to a permanent, long-term redirection of State funding to support the Office of the President instead.

ELEMENTS OF THE 2018-19 BUDGET PLAN

Expenditure Outlook

The 2018-19 budget plan will address anticipated expenditures associated with undergraduate and graduate enrollment growth, mandatory operating expenses, financing obligations related to specified capital investments, and other high-priority programs.

The budget plan will include the estimated costs associated with enrollment growth of at least 1,500 California undergraduate students and 500 graduate students to ensure that the University continues to accommodate all eligible California resident undergraduates who wish to attend, and to expand graduate programs to respond to both institutional and state workforce needs.

The University also anticipates mandatory cost increases, including the following:

- Employer contributions to the University's retirement program will increase in 2018-19, attributable to changes in the University's overall payroll and the increase in the University contribution rate from 14 percent to 15 percent, which was approved by the Regents in July.

- Costs associated with employee and retiree health benefit programs are expected to increase in 2018-19 over 2017-18 levels. However, cost containment efforts are expected to result in smaller increases than in the past.

- The University must fund compensation increases for represented employees consistent with existing collective bargaining agreements.

- The University will provide additional funding as needed to maintain the academic merit program, which is critical for retaining high-performing faculty in an extremely competitive labor market.

- The University must keep pace with inflationary costs for instructional equipment, technology, purchased utilities, and other non-salary items. The University's systemwide procurement efforts and other cost containment measures are expected to have an impact these expenditures as well, allowing the University to budget annual cost increases that are below the general rate of inflation.

The University must also address other needs in order to ensure that future generations of high-achieving students have access to a world-class education, along with the facilities and services that they require. These needs include:

- continued investment to maintain and improve academic quality, such as reducing the student-faculty ratio, providing funds for start-up costs associated with hiring new faculty, increasing graduate student support, and enhancing undergraduate instructional support;

- student financial aid to ensure that cost considerations, including the total cost of attendance, do not deter students from families with limited resources from enrolling at UC and successfully completing their intended course of study;

- efforts to mitigate further erosion in the market competitiveness of UC salaries for faculty and non-represented staff, as appropriate; and

- expanding and renewing essential infrastructure and facilities to meet evolving programmatic needs, and maintaining progress on seismic and other life-safety improvements.

Revenue Outlook

The 2018-19 budget plan will include a projected increase in permanent State General Fund support for the University's base budget. As noted earlier, based upon the terms of the framework and subsequent guidance provided in the Governor's May Revise, the increase is expected to be between three and four percent of the University's 2017-18 permanent State General Fund appropriation.

The budget plan will also incorporate revenue associated with the levels of enrollment growth described above. A portion of the revenue will be attributable to the tuition and fees paid by the students themselves. The University will consult with representatives from the Legislature and the Department of Finance to identify additional fund sources to support this enrollment growth through a combination of internal and external resources.

The plan will also incorporate additional resources to be generated from internal sources. These include both new revenue (such as that resulting from further optimization of the University's asset management strategy) and cost savings (such as the continued phase-out of need-based financial aid awarded to nonresident undergraduate students). In addition, consistent with the long-term funding framework agreed to between the University and the Governor, the University will explore the possibility of a modest tuition adjustment pegged generally to economic indicators that reflect cost increases in the broader economy.

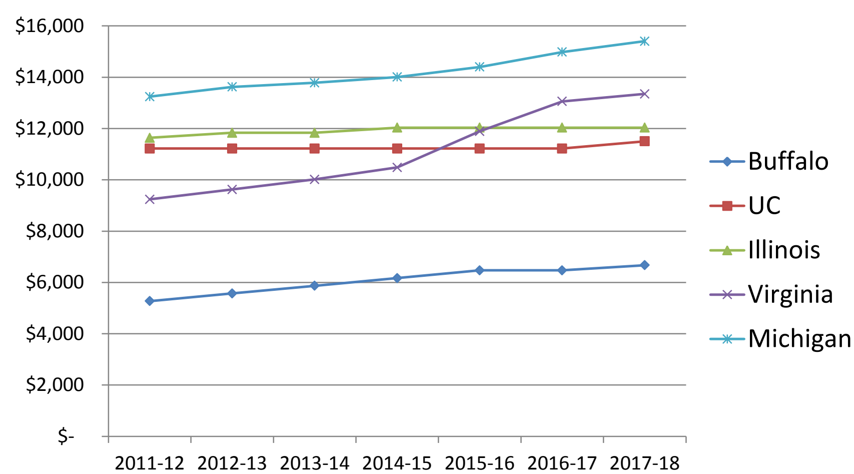
TUITION, ACADEMIC EXCELLENCE, AND UC AFFORDABILITY

Any consideration of a tuition adjustment must take into account, first and foremost, its potential impact on UC students – both in terms of the additional resources provided by such an increase, which allow campuses to maintain and enhance the quality of students' overall educational experience, and its impact on UC affordability when combined with other student expenses (room and board, books and supplies, transportation, etc.) that collectively comprise a student's total cost of attendance. These factors are discussed in greater detail below.

