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Office of the President

TO MEMBERS OF THE FINANCE AND CAPITAL STRATEGIES COMMITTEE:

DISCUSSION ITEM

For Meeting of September 26, 2018

PRELIMINARY DISCUSSION OF THE UNIVERSITY OF CALIFORNIA 2019-20 BUDGET

EXECUTIVE SUMMARY

The University of California is in the process of developing a multi-year budget and enrollment plan that, once established, would provide much-needed stability and predictability for UC campuses, students and their families, and other University stakeholders. Under the work plan discussed in the July Regents meeting, broad outlines of such a plan are to be shared with the Board in November, which would then be refined following consultation with the Governor-elect and other State officials and presented to the Board for approval in January.

The University, like other State agencies, is expected to submit a preliminary budget proposal to the California Department of Finance each fall for consideration by the Department of Finance as it prepares the Governor's January budget proposal for the following fiscal year. Although details of the University's multi-year plan will not be finalized until January, the University will have an opportunity in November to submit a preliminary expenditure plan and budget request in order to inform the development of the Governor's January budget proposal. This discussion item is intended to facilitate discussion about the potential elements of such a plan. Anticipated expenditure categories include enrollment growth; efforts to increase student graduation rates and reduce time-to-degree; investments in faculty and staff; the need to address retirement-related expenses; and meeting the University's most pressing capital needs.

State support will be critical to covering a portion of these costs. In addition, new resources resulting from the improved management of University working capital, cost-saving strategies, fundraising efforts, tuition, and other sources will each play a role in achieving a sustainable budget plan.

BACKGROUND

At its July 2018 meeting, the Board of Regents reviewed the University's work plan to engage a variety of UC stakeholders to develop a multi-year plan for enrollment growth and funding that would encompass the next four years. (See item B2 on the agenda for the full Board, *Work Plan for Multi-Year Enrollment and Budget Planning*, and the related presentation.) A multi-year plan would benefit UC campuses, California students and their families, and the State as a whole in a wide variety of ways. For example:

- Campuses could optimize their own multi-year plans for course offerings and class availability to reduce overcrowding or the likelihood that students would be unable to take courses that are required to make progress towards their degrees.

- Campuses would be able to develop long-term hiring strategies for faculty and staff and to link those plans to predictable, reliable funding streams.

- The University could achieve cost savings by entering into longer-term, systemwide purchasing agreements based upon a predictable set of needs and resources.

- Prospective students and their families would benefit from knowing projected trends in UC tuition, fees, and financial aid.

- State Budget Acts could be developed to provide a predictable source of permanent funding for the University instead of one-time support, the availability of which can change significantly and unpredictably from year to year.

- The University could better prioritize its capital needs – including facilities that have historically relied heavily on State support to fund (e.g., classroom and teaching laboratory space) as well as facilities that the University can finance itself (e.g., student housing).

Past multi-year agreements between the University and the State were successful in achieving some if not all of the goals described above. For example,

- Governor Wilson established a Compact with Higher Education that was operational from 1995-96 to 1999-00. Its goal was to provide fiscal stability after years of budget cuts and allow for enrollment growth through a combination of State General Funds and student fee revenue. The Compact was remarkably successful, allowing the University to maintain the quality, accessibility, and affordability that have been the hallmarks of California's public higher education system. UC enrolled more students than the Compact anticipated – particularly at the undergraduate level – and the State provided funding to support them. Faculty salaries were restored to competitive levels and deterioration of the University's budget was halted and reversed. Indeed, the Governor and the Legislature not only honored the funding principles in the Compact but also provided funding above the levels envisioned in the Compact to buy out student fee increases, increase funding for K-14 graduate outreach, and advance other State and University goals.

