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Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:

DISCUSSION ITEM

For Meeting of September 15, 2011

DEVELOPMENT OF A MULTI-YEAR BUDGET PLAN FOR THE UNIVERSITY OF CALIFORNIA

EXECUTIVE SUMMARY

Executive Vice President Brostrom and Vice President Lenz will make a presentation regarding the development of a four-year budget plan for the 2012-13 through 2015-16 fiscal years.

Over the last 140 years, the University of California has become the premier public higher education system in the world. In the 2011 Academic Ranking of World Universities, compiled by the Center for World-Class Universities of Shanghai Jiao Tong University, seven of the world's top 50 universities were UC campuses. The University has achieved this through a commitment to excellence with broad support from the government and people of the State of California. Since the onset of the fiscal crisis in 2008-09, the University has had to radically adapt its approaches in a changing environment of fiscal uncertainty in order to maintain the long-held quality of the institution. A bold new approach is necessary to save the University from an irreversible decline into mediocrity.

In the last two decades, the University has experienced major swings in State support. Three fiscal crises have resulted in significant reductions in State funding while intervening years have been characterized by efforts to restore support and freeze or limit student fees. At the same time, enrollment demand has increased dramatically. As a result, student enrollment in 2011-12 is 51 percent greater than 1990-91 levels, while State support for UC is just ten percent higher, a discrepancy that is further exacerbated by inflation that has occurred over the last 20 years. In 2011-12, the University is facing a $1 billion shortfall, consisting of a $650 million base budget reduction and more than $360 million in mandatory cost increases.

Moreover, the primary responsibility for funding the University's core instructional program has shifted from the State to the students. State support for education on a per student basis has decreased by 60 percent in inflation-adjusted dollars while the amount students pay toward these costs has tripled. State funds for UC now total $2.37 billion while revenue from tuition and fees exceeds $2.8 billion.

The magnitude and frequency of State budget cuts have made it extremely difficult for campuses, students and their families to plan. Decisions to hire and tenure faculty, enroll students, add or expand academic programs, build new residence halls, classrooms or new research facilities, invest in books or digital technology for libraries--all involve long-term investments that must be based on some assurance of stable funding in the future. In addition, the inability of the State to resolve its ongoing structural deficit is leading to a loss of confidence among faculty and prospective students. A multi-year plan would establish a framework for negotiations with the Governor and the State Legislature, provide parameters from which the University community could plan for the next several years, and promote stability among concerned University faculty.

As indicated in past presentations, it is estimated the University will need an additional $2.5 billion by 2015-16 to meet funding requirements for enrollment growth and mandatory cost increases. Systemwide efficiencies and revenue generating measures are projected to address $1 billion of this shortfall; another $1.5 billion is needed from a combination of State funds and student tuition and fees.

Components of a multi-year plan would include the assumptions about efficiencies and revenue-generating strategies, and a proposal that, under the optimal scenario, would call for eight percent annual increases each in State funds and in tuition and fees through 2015-16. If the State is unable to meet its share of this cost, student fees would be raised further to make up the State's deficit. Thus, if the State provides only four percent increases each year, student tuition and fees would increase by 12 percent annually. If the State provides no increase, student tuition and fees would increase by 16 percent annually. Incorporating this principle into a multi-year plan will make clear to all stakeholders that a failure to invest in the University will directly increase the amount students and their families pay to attend.

Of course, there are other approaches. The student-faculty ratio could be permitted to rise, faculty salaries might further drift into non-competitiveness, access to classes might be diminished (increasing time to degree), and the commitment to graduate education might be eroded. But such efforts to reduce costs would destroy UC's historic commitment to quality. University officials are developing proposals to introduce and expand new revenue sources to support financial aid, and to enhance support for middle-class students. This initiative is intended to supplement traditional forms of financial aid and could help ameliorate the impact of tuition increases contemplated in the multi-year plan.

Adoption of a multi-year plan that signals the Board's intent to fund adequately the University's core operating function and prevent further declines in quality will provide a critical element of stability missing in the current environment and revitalize the University's commitment to excellence. Adopting this plan is a difficult decision – it signals the possibility of significant tuition and fee increases over the next several years, an eventuality which is not welcomed by University leadership, members of the Board, or any of our UC stakeholder groups. However, the reality of the State's fiscal situation combined with the perilous state of campus finances and the inability to plan in an environment of continuous uncertainty make it imperative that the Board take action to preserve the near-term future of the University.

This is an item for discussion at the September meeting; the Board is not being asked for an action at this time. It is anticipated the plan will be put before the Board for approval at the November meeting and will form the basis for the 2012-13 budget request, which will also be put before the Board for approval at the November meeting.

