

Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:

DISCUSSION ITEM

For Meeting of September 17, 2014

PRELIMINARY DISCUSSION OF 2015-16 BUDGET

EXECUTIVE SUMMARY

The 2014-15 fiscal year represents the second year in a multi-year funding plan proposed by the Governor. That plan calls for annual base budget increases over four years: five percent in 2013-14, another five percent in 2014-15, four percent in 2015-16, and another four percent in 2016-17.

The multi-year plan provides much-needed stability and predictability in State support for the University, which remains a critical component of the University's overall budget. The plan follows a half-decade of base budget cuts and extreme fiscal volatility, the consequences of which are still being felt across the core-funded enterprise. For example:

- In 2014-15, the University enrolls an estimated 6,000 California resident students for whom it has never received State funding.
- University of California faculty salaries continue to lag those at its comparison institutions, placing at risk the University's ability to retain talented faculty members and to replenish faculty ranks as many reach retirement age in the upcoming years. Class sizes have increased and breadth and depth of course offerings have been reduced, directly affecting the educational experience for UC students.
- Instructional equipment replacement, instructional technology, and purchase of library materials have not kept pace with demand, all of which are critical to the quality of education in a research university.
- Deferred maintenance continues to rise, exacerbated by aging facilities and supporting infrastructure and inadequate funding of basic building maintenance.
- A large inventory of buildings requiring seismic upgrades and modernization and systems renewal exists that, if left unaddressed, threatens the health and safety of UC students and employees and the ability of the University to provide facilities that can continue to support the instructional and research programs that are the foundation of a modern research university.
- The University has faced significant challenges in improving its ability to compete for the best and brightest academic graduate students, who are critical to the University's research mission, the delivery of instruction, and to the ability to attract and retain faculty members.

Moreover, while predictable annual increases in State support represent a welcome change from prior years, it is important to note that State support represents only 40 percent of the University's core funds. Put another way, the five percent increase in State support in 2014-15 represents only a two percent increase in the University's core funds – less than the increase in inflation for higher education expenses during that period.¹

It is within this context that development of the University's budget plan for 2015-16 is occurring. The September Board meeting will include a discussion of the key cost drivers projected for the 2015-16 budget, such as funding for mandatory cost increases, other high priority budget items, and spending on UC's "Reinvestment in Quality" initiatives. A proposed budget plan for 2015-16 will be brought before the Board for approval in November.

BACKGROUND

The University's core funds budget – the funds used to support the basic educational mission of the University – 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). Core funds comprise only about one-fourth of the University's overall expenditures; however, they form the basis – what may be considered the seed money – for all other activities included in the \$26 billion enterprise. As a result, they are critical to the overall success of the University.

2014-15 State Budget Outcome

The final 2014-15 State budget provided the University with an additional \$142.2 million in permanent funding from the State General Fund, representing a five percent increase in the University's base State General Fund budget. (The 2014-15 Regents budget plan included \$383 million of expenditures, of which \$168 million were mandatory costs.) The budget also provided the following:

- \$2 million in permanent funding from the \$142.2 million base increase for the Labor Centers at UC Berkeley and UCLA;
- An additional \$2 million in one-time funds for the Labor Centers;
- \$2 million in one-time funds to establish the California Blueprint for Research to Advance Innovations in Neuroscience (Cal BRAIN) program, which would leverage federal funding opportunities to accelerate the development of brain mapping techniques;
- Funding for the UC Berkeley Tolman Hall Seismic Replacement Project in the 2014-15 budget;
- \$12.3 million from the Proposition 63 mental health fund for the Behavioral Health Centers of Excellence for California at UC Davis and UCLA (with three years to expend) and \$2.7 million of additional funding if certain revenue thresholds are achieved by the State; and

¹ The Higher Education Price Index (HEPI), which reflects the estimated cost of higher education "inputs" such as faculty and staff salaries, libraries, etc. increased by three percent between 2013 and 2014.

- \$50 million in one-time funds for the Governor's Innovation Awards, an initiative he proposed in his January budget that would fund proposals from any of the three California higher education segments for programs that promote increased graduation rates, decreased time to degree, or improved Community College transfer.

The State budget provided no new permanent funds for key components of the University's 2014-15 budget plan. Specifically:

- The State budget included no new funding toward the State contribution to the University of California Retirement Plan (UCRP). In contrast, the State budget provided \$876.2 million to address higher costs for State employee pensions (including employees of the California State University) and initiated a long-term infusion of State funds to fully fund the California State Teachers' Retirement System.
- The State budget provided no new funding for enrollment growth, or to address unfunded California students that the University continues to enroll. The State did, however, provide the California Community Colleges with new funding for enrollment growth of 2.75 percent, allowing them to serve approximately 30,000 new students.
- The State budget provided no funding for reinvestment in academic quality to address the consequence of prior shortfalls in State funding, including a rising student-faculty ratio, growing faculty and staff salary gaps, instructional equipment and technology needs, or unmet needs related to graduate and undergraduate education.