Context: Trends in Tuition at UC and Other Institutions

Between 2011-12 and 2017-18, UC tuition rose by a total of $282 (2.5 percent) and actually declined in inflation-adjusted dollars. In contrast, tuition increased consistently – and more rapidly – at most of UC's four public comparison institutions, as shown in Display 1. UC tuition remains below tuition at three of the University's four public comparison institutions.

Display 1: Trends in Tuition at UC and Public Comparison Universities



Figures not adjusted for inflation.

Tuition and Academic Excellence

The tuition increase approved by the Regents for 2017-18 is expected to provide an estimated $48 million in incremental revenue for UC campuses this year, net of the amount set aside for undergraduate need-based aid. This revenue is enabling campuses to budget for a variety of investments that directly and indirectly enhance students' educational experience. These include, but are not limited to, the following:

- Hiring additional ladder-rank faculty, lecturers, and graduate student teaching assistants to further expand undergraduate course sections
- Enhancing graduate student fellowships
- Improving service delivery in financial aid offices, academic advising, student counseling, and other areas of student support
- Technology upgrades in classrooms and lecture halls, particularly to support expanded instruction in data science
- Addressing critical deferred maintenance and student safety needs
- Library support

These investments can benefit students in myriad ways. Increased opportunities to work with outstanding graduate students and faculty members, for example, can influence undergraduates' choice of major and careers, allowing students to make academic and professional contributions that they had not previously thought possible. Having adequate class sections for in-demand courses can increase the likelihood that students graduate within four years – or sooner – which can greatly reduce their educational expenses and student debt at graduation. Living and learning within a safe, modern physical environment can improve student health and safety. All of these investments require resources. To the extent that other fund sources are already fully utilized to address mandatory cost increases described above, revenue from a tuition adjustment can provide critical budget relief and enable the types of student-focused investments described here.

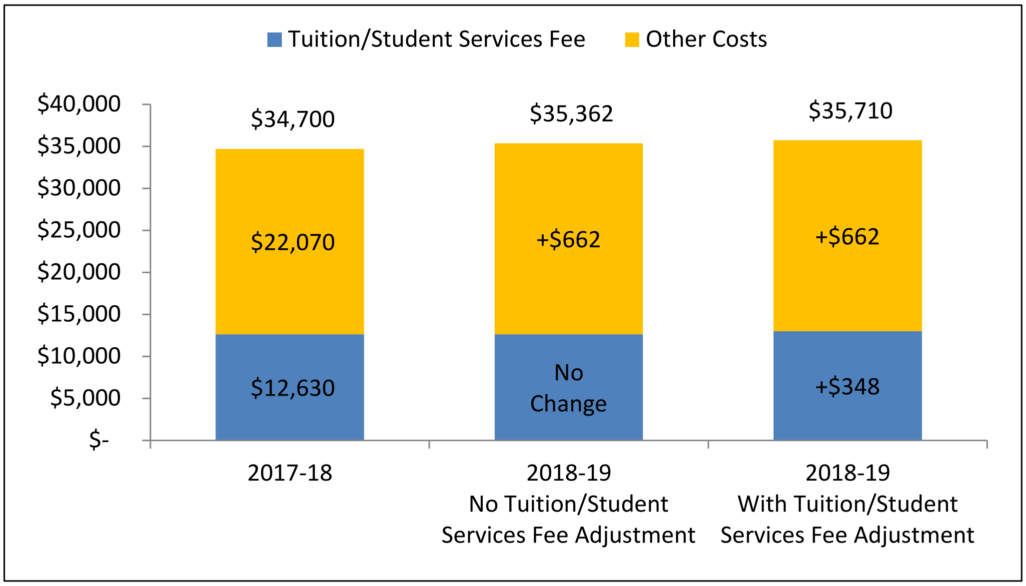
UC Affordability, Tuition, and Financial Aid

The University has long recognized that financing a UC education requires more than covering the cost of tuition and fees. Students also face expenses such as room and board, books and supplies, transportation, health insurance, and other costs that must be addressed. For that reason, Regents Policy 3201: The University of California Financial Aid Policy calls upon the University to enable California resident undergraduates to cover their *total cost of attendance* through a combination of a manageable parental contribution calculated according to a federal formula, a manageable student contribution from borrowing and work, and grant assistance from federal, State, and University sources.