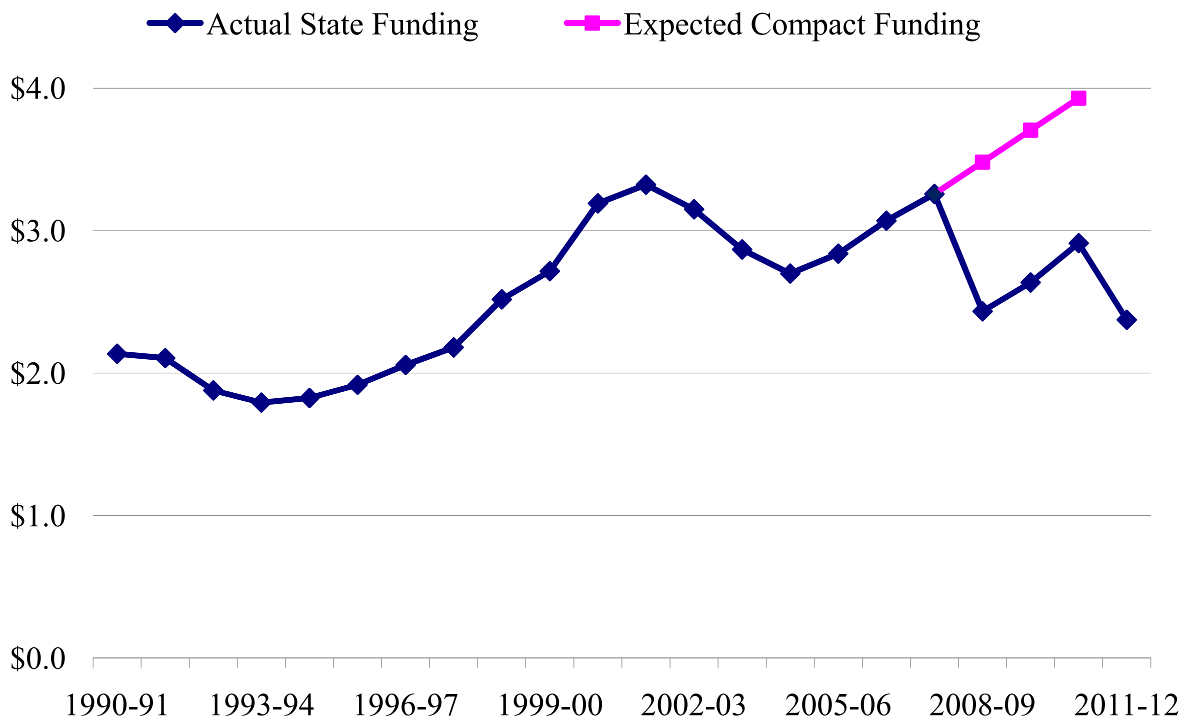
BACKGROUND

The development of a multi-year budget plan occurs in a context shaped by the State's enduring fiscal challenges and the University's efforts to respond to inadequate and unreliable State funding. Since 1990-91, State funding for the University of California has been marked by dramatic reductions due to recurring fiscal crises followed by temporary increases tied to ambitious plans to restore support.

