Senate Budget and Fiscal Review—Mark Leno, Chair

SUBCOMMITTEE NO. 1 Agenda

Senator Carol Liu, Chair
Senator Ted Gaines
Senator Roderick Wright

Thursday, March 15, 2012
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Room 3191, State Capitol

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Item 1: LAO Overview of the Governor's Higher Education Budget Proposals

Description (Informational Item). The LAO will provide to the Subcommittee a brief overview of the Governor 2012-13 Higher Education Budget proposals. The items that follow on today's agenda are the segment specific budget proposals for *only* the University of California (UC), California State University (CSU), and the Hastings College of the Law (Hastings).

This subcommittee is scheduled to hear the Governor's 2012-13 budget proposals for: (1) California Community Colleges (CCC) on March 29; (2) California Student Aid Commission, including financial aid programs such as Cal Grants, on April 19; and (3) Capital Outlay for all departments on May 3.

Figure 1 – Higher Education Core Funding (dollars in millions)

		2007-08 Actual	2008-09 Actual	2009-10 Actual	2010-11 Actual	2011-12 Revised	2012-13 Proposed
UC	GF[1]	$3,257.4	$2,418.3	$2,591.2	$2,910.7	$2,273.6	$2,570.8
	Net Tuition[2]	1,365.3	1,437.4	1,751.4	1,793.1	2,403.7	2,444.1
	ARRA		716.5		106.6		
	Lottery	25.5	24.9	26.1	27.0	32.9	32.9
	subtotal [1]	**4,648.2**	**4,597.1**	**4,368.6**	**4,837.3**	**4,710.2**	**5,047.8**
CSU	GF[1]	2,970.6	2,155.3	2,345.7	2,577.6	2,002.7	2,200.4
	Net Tuition[2]	1,045.8	1,239.3	1,351.7	1,362.4	1,626.0	1,626.0
	ARRA		716.5		106.6		
	Lottery	58.1	42.1	42.4	42.4	47.8	47.8
	subtotal [1]	**4,074.5**	**4,153.2**	**3,739.9**	**4,089.1**	**3,676.5**	**3,874.3**
CCC	GF	4,272.2	3,975.7	3,735.3	3,994.0	3,276.7	3,740.2
	Fees	281.4	302.7	353.6	316.9	353.9	359.2
	LPT	1,970.8	2,028.8	1,992.6	1,959.3	2,107.3	2,101.1
	ARRA			35.0	4.0	0.0	
	Lottery	168.7	148.7	163.0	172.8	178.6	178.6
	subtotal	**6,693.1**	**6,455.9**	**6,279.6**	**6,447.0**	**5,916.4**	**6,379.0**
Hastings	GF[1]	10.6	10.1	8.3	8.4	6.9	8.8
	Net Tuition[2]	21.6	26.6	30.7	36.8	36.5	34.8
	Lottery	0.1	0.1	0.1	0.2	0.2	0.2
	subtotal [1]	**32.3**	**36.8**	**39.1**	**45.3**	**43.6**	**43.8**
CPEC	**GF**	**2.1**	**2.0**	**1.8**	**1.9**	**0.9**	**0.0**
CSAC	GF	866.7	888.3	1,043.5	1,251.0	1,481.7	567.9
	Other[3]	0.0	24.0	32.0	100.0	62.3	766.4
	subtotal	**866.7**	**912.3**	**1,075.5**	**1,351.0**	**1,543.9**	**1,334.3**
GRAND TOTALS		**$16,316.8**	**$16,157.4**	**$15,504.5**	**$16,771.6**	**$15,891.6**	**$16,679.2**
	GF	11,379.6	9,449.7	9,725.8	10,743.6	9,042.4	9,088.1
	Fees/Tuition	2,714.1	3,006.1	3,487.3	3,509.2	4,420.1	4,464.1
	ARRA	0.0	1,433.0	35.0	217.2	0.0	0.0
	LPT	1,970.8	2,028.8	1,992.6	1,959.3	2,107.3	2,101.1
	Lottery	252.4	215.8	231.7	242.4	259.5	259.5
	Other	0.0	24.0	32.0	100.0	62.3	766.4

Source: Legislative Analyst's Office

[1]2012-13 amount includes GO bond debt service.

[2]Includes systemwide and nonresident tuition and fee revenues less amounts redirected to institutional financial aid programs.

[3]Other funds for CSAC include SLOF and TANF reimbursements.

Staff Recommendation. None; this is an informational item.

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Item 2: Highlights of the Governor's Long-Term Plan for Higher Education

Description (Informational Item). The Administration will provide to the Subcommittee the highlights of the Governor's long-term budget plan for UC, CSU, and Hastings. This long-term plan is comprised of several major components; each of these components will be individually discussed in detail in Agenda Items 3 thru 7 below.

Background. California's public higher education system involves three "segments," UC, CSU, and CCC, and the Hastings College of the Law. The state's Master Plan for Higher Education ascribes distinct missions to each of the segments and expresses a set of general policies, including the state's intent that higher education remain accessible, affordable, high-quality, and accountable.