Display 2, below, shows the average total cost of attendance in 2017-18 for students who live in on-campus housing, the most common housing choice among first-year UC undergraduates. Mandatory systemwide charges of Tuition and the Student Services Fee (shown in blue) represent less than half of these students' total costs.

Display 2 also shows projected 2018-19 costs under two scenarios: one in which Tuition and the Student Services Fee remain flat compared to 2017-18 and one where they are adjusted by a total of $348 (equivalent to a 2.5 percent adjustment to Tuition and a five percent adjustment to the Student Services Fee). In both scenarios, other student expenses (shown in yellow) are assumed to increase by three percent ($662) due to inflation.

Display 2: Average Total Cost of Attendance for Undergraduates in On-Campus Housing, 2017-18 and 2018-19 (Projected)



To assess the impact of these cost increases on UC *affordability*, however, it is important to consider the additional need-based grant assistance that will be generated by a tuition adjustment. That additional grant aid is provided by two sources: the State's Cal Grant program, which covers increases in mandatory systemwide charges for over 65,000 UC undergraduates, and UC's own undergraduate student aid program, which is augmented by 33 percent of all new revenue generated from an adjustment to Tuition and the Student Services Fee. Because both awards are made to students on the basis of financial need, the impact of these awards depends upon the financial resources of the student's family. For an estimated 100,000 UC undergraduates, *the combination of these awards will increase by more than the increase in systemwide charges* – resulting in about $100 of additional aid to help students cover the assumed $662 increase in other costs shown in Display 2. As a result, in the event of a tuition increase, the net cost of attending UC would actually be *less* for about 100,000 UC students than if tuition were to remain flat.

In addition, the State's Middle Class Scholarship Program (MCSP) will cover between ten percent and 40 percent of an increase in mandatory systemwide charges for families earning up to $165,000 if the student does not otherwise qualify for need-based grants.

Display 3, below, shows the impact of a tuition adjustment on the total cost of attendance, grant aid, and the net cost of attendance for typical students with different parent income levels. For the first three students (those with parent incomes of $20,000, $60,000, and $100,000), the net cost of attendance – i.e., the combined contribution from parents and students – would decline by $100 due to a tuition adjustment. For the student with parent income of $140,000, net cost would increase by only $266 instead of the full $348 due to the MCSP. In general, only students from families with parent income above $165,000 would pay the full cost of the adjustment.

Display 3: Estimated Impact of a Tuition/Student Services Fee Adjustment on UC Affordability by Parent Income

	With Flat Tuition/Student Services Fee Total Cost (Sticker Price): $35,362				With Tuition/Fee Adjustment of $348 Total Cost (Sticker Price): $35,710				Change In Net Cost Due to Tuition Adj.
Parent Income	Typical Grant Assistance	Parents	Student Self-Help (Loan/Work)	Net Cost (Parent + Student)	Typical Grant Assistance	Parents	Student Self-Help (Loan/Work)	Net Cost (Parent + Student)	
$20,000	$24,862	$0	$10,500	$10,500	$25,310	$0	$10,400	$10,400	($100)
$60,000	$20,062	$4,800	$10,500	$15,300	$20,510	$4,800	$10,400	$15,200	($100)
$100,000	$6,562	$18,300	$10,500	$28,800	$7,010	$18,300	$10,400	$28,700	($100)
$140,000	$2,985	$21,877	$10,500	$32,377	$3,068	$22,242	$10,400	$32,642	$266
$180,000	$0	$24,862	$10,500	$35,362	$0	$25,310	$10,400	$35,710	$348

Conclusion

Executive Vice President Brostrom will make an oral presentation to the Board on these and other considerations being discussed as part of the development of the 2018-19 budget. Discussion by the Board at the September meeting will help inform further development of the plan. The final budget plan will be presented for approval at the November 2017 meeting of the Board for submission to the Governor in advance of his January 2018 budget proposal for the State.

Key to Acronyms

MCSP	Middle Class Scholarship Program
UCRP	University of California Retirement Plan