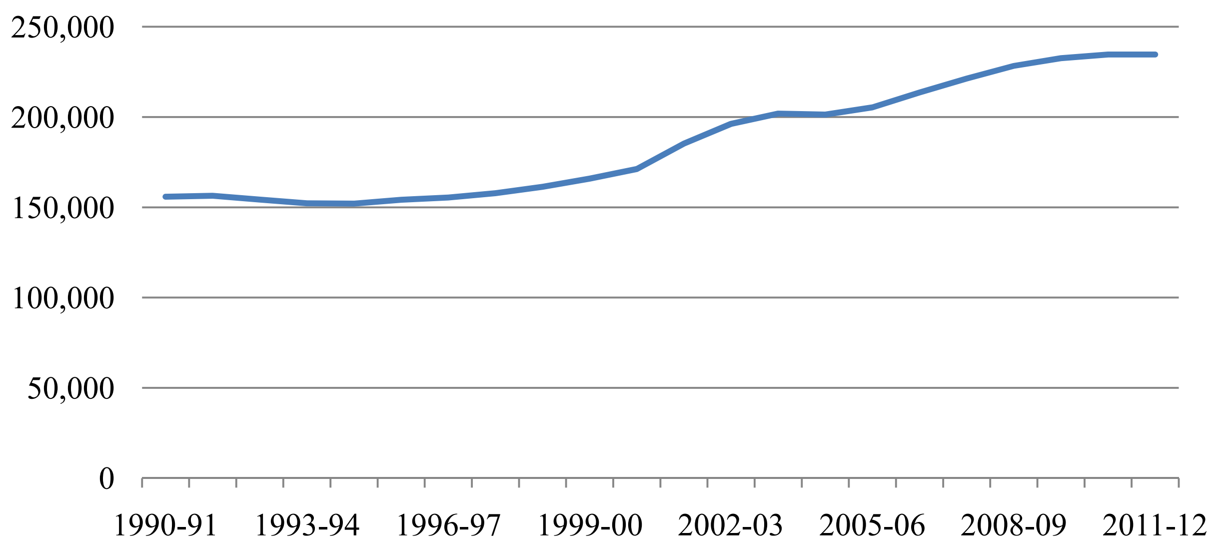
- In the early 1990s, the University lost the equivalent of 20 percent of its State support.
- Later in the decade under agreements with Governors Wilson and Davis, significant funding increases were provided for enrollment growth necessary to maintain the Master Plan, to avoid student fee increases, and to maintain quality.
- Another State fiscal crisis during the early 2000s meant a significant step back in State support, during a time of rapid enrollment growth due to increases in the numbers of state high school graduates.
- In the middle of the last decade, UC entered a six-year Compact with Governor Schwarzenegger to provide *minimum* resources needed for the University to accommodate enrollment growth and sustain the quality of the institution. From 2005-06 through 2007-08, the Compact served the University, students, and the State well, allowing UC to continue enrollment growth, provide compensation increases for faculty and staff, and avoid a student fee increase in 2006-07.
- The State's ongoing budget shortfalls, compounded by the global financial crisis, led the State to renege on the Governor's Compact, and resulted in significant reductions in State support at the end of the decade. For two years, no funding was provided for enrollment growth and the base budget was reduced, at a time when demand for UC was soaring. Federal economic stimulus funds provided temporary support.
- When contributions to the UC Retirement Plan (UCRP) were restarted in April 2010, the State failed to contribute its fair share, which only increased the budgetary pressure on campuses and medical centers. The State continues to neglect this obligation for UC while continuing to pay for the pension costs for CSU and the Community Colleges.
- In 2011-12, due to the slow economy and the State's inability to extend temporary tax increases, State support is more than $1.5 billion less than it would have been under the most recent agreement with the Governor and nearly $900 million less than provided in 2007-08.

The net result of these swings is that State support is just $240 million above the amount provided in 1990-91 in non-inflation-adjusted dollars, reflecting average annual growth of just 0.5 percent. During this same period of volatility in State funding, the number of California high school graduates has soared. The University accepted the challenge to accommodate growing numbers of students prepared for and seeking a quality university education, and succeeded in enrolling many more students. Student enrollment in 2011-12 is 51 percent greater than 1990-91 levels, and UC has opened a tenth campus, while State support for UC is just ten percent higher in non-inflation-adjusted dollars.

DISPLAY 1
State Funding for UC (dollars in billions)
Volatility in State support for UC has meant that funding in 2011-12 is just ten percent above the amount provided in 1990-91 and more than $1.5 billion below normal workload funding promised in the last Compact.



DISPLAY 2
Student Enrollment Over Time
Since 1990-91, student enrollment has increased by more than 50 percent as the University has kept its promise to accommodate eligible California residents.