- Governor Davis and the University formed a Partnership Agreement in 2000-01 that represented a comprehensive statement of the minimum resources needed for the University to maintain quality and accommodate enrollment growth projected throughout the decade. The Partnership was accompanied by the expectation that the University would manage these resources in such a way as to maintain quality, improve relationships with K-12 schools, and increase community college transfer, among other goals. The funding provided during the first year of the Partnership allowed UC to address salary lags for staff employees, make progress in reducing funding shortfalls in core areas of the budget, keep student fees low, and support a variety of research and public service initiatives of importance to the State and the University. Unfortunately, deterioration in the State's fiscal condition resulted in only partial funding of the Partnership in 2001-02, and State support for UC declined in each of the next three years.

- Governor Schwarzenegger announced a new higher education Compact in May 2004, which helped mitigate the effect of budget cuts made in preceding years. The Compact included base budget adjustments of three percent in 2005-06 and 2006-07 and adjustments of four percent for 2007-08 through 2010-11. The Compact promised base budget adjustments of an additional one percent in 2008-09 through 2010-11 to address shortfalls in core parts of the University's budget and included full funding for enrollment growth of 5,000 students per year. Under the Compact, beginning in 2007-08, student fee increases were to be capped at the rise in California per capital personal income unless compelling fiscal circumstances required a higher increase. Over the three-year period from 2005-06 to 2007-08, the combination of new State funding and student fee revenue provided under the Compact helped cover costs associated with rapid enrollment growth, necessary salary adjustments for faculty and staff, health and welfare benefit cost increases, and investment in programs related to student outreach and other categories of public service. By 2008-09, unfortunately, the fiscal circumstances of the State and the nation as a whole had changed dramatically. As a result, the State was no longer able to sustain then-current levels of support to UC, let alone follow through on projected increases in State funding.

- Governor Brown and the University established a long-term funding framework in May 2015 that included annual increases of four percent to the State's base level of support for the University for four years; State contributions to the University of California Retirement System totaling $436 million; tuition increases generally pegged to the rate of inflation beginning in 2017-18; programmatic innovations to improve student success; and a commitment by the University to modify its defined benefit pension plan for new employees by capping pensionable salary at the level set by the California Public Employees' Pension Reform Act of 2013 (PEPRA). Consistent with the framework, the University received base budget adjustments of four percent in 2015-16, 2016-17, and 2017-18, and tuition increased by only a modest 2.5 percent in 2017-18. The University's financial circumstances remained challenged, however, as California resident undergraduate enrollment grew rapidly during this period – by about 15,000 students between 2014-15 and 2018-19 – with the State providing only a fraction of its traditional funding level for enrollment growth. Moreover, despite a robust State economy, the 2018-19 State Budget provided less than a three percent increase in permanent State support for UC rather than the four percent indicated by the framework. One-time funding in 2018-19 avoided the need for a tuition increase that year.

While not all of these of multi-year agreements were equally sustainable, each represented an opportunity for State leaders and the University to agree on a broad set of objectives to be achieved over a multi-year period, accompanied by a funding plan that aligned State and University resources with shared State and institutional priorities.

2019-20: THE FIRST YEAR OF A MULTI-YEAR PLAN

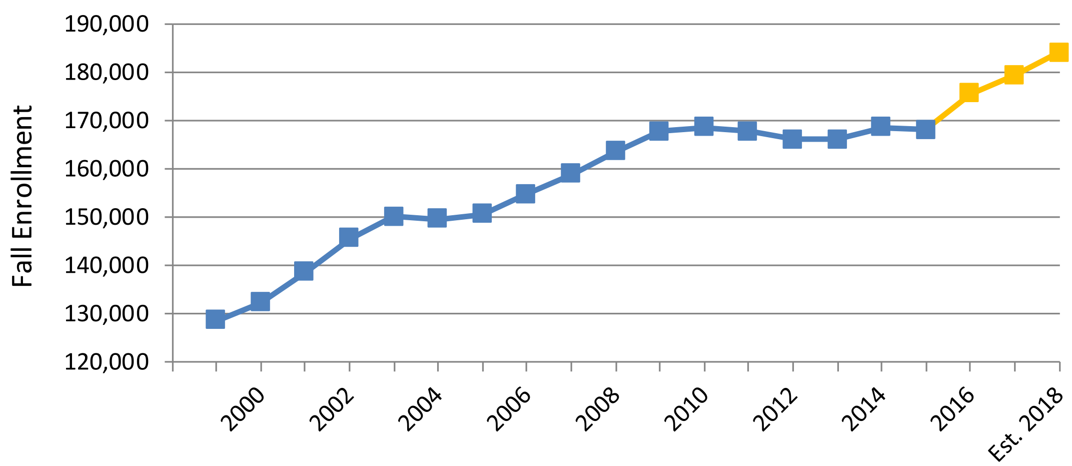
Under the work plan reviewed by the Board in July 2018, major components of a potential multi-year plan are to be shared with the Board in November. The plan would then be refined following consultation with the Governor-elect and other State officials and presented to the Board for approval in January.