The State funds provided in 2014-15 are sufficient to fund only the cost increases on the State-funded portion of the budget, which is now less than half of the total core funds. The University has committed to holding tuition flat in 2014-15, leaving mandatory systemwide charges for in-state undergraduate and graduate students unchanged since 2011-12. As a result, the largest portion of the core-funded budget will receive no cost increase funding in the current year.

Development of the 2015-16 Budget

Key cost drivers to be considered in the development of the 2015-16 budget plan are outlined below.

Expenditure Outlook

Funding for Mandatory Cost Increases. Mandatory cost increases, estimated to be between \$120 million and \$135 million for 2015-16, represent the primary drivers of increased costs in the University's core-funded budget. They include the following:

- Employer contributions to the University's retirement program to ensure the financial viability of the plan. In recent years, this has been a major cost driver for the University as employer contributions have increased two percent per year since the restart of contributions occurred in 2010; however, the University has reached a stable level of contributions, so the cost increases associated with this element in the budget will be considerably less moving forward for the foreseeable future (only attributable to changes in staffing and salaries). Estimates of this cost for 2015-16 are not yet available, but early

- projections indicate they will be in the range of \$18 million – \$20 million;
- Preserving the quality of employee health benefits programs while striving to contain cost increases. For 2015-16, current projections indicate these costs will increase by between five percent and seven percent, which would require additional funds in the range of \$28 million – \$34 million;
 - Funding projected cost increases associated with health benefits for the University's retirees. For 2015-16, these costs are expected to increase by between five percent and seven percent, requiring an additional \$5 million to \$7 million;
 - Funding compensation increases already approved as part of the collective bargaining process. For 2015-16, this cost is estimated to total \$15 million to \$18 million;
 - Maintaining the academic merit increase program, a critical activity for retaining high-performing faculty. For 2015-16, this will require \$30 million;
 - Keeping pace with inflationary costs for instructional equipment, technology, library materials, purchased utilities, and other non-salary items. It is estimated these costs will increase by about two percent, which will require approximately \$25 million.

These are unavoidable costs that must be covered before other high-priority costs or initiatives can be funded.

Other High Priority Budget Items. In addition to the mandatory cost increases described above, the University must address other needs in order to provide access to future generations of high-achieving students to a world-class education, along with the facilities and services that they require. These needs, which have an estimated total cost of between \$190 million and \$205 million, include:

- Compensation increases for faculty and non-represented staff in order to prevent further erosion of market competitiveness of UC salaries. For 2015-16, it is estimated that a three percent increase in compensation for all faculty and non-represented staff (including associated benefits) will require approximately \$120 million;
- Support for modest enrollment growth to ensure that the University continues to accommodate all eligible California resident undergraduates who wish to attend, as well as more properly balance the proportion of graduate students to undergraduate students, to better respond to both institutional and state workforce needs. For example, increasing enrollment by one percent would require an additional \$22 million for 2,200 students, based upon the agreed-upon marginal cost of instruction;
- Addressing deferred maintenance and capital renewal needs, which have not received systematic funding for more than a decade, which in turn places many of the University's physical assets in jeopardy of becoming unable to support critical core programs. Funding for this purpose is likely to range from \$35 million – \$50 million; and
- Expanding and renewing essential infrastructure and facilities to meet evolving programmatic needs, and maintaining progress on seismic and other life-safety improvements. For 2015-16, it is estimated that between \$10 million and \$15 million will be required for debt service payments related to buildings opening for use in the budget year. In a separate item at the September meeting, the Board is being asked to approve State-eligible capital projects for 2015-16 that total \$297.9 million, which will ultimately require an ongoing commitment of approximately \$24 million annually, although the

determination of when debt service payments will begin will be made in future years.

Reinvestment in Quality. The University has identified a number of areas that are key to maintaining quality and excellence. One example is the need to address the University's competitive disadvantage in the area of faculty compensation. As documented by the most recent total remuneration study, UC general campus ladder-rank faculty salaries currently lag those at its comparison institutions by 12 percent, compared to a ten percent lag in 2009. Other needs include reducing the student-faculty ratio, providing funds for start-up costs associated with hiring new faculty, reducing the salary gap for staff, increasing graduate student support, and enhancing undergraduate instructional support. When adequately funded, these areas make a profound contribution to the quality of the education UC students receive. A projection for these costs in 2015-16 is still being developed. Collectively, the cost of making meaningful progress towards addressing these needs is likely to be approximately \$50 million.

Revenue Outlook

Planning for the 2015-16 budget assumes the revenue needed to support projected cost increases will come from a combination of sources. The Governor's multi-year plan calls for a four percent base budget adjustment, which will yield approximately \$119 million. Additional revenue is expected to be generated from internal sources, including savings achieved through continued implementation of revenue-generating and asset strategy measures, as well as operating efficiencies. The remaining support needed to fund the budget plan will likely require either additional State funds or increases in mandatory systemwide tuition and fees.

Executive Vice President Brostrom and Vice President Lenz will make an oral presentation to the Board on options and considerations being discussed as part of the development of the 2015-16 budget.