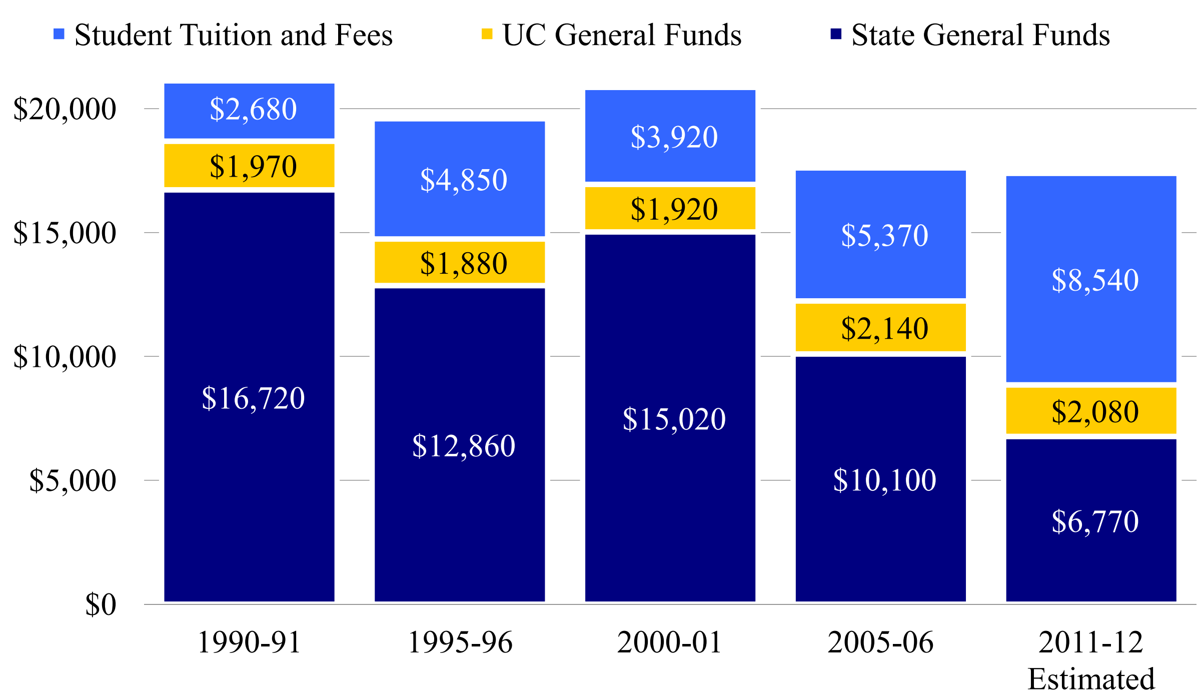


To help address the inadequacy of State funding and maintain the quality of the University, UC has been obligated to increase student tuition and fees. In 1990-91, tuition and fees were just $1,624 for all California residents. In 2011-12, mandatory systemwide tuition and fees total $12,192 for California resident undergraduates and graduate academic students, and are even higher for graduate professional students. Tuition and fee increases have always been a direct result of inadequate and volatile State support.

Even so, tuition and fee increases have only partially made up for inadequate State support. As shown in Display 3, which is an updated version of a table included in most recent presentations, resources for educational programs for general campus students have declined on an inflation-adjusted per-student basis – in other words, UC is spending less per student.

- The average expenditure per student for a UC education has declined more than 19 percent over 20 years —from $21,370 in 1990-91 to $17,390 in 2011-12.
- State funding per student declined significantly — by 60 percent over a 20-year period. In 1990-91, the State contributed $16,720 per student — 78 percent of the total cost. In 2011-12, the State share declined to $6,770, just 39 percent.
- As the State subsidy has declined, the share students pay has more than tripled. In 1990-91, students contributed 13 percent of the cost of their education; in 2011-12, students are paying 49 percent of the cost of their education.

DISPLAY 3
Per-Student Average Expenditures for Education
Since 1990-91, average inflation-adjusted expenditures for educating UC students have declined more than 19%. The State's share of expenditures has plunged even more steeply – by 60%, while the student share, net of financial aid, has more than tripled, from 13% to 49%.



Average inflation-adjusted resources per general campus student. Excludes financial aid. 2010-11 dollars.

The fiscal problems associated with the inability of the State to provide the funding called for in the recent Compact with Governor Schwarzenegger – including funding for 2.5 percent enrollment growth annually – and subsequent funding reductions have been further compounded for UC by unfunded cost increases for academic merit increases, collective bargaining agreements, health benefits, purchased utilities, and, beginning in 2009-10, employer contributions to the UCRP.

The inadequacy of State support to address inflationary cost increases during a period of rapid enrollment growth has led the University to take a number of actions, some positive, but many negative. Positive actions include operational improvements such as development of IT systems that reduce personnel effort, strategic sourcing, shared library resources, energy savings programs, curriculum redesign, elimination or consolidation of redundant operations, new financial investment strategies, and alternative instructional delivery.

More significant, however, are the austerity measures necessitated by the lack of support which have a negative impact on quality and functionality:

- Faculty and staff salaries that significantly lag the market
- Reduced faculty hiring, leading to higher student-faculty ratios
- Larger class sizes
- Less depth and breadth in course offerings
- A reduction in services and service hours
- Inadequate graduate student support
- Deferral of library material purchases and equipment replacement
- Deferral of maintenance and capital renewal, and
- Increased risk of non-compliance due to suboptimal oversight