University of California. Drawing from the top 12.5 percent of the state's high school graduates, the UC has ten campuses and is the primary institution authorized to independently award doctoral degrees and professional degrees in law, medicine, business, dentistry, veterinary medicine, and other programs. UC manages one U.S. Department of Energy national laboratory, partners with private industry to manage two others, and operates five medical centers that support the clinical teaching programs of the UC's medical and health sciences schools and handle more than 3.8 million patient visits each year.

Figure 2 – UC Full-Time Equivalent Student Enrollment

	2010-11	2011-12	2012-13
General Campuses			
Undergraduate	169,664	171,421	171,421
Graduate	34,354	34,408	34,408
Subtotal, General Campus	*204,018*	*205,829*	*205,829*
State-Supported Summer	16,275	16,653	16,653
Total, General Campus	**220,293**	**222,482**	**222,482**
Resident	*200,809*	*200,095*	*200,095*
Non-Resident	*19,484*	*22,387*	*22,387*
Health Sciences	14,579	14,736	14,736
Total Enrollment	**234,872**	**237,218**	**237,218**
Resident	*214,692*	*214,112*	*214,112*
Non-Resident	*20,180*	*23,106*	*23,106*

California State University. Drawing students from the top one-third of the state's high school graduates, as well as transfer students who have successfully completed specified college work, the CSU provides undergraduate and graduate instruction through master's degrees and independently awards doctoral degrees in education, nursing practice, and physical therapy, or jointly with UC or private institutions in other fields of study. With 23 campuses, the CSU is the largest and most diverse university system in the country. It also is one of the most affordable. The CSU plays a critical role in preparing the workforce of California.

Figure 3 – CSU Full-Time Equivalent Student Enrollment

	2010-11	2011-12	2012-13
Undergraduate	295,493	303,763	310,938
All Graduate, including Post-Baccalaureate	43,741	44,902	45,911
State-Supported Summer	2,495	4,909	5,025
Total Enrollment	**341,729**	**353,574**	**361,874**
Resident	*328,155*	*340,000*	*348,300*
Non-Resident	*13,574*	*13,574*	*13,574*

Hastings College of the Law. Hastings was founded in 1878 and on March 26, 1878, the Legislature provided for affiliation with the UC. Hastings' campus consists of four buildings in the historic Civic Center neighborhood of San Francisco: two academic facilities, a mixed use facility primarily serving as student housing, and a parking garage with ground floor retail. Hastings is the oldest law school and one of the largest public law schools in the West. Its mission is to provide an academic program of the highest quality, based upon scholarship, teaching, and research.

Figure 4 – Hastings Full-Time Equivalent Student Enrollment

	2010-11	2011-12	2012-13
Total Enrollment	**1,283**	**1,254**	**1,135**
Resident	*1,183*	*1,165*	*1,058*
Non-Resident	*100*	*89*	*77*

From 2007-08 through 2012-13, the state reduced funding for UC, CSU, and Hastings by roughly $1.8 billion GF. The most notable consequences of these reductions have been significant student tuition fee increases (as illustrated in Figure 5 below), effectively shifting a larger share of total education cost to students, and declining course offerings, which have made it difficult for students to complete their degrees in a timely manner.

Figure 5 – UC, CSU, and Hastings Annual Tuition Fees

Full-Time Resident Students							Change from 2007-08	
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13*	Amount	Percent
University of California								
Undergraduate	$ 6,636	$ 7,126	$ 8,373	$ 10,302	$ 12,192	$ 12,192	$ 5,556	84%
Graduate	7,440	7,986	8,847	10,302	12,192	12,192	$ 4,752	64%
California State University								
Undergraduate	2,772	3,048	4,026	4,440	5,472	5,472	$ 2,700	97%
Teacher credential	3,216	3,540	4,674	5,154	6,348	6,348	$ 3,132	97%
Graduate	3,414	3,756	4,962	5,472	6,738	6,738	$ 3,324	97%
Doctoral	7,380	7,926	8,676	9,546	10,500	10,500	$ 3,120	42%
Hastings College of the Law	21,303	26,003	29,383	36,000	37,747	43,486	$ 22,183	104%

Source: Legislative Analyst's Office
*Proposed.

THE GOVERNOR'S LONG-TERM PLAN FOR HIGHER EDUCATION

The Administration's long-term plan for UC and CSU is rooted in the belief that higher education should be affordable and that student success can be improved. The Administration proposes stable and increasing state funding and fiscal incentives to allow UC and CSU to better manage their resources. The significant components are:

1. *Affordability*. The plan will curtail tuition fee increases and lessen the pressure for students to take out loans.
2. *Student Success*. The plan will make annual GF augmentations contingent upon each institution achieving the Administration's priorities, including improvements in specific accountability metrics, such as graduation rates, time to completion, transfer students enrolled, and faculty teaching workload.
3. *Stable Funding Source*. The state will increase its GF contribution annually by a minimum of four percent per year, from 2013-14 through 2015-16, contingent upon the passage of the Governor's tax initiative in November 2012.
4. *Fiscal Incentives*. The state currently budgets separately, and adjusts annually, the retirement program contributions and general obligation and lease revenue bond debt service for UC and CSU capital improvement projects. The budget proposes to move these appropriations into each segment's base budget in 2012-13. The Administration further states that no further augmentations for these purposes will be provided, to encourage the segments to factor these costs into their overall fiscal outlook and decision-making process. However, the entire, enlarged base budgets would be subject to the four percent annual increase described above.
5. *Flexibility*. The plan will remove nearly all "earmarks" from UC's and CSU's GF appropriations and provides no enrollment targets.