Like other State agencies, the University is expected to submit a preliminary budget proposal to the California Department of Finance each fall for consideration as the Department prepares the Governor's January budget proposal for the following fiscal year. As a result, although details of the University's multi-year plan will not be finalized until January, the University will have an opportunity in November to submit a preliminary expenditure plan and budget request in order to inform the development of the Governor's January budget proposal for 2019-20 and to frame subsequent discussions with the new Governor and the Legislature. Categories of investments that are likely to be reflected in the multi-year plan are described below.

Potential Areas for Investment

Enrollment Growth. As shown in Display 1 below, California resident undergraduate enrollment continued to grow in 2018-19. Although final 2018-19 enrollment figures are not yet available, the University currently expects to enroll over 4,000 more California undergraduates in Fall 2018 compared to Fall 2017, and over 15,000 more California undergraduates compared to Fall 2014. The incoming class also includes the largest number ever of new California transfer students, consistent with the high priority that Governor Brown and members of the Legislature have placed on expanding opportunities for transfer enrollment.

DISPLAY 1: Fall Enrollment of California Resident Undergraduates at UC



As a result of this growth, the University serves more California resident undergraduates now than at any time in history. This is good news for California students and their families, but it has also created challenges on campuses where the recent growth has been greater than anticipated due to higher-than-expected yield rates (i.e., a greater percentage of students admitted to the campus chose to enroll at the campus compared to past years).

Even with this recent growth, it is likely that moderate levels of annual enrollment growth will be needed if the University's enrollment of California residents is to keep pace with projected increases in the number of California public high school graduates.

Resident undergraduate enrollment growth is directly supported by two primary sources of revenue: the tuition paid by the students themselves (less the amount set aside for financial aid) and State funding. Together, these funds are intended to fully cover the marginal cost of enrollment growth, excluding any additional capital requirements (e.g., new classroom space or additional student housing).

Investments to Improve Graduation Rates, Reduce Time-to-Degree, and Increase Degree Production. At the November 2017 meeting of the Board of Regents, representatives from the Public Policy Institute of California (PPIC) presented research findings indicating that, by 2030, 1.1 million jobs requiring a bachelor's degree will be available in California without qualified workers to meet this demand. (See item B1 on the November 16, 2017 agenda for the full Board, *The Role of Higher Education in California's Future: A Presentation by the Public Policy Institute of California.*) To address this workforce skills gap, PPIC proposes that the University of California award an additional 251,000 degrees between 2015-16 and 2029-30 above and beyond the number that it would normally be expected to award based on recent trends. The University's own models have shown that enrollment growth alone will not be sufficient to achieve this target. However, sustained efforts to increase degree production, coupled with enrollment growth, would allow the University to make significant progress towards this goal.

In addition to helping the State meet its projected workforce needs, improved graduation rates and reduced time-to-degree offer other benefits that support multiple goals. For example,

- A shorter time-to-degree increases the affordability of a UC education by reducing the costs to students and parents associated with an additional term or year of attendance.

- Students' lifelong earning potential is increased when they enter the workforce sooner rather than later, thereby contributing towards students' upward socioeconomic mobility.