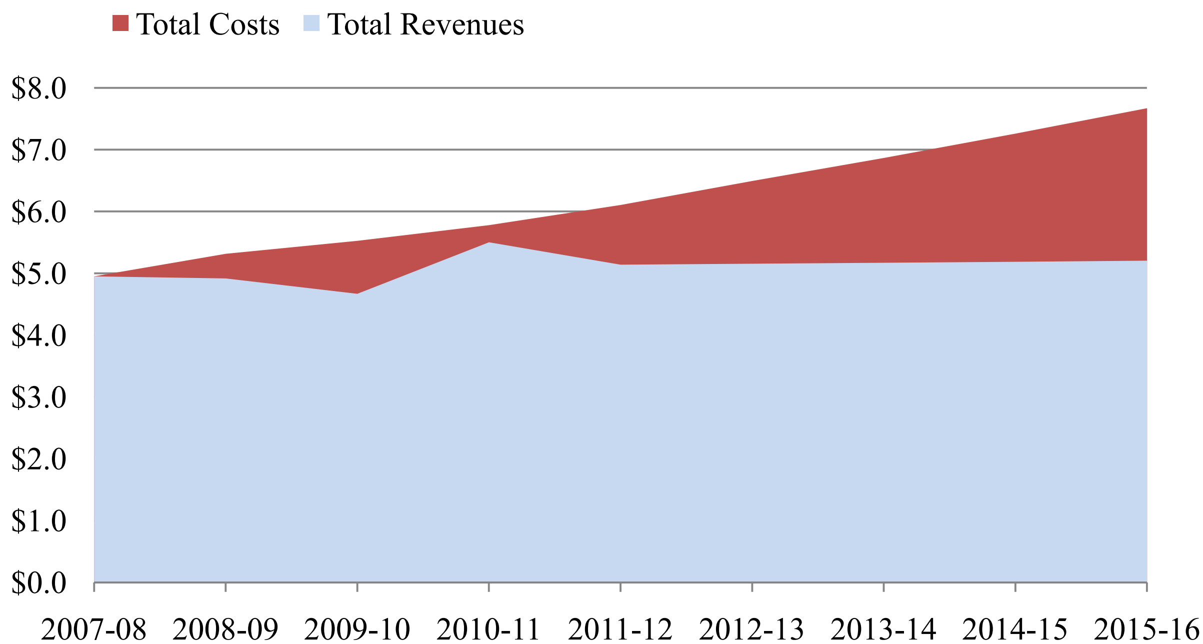
In 2011-12, the University was faced with a budget shortfall of $1 billion due to a $650 million reduction in State support and mandatory cost increases of more than $360 million. About 26 percent of the shortfall was addressed through tuition and fee increases. Additional actions included short-term revenue strategies as well as program reductions and cost avoidance.

Looking ahead, without substantial new revenues the University's budget shortfall will grow dramatically over the next four years due to a variety of factors, including:

- Expected enrollment growth of one percent annually
- Salary increases for faculty and staff
- Employer contributions to the UCRP and costs of retiree health benefits
- Employer contributions to employee health and welfare benefits
- High priority capital renewal needs
- Other non-salary costs

These items have been discussed at the March, May, and July Board meetings and are described in greater detail in Attachment 1. As a result of these cost pressures, the budget shortfall is projected to grow to $2.5 billion by 2015-16, if no additional revenues or other solutions are identified and there are no further changes in State support.

DISPLAY 4
The Looming Budget Shortfall Assuming No New Revenues (dollars in billions)
Over the last several years, projected costs have exceeded revenues due to State funding reductions. To date, the University has addressed the shortfall through implementation of new efficiencies as well as undesirable austerity measures. Going forward, costs will continue to rise, resulting in a $2.5 billion gap by 2015-16 if additional cost savings and new revenues are not identified.



A Multi-Year Plan Would Provide Fiscal Stability
The volatility in State funding in recent years has made it difficult for campuses to plan and yet long-term planning is fundamental to an institution like UC. Decisions to hire and tenure faculty, enroll students, add or expand academic programs, build new residence halls, classrooms or new research facilities, invest in books or digital technology for libraries – all involve long term investments that must be based on some assurance of stable funding in the future. Without that assurance, the University is inhibited from making decisions that are essential to running a major research institution and allowing it to move forward. The University of California is a world-class institution constantly on the cutting edge of knowledge development. Maintaining this status requires that UC remain competitive for the best faculty and students, for attracting research grants from the federal government and other sources, and for securing private donations that are essential to its survival. Such an institution cannot remain static for any length of time. And yet, the swings in State support, now deeper and of longer durations, have made it impossible to react to changing events while maintaining a longer term vision. The unpredictability and uncertainty that characterize the current environment have led to a growing lack of confidence among many faculty about UC's ability to maintain quality and an uneasiness among students and their families about whether the kind of education students have worked hard to gain access to will be available in future years.

Put another way, the University is not like many businesses, which can quickly increase or reduce production and inventories depending on market conditions. The excellence that has made the University of California one of the very best universities in the world is based on a long-term investment that has taken many decades to develop. And yet, that excellence is fragile and can rapidly disappear if the current disinvestment by the State is not addressed. Many say that the high quality of UC's faculty is its most precious asset. Continued instability of UC's core funding will jeopardize the institution's ability to recruit and retain this high quality faculty. Many of the measures campuses are taking to address the current fiscal crisis, such as those listed above, are not sustainable in the long run if the quality of the institution is to be preserved. The State's continued failure to develop a budget solution that addresses its ongoing structural deficit is a signal to those who are justifiably concerned that this may not be a temporary problem and that models for sustaining the University in a new environment requiring more self-sufficiency must be pursued. At the same time, students and their families have been hit with large, frequent, unpredictable, and untimely tuition increases. For UC to remain the high-quality institution it has been for more than 140 years, the University must adopt a multi-year plan to secure adequate resources requiring significant efficiency improvements, new sources of revenue, and, unless State support is provided, significant tuition increases. A multi-year plan would establish a framework for negotiations with the State, provide parameters from which campuses, students, and their families could plan over the next several years, and reassure concerned faculty that the University is taking the necessary steps to reestablish a secure funding base.

Key Features of a Possible Multi-Year Plan

To address the looming $2.5 billion budget shortfall, a multi-year funding plan should establish the following goals:

- Implement operational efficiencies and develop alternative revenue sources to address $1 billion of the shortfall over the multi-year period.
- Obtain State funding increases totaling eight percent annually to support normal cost increases, funding for the State's obligation to UC retirees, enrollment growth, and instructional programs.
- Raise student tuition and fees by eight percent annually to fund normal cost increases on tuition-supported portions of the budget. If the State is unable to fully fund the University's request, student tuition and fees will be increased to make up the shortfall. Failure of the State to provide any funding increases would cause tuition and fees to rise by 16 percent annually.
- Strengthen the University's commitment to affordability for students from lower- and middle-income families.

A multi-year plan is essential for maintaining the excellence that has long been the hallmark of the University of California. In the coming months, the University will be discussing a new funding and accountability agreement with the Governor and the Legislature. Based on these discussions, the President would request approval of the multi-year plan by the Regents.

Components of a Multi-Year Plan

The scope of the multi-year funding plan is limited to core funds, which are comprised of State General Funds, UC General Funds, and student fee revenue, and which represent an estimated

29 percent of the University's total expenditures during 2010-11. These sources provide permanent support for the University's tripartite mission of instruction, research, and public service, as well as activities that support that mission, including faculty salaries and benefits, academic and administrative support, student services, operation and maintenance of plant, and student financial aid. Much of the focus of the University's strategic budget process and negotiation with the State is dedicated to the uses of these fund sources. While other fund sources help augment and complement the University's core activities of instruction and research, these other sources cannot replace core funding from the State.

Other areas of the University's operations, such as the medical centers, auxiliary enterprises, and activities funded by federal and private research grants, will face many of the same cost pressures described below. Although the financial aspects of these areas typically do not directly influence the core mission programs and do not require increases in State General Fund support or student tuition, the University will identify solutions in these areas through efficiencies and other costs savings measures as well as revenue increases.

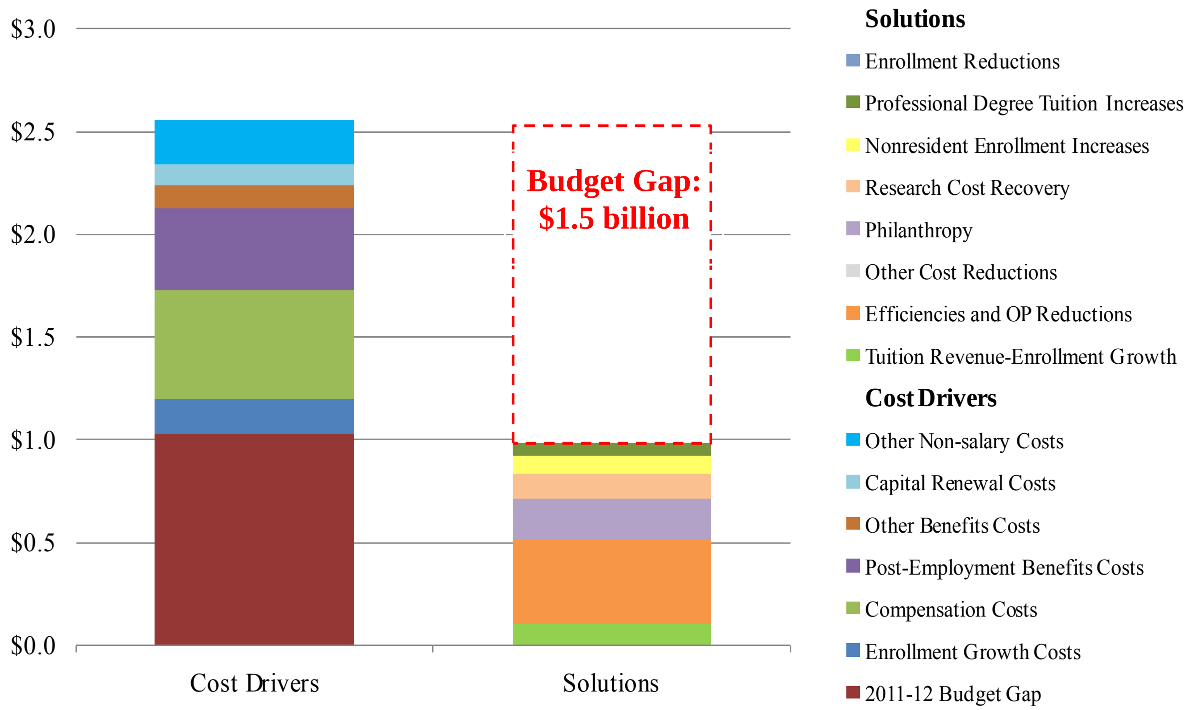
Cost Reductions and Alternative Revenues