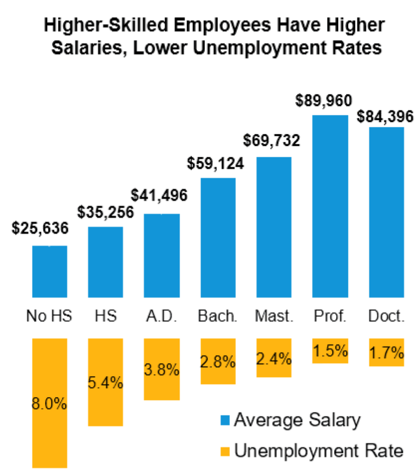
- Having students graduate sooner creates more space on campuses to permit larger incoming classes while reducing the need for additional capital investment.

Strategies to increase degree production can benefit from both permanent and one-time funding. Permanent funding is essential for critical investments such as hiring additional faculty to ensure course availability, or increasing the number of academic advisors to help students stay on track. One-time funding enables investments such as degree planning and auditing software, course development, upgrades to instructional technology, and faculty start-up costs.

Investments in Faculty and Staff. Creating and transmitting knowledge in a safe and supportive environment is, inherently, a people-intensive mission. As a result, faculty and staff salaries represent a significant portion of the University's expenditures from core funds, as they do at other research universities. Moreover, research universities are especially reliant on employees with a college degree and, in the case of faculty members and many administrators, an advanced degree. As shown in Display 2, research and development along with education – industry sectors that, taken together, represent the crux of the University's mission – rely on highly skilled employees to a greater degree than other industries. Display 2 also shows that these employees are in high demand, as evidenced by their relatively higher wages (shown in blue) and their relatively lower levels of unemployment (show in gold).

DISPLAY 2: Employment and Earnings Differentials of High-Skilled Employees

Industry	% High-Skill
Research & Development	72.0
Education	68.3
Computer & Related Activities	65.7
Publishing	49.3
Electrical & Optical Equipment	42.8
Telecommunications and Post	38.2
Motor Vehicles	22.1
Transport and Storage	18.1
Construction	11.2



Source: Salary and unemployment data from Bureau of Labor Statistics, *Current Population Survey 2016.*

To attract and retain a diverse and talented employee population, the University must continually ensure that its pay practices are fair and competitive with those of institutions with which it competes. The University regularly compares its faculty salaries with those of eight peer institutions to evaluate its market position. UC's faculty salaries were on par with the market 15 years ago. Since then, however, they have fallen precipitously relative to the market. Despite a modest recovery in recent years, UC's faculty salaries remained 8.4 percent below market in 2016-17. Comparable figures are not available for UC staff, but industry surveys indicate that the University's merit-based salary review program for non-represented staff has not kept pace with the average wage increase among over 1,000 other employers in the western United States, and UC was unable to fund a salary increase program in four of the last ten years. In addition, the University must meet its contractual commitments to represented employees.

Retiree Benefits. Costs incurred by the University related to retiree benefits fall into two broad categories: employer contributions to the University of California Retirement Plan (UCRP) and the University's share of health benefit costs for covered retirees and their dependents. Actuarial projections indicate that the current UCRP employer contribution rate of 14 percent (including an employer assessment of six percent for Savings Choice participants in the Defined Contribution Plan) will lead to gradual but sustained improvements to the funded status of UCRP, which is projected to be 90 percent funded by July 1, 2023. Even with no change to the employer contribution rate, however, some cost increases can be anticipated based on growth in the UC employee population and changes in covered compensation up to the pensionable salary cap.

Costs attributable to health benefits for covered retirees and their dependents are likely to rise more quickly as larger cohorts of UC employees decide to retire. UC, like the State overall, can anticipate faster increases in its retiree population as members of the baby boom generation reach retirement age. (PPIC refers to this trend as the "silver tsunami.") The University continues to explore ways to control costs associated with health benefits for this growing population.