As noted earlier, the University is taking steps to reduce costs and identify alternative revenue streams in a variety of areas. These efforts, which would help reduce the long-term budget shortfall by nearly $1 billion, include:

- Administrative efficiencies, targeted at $100 million annually over five years, two-thirds of which would accrue to core fund sources;
- Reductions in UCOP administration and earmarked programs, saving up to $80 million annually;
- Reductions in cost increases associated with employee and retiree health benefits;
- Increases in research indirect cost recovery through negotiated federal rate increases and reductions in waivers, resulting in $30 million in additional cost recovery annually;
- Development of unrestricted philanthropic funding of $50 million annually;
- Development of new revenue sources to support financial aid and to enhance support for middle-class students, projected to be $50 million annually;
- Growth in enrollment of nonresident students, whose supplemental tuition payments enhance program quality and access for California residents; and
- Expansion of professional degree and self-supporting instructional programs.

These items were thoroughly discussed at the March, May, and July meetings of the Board and are described in more detail in Attachment 1 to this document.

DISPLAY 5
Cost Drivers, Efficiencies, Alternative Revenues, and the Remaining Budget Gap (dollars in billions)
Cost increases over the next four years will result in a $2.5 billion budget gap by 2015-16. Efficiencies and alternative revenues are projected to address $1 billion of this problem, leaving a $1.5 billion gap.

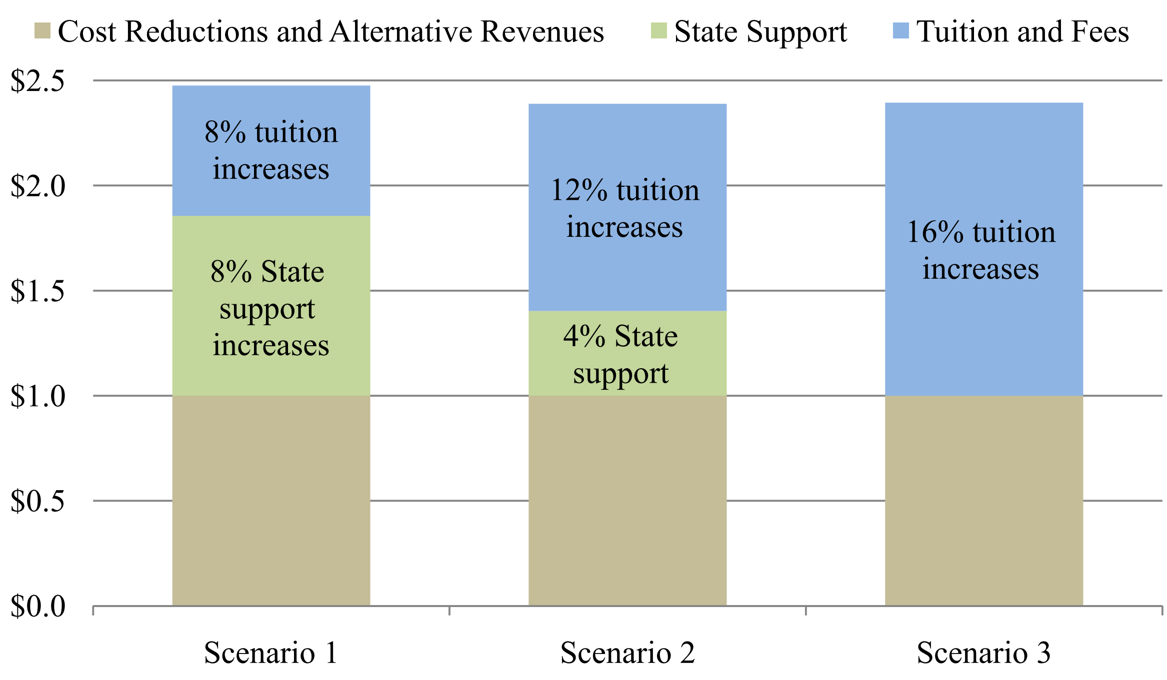


State General Funds and Student Tuition and Fees
Under the optimal scenario in a multi-year funding plan, State funds and tuition and fees would each increase by eight percent annually to support the basic operating budget. This is regarded as the optimal scenario because the State and student tuition would bear equal responsibility for the burden of cost increases not addressed by efficiencies and revenue generating strategies; under the current fiscal circumstances, it is believed this is the most the State could provide for UC.

However, if the State is unable to reinvest in the University at the proposed level, the University must implement greater tuition and fee increases as needed to replace inadequate State support. For example, if the State is able to provide increases in support equivalent to only four percent annually, thereby falling short of the requested eight percent increases, then student tuition and fee levels will rise an additional four percent annually. Alternatively, if no additional State support is provided, student tuition and fee levels will rise by 16 percent annually, representing the eight percent initially proposed from tuition and fees plus an additional eight percent to address the lack of State funding. If State support were to decline from the $2.37 billion provided in 2011-12, student tuition and fees will be increased further to replace lost funds.

Thus, if State support increases fall short or if further base budget cuts are instituted, then tuition and fees will increase at a faster rate commensurate with the shortfall in State support. Establishing the direct relationship between State funding and required tuition increases into a multi-year plan will make clear to all stakeholders – the Governor and Legislature, students and parents, and other interested citizens – that a failure to invest in the University will cause an increase in the amount students and their families pay to attend. Incorporating this understanding into the multi-year plan is critical to its effectiveness. Having a certain source of revenue that will be available to fund basic needs and help maintain quality is needed to stave off what many are concerned could be a whittling away of the University's world-class faculty, which has taken the institution years to develop, due to the inability of the University to secure its financial status.

DISPLAY 6
Scenarios for Closing the Looming Budget Shortfall (dollars in billions)
Cost reductions and alternative revenue sources are expected to yield $1 billion to help close the projected $2.5 billion budget gap. The remaining gap will need to be closed with either renewed investment from the State or student tuition and fee increases. For example, one scenario would involve 8 percent annual increases in State support and 8 percent annual increases in tuition and fees. If no State support increases are provided, tuition and fees would need to rise 16 percent annually.



An overall eight percent increase in core funds (from some combination of State support and student tuition and fees) is needed to generate $1.5 billion in revenue over the four-year period. It is important to note that while student tuition and fees may need to increase by up to 16 percent annually to address this shortfall if the state provides no new funding, the revenue generated would be equivalent to an eight percent increase in the overall budget.

Student Financial Support

It is the University's intention, as it has done in the past, to augment UC financial aid to mitigate the impact of cost increases, including tuition and fee increases, on financially needy students. Financial aid strategies for 2012-13 and future years were discussed at the May 2011 Regents' meeting and include ensuring that the amount that students are expected to contribute from work and borrowing remains manageable, and expanding UC's commitment to cover tuition and fees for needy middle-income families. UC projects that over time, financial aid initiatives such as these will require additional funding beyond the University's traditional practice of setting aside 33 percent of new tuition and fee revenue for undergraduate student aid. To generate these funds, the University is exploring a combination of new corporate fundraising and balance sheet strategies that, combined with a portion of new tuition and fee revenue, will support the cost of these initiatives.

Quality Initiatives

This proposed multi-year budget plan is focused on addressing current and projected shortfalls for critical needs. The plan does not provide additional funding that would be needed to support quality initiatives previously identified by the Regents, including reducing the student/faculty ratio, increasing graduate student support, expanding funding for academic support and building maintenance, investing in systemwide IT improvements, and reducing employee salary lags.

Conclusion

A multi-year plan not only provides the parameters needed for securing base budget support for the University's most critical needs, it also creates a sense of stability and predictability which is critical to retaining faculty, attracting high quality students, maintaining program excellence, and providing an opportunity for families to anticipate the costs of a UC education over for the next several years. The University has carried out a comprehensive review of opportunities to reduce costs through operational efficiencies and secure new revenues to offset declining state support. As a result of this review, the University has implemented an expansive program to reduce operational costs and has moved aggressively to tap an array of new revenue sources. Even under the most optimistic scenario, however, these efficiencies and new revenues will address at most $1 billion of the projected $2.5 billion funding gap by 2015-16. The remaining $1.5 billion of the gap must be addressed by a combination of State funds, and tuition and fees. A multi-year plan would provide a stable and predictable framework by which the University can meet its base budget needs, even as the State's fiscal situation continues to be immensely unstable. A multi-year plan will provide an essential framework that will allow the University to move forward to protect the institution's extraordinary legacy.

(Attachment)