Critical Capital Needs. The University's capital improvement program is described in detail in the University's 2017-27 Capital Financial Plan, which was presented to the Regents in November 2017. (See item F9 on the November 15, 2017 agenda for the Finance and Capital Strategies Committee, *Acceptance of the 2017-27 Capital Financial Plan*.) As indicated in the plan, facilities that support the instructional and research mission of the University are aging; sustained enrollment growth will require additional space; and changes in pedagogy and technology require the modernization of existing space.

A new State General Obligation Bond would provide much-needed resources to help close the gap between the University's projected capital needs and currently available resources. Until such funding is available, however, the University will continue to use the funding mechanism established by Assembly Bill 84 (2013) to help address its most critical capital needs. This mechanism allows the University to use a portion of its State General Fund allocation, subject to certain conditions, to finance the design, construction, and equipment of academic facilities to address seismic and life safety needs, enrollment growth, modernization of out-of-date facilities, and renewal or expansion of infrastructure to serve academic programs. As in past years, the budget proposal for 2019-20 will include an allocation of State General Funds for this purpose.

Other Cost Increases. Prices for items such as instructional equipment, laboratory supplies, computers, machinery, library materials, travel, and purchased utilities tend to rise each year. Through cost-saving efforts such as strategic sourcing, the University hopes to keep budget adjustments for this general expense category below the rate of inflation.

Underlying Principles for Funding the Multi-Year Plan

The University's estimated funding needs for 2019-20 and subsequent years will continue to evolve as more specific elements of the multi-year plan are identified and as more stakeholders are engaged in the process. Once those have been established, the following underlying principles are proposed to guide the development of an associated revenue plan:

- *The State is an essential partner for expanding access, maintaining or improving UC affordability, and restoring quality.* Many examples exist of public and private universities that have achieved only one or two of the University's three primary goals of access, affordability, and quality. The State's historic investment in UC over the past 150 years has been critical to the University's ability to achieve an unparalleled combination of all three goals. That support is no less critical to the University's ability to sustain that achievement for future generations of Californians.

- *The University has a key role to play in identifying alternative revenue sources, controlling costs, and improving efficiency.* The State, students, and families should expect the University to do its part to identify revenue sources in addition to State support and to use its resources responsibly and efficiently. Increasing philanthropy, making optimal use of working capital, strategic sourcing, and workforce planning are all example of such efforts.

- *Tuition increases – if any – should be pegged generally to inflation, well justified, and accompanied by more financial aid.* Absent a significant shortfall in State funding, the University should strive to keep tuition increases at or below the rate of inflation so as to avoid placing a greater burden on families who do not qualify for need-based financial aid.

CONSULTATION WITH STUDENTS

Staff from the University of California Office of the President (UCOP) have consulted with representatives for the University of California Student Association (UCSA) about students' budget priorities for the upcoming fiscal year and beyond. UCSA leadership recently provided UCOP with its preliminary list of budget priorities, which includes the following items:

- Ongoing, permanent State General Fund support to reduce tuition by at least $1,257/year (ten percent of base tuition and fees) or provide an equivalent increase in financial aid to help students cover costs other than tuition.

- Expansion of Cal Grant A awards to cover summer sessions, and expansion of Cal Grant B awards to improve support for costs other than tuition. UCSA notes that the cost of this proposal could be partly offset by Cal Grant savings resulting from a tuition decrease.

- At least $40 million dollars in ongoing State General Fund support for critical student services, including mental health services and academic advising services at every campus.

- Ongoing State General Fund support of approximately $5 million to provide immigration legal support, mental health support, and frontline program coordination to assist undocumented UC students at every UC campus.

- Ongoing State General Fund support for underserved student communities, including the creation or support of existing student recruitment and retention centers and student centers for differently-abled students, transfer students, underrepresented students (such as re-entry students, student parents, and formerly incarcerated students), and undocumented students.

Key to Acronyms

PEPRA	California Public Employees’ Pension Reform Act of 2013
UCOP	University of California Office of the President
UCRP	University of California Retirement Plan
UCSA	University of California Student Association