Note, the only portions of the long-term plan applicable to Hastings' are: (1) a $49,000 base budget adjustment for retired annuitant health and dental benefit cost increases and (2) a $1.8 million base budget augmentation for general obligation debt service costs.

Staff Comment. The Administration is proposing to recast the higher education funding model. First, the Administration proposes to "reset" the higher education budgets with most costs included and provide the funding with significantly new flexibility beginning in 2012-13. Starting in 2013-14, and contingent upon passage of the Governor's tax initiative, a new "funding agreement" is proposed through 2015-16 that increases each segment's base budget by a minimum of four percent per year if the segment achieves the Administration's priorities.

However, for purposes of 2012-13 the Administration's proposal is best described as: (1) providing UC and CSU with flat year-to-year funding, effectively resetting the segments' budgets to current workload and (2) via new and increased flexibility, directing the segments to do the best they can, in a constrained fiscal environment, to manage their budgetary demands within those resources. However, should the voters reject the tax package, the segments' budgets would be reduced by $200 million each.

LAO Comment. While the LAO can appreciate the Governor's attention to higher education accountability, many aspects of the Governor's plan would reduce the Legislature's ability to allocate higher education funding according to its priorities. The elimination of enrollment targets and the promise of automatic funding increases are of particular concern.

Staff Recommendation. None; this is an informational item.

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Item 3a: Flexibility Provisions – Earmarks

Governor's Budget Proposal. To provide UC and CSU with new flexibility, the January budget proposes to remove nearly all "earmarks" from the segments' GF appropriations.

Background. Typically, the annual budget act includes a number of conditions on UC's and CSU's GF appropriations. These earmarks for UC and CSU funding have varied over the years in keeping with the Legislature's and Governor's particular concerns at the time. They are either separately scheduled GF appropriations or contained in budget provisional language, as illustrated in Figure 6 below.

Figure 6 – 2011-12 UC and CSU GF Earmarks (dollars in millions)

UC		***CSU***	
Separately Scheduled General Fund Appropriations		Separately Scheduled General Fund Appropriations	
$8.7	Charles R. Drew Medical Program	$3.0	Assembly, Senate, Executive, & Judicial Fellows Programs**
$9.2	AIDS research	$65.5	Lease-purchase bond debt service
$52.2	Student Financial Aid		
$3.2	San Diego Supercomputer Center		
$5.0	Subject Matter Projects*		
$15.0	UC Merced		
$202.2	Lease-purchase bond debt service		
$4.8	Cal Institutes for Science & Innovation		
Provisional Language		Provisional Language	
$2.8	Energy service contracts	$2.7	Science and Math Teacher Initiative
$1.9	COSMOS	$0.6	Entry-level master's degree nursing programs
$1.1	Science and Math Teacher Initiative	$1.7	Entry-level master's degree nursing programs
$2.0	PRIME	$0.4	Baccalaureate degree nursing programs
$1.7	nursing enrollment increase	$3.6	Baccalaureate degree nursing programs
$3.0	2/12/09 MOU for service employees	$33.8	Student financial aid
		$0.35	Txfr to Affordable Student Housing Revolving Fund

Source: Legislative Analyst's Office
* Would be funded through the Department of Education in Governor's 2012-13 budget proposal.
** Remains earmarked in the Governor's 2012-13 budget proposal.

The Administration indicates that this proposal is intended to expand the segments' freedom to determine how their funding should be used and, when taken as a whole with other proposed changes, to provide incentives for the segments to make better use of their base funding. In addition, the Administration indicates that this proposal is intended to assist the segments in their management of recent unallocated budget reductions.

Staff Comment. The UC and CSU are governed by independent boards that make various decisions about how the universities will spend their resources, including the number of students enrolled; the number of faculty, executives, and other employees on the payroll and those employees' salary and benefits; student tuition levels; and the amount of tuition revenue redirected to financial aid; among other fiscal decisions. Further, UC has constitutional autonomy afforded by the California Constitution, under which the Regents have "full powers of organization and governance" subject only to very specific areas of legislative control, such as budget act appropriations.

Given this dynamic, where significant budget authority has already been delegated to UC and CSU, staff notes that the Legislature has relied on earmarks to ensure key concerns are addressed within the funding appropriated to the universities. This is more evident with UC's budget, as illustrated in Figure 6 above; given UC's constitutional autonomy, a greater number of programs have been "earmarked." The inclusion of earmarks in the budget bill provides a clear public record of budgetary allocations and expectations. The Governor's proposal effectively eliminates this budgetary tool. It is not clear what, if any, tools would remain that are as effective and would ensure that state funds are spent in a manner consistent with the Legislature's intent.

It is also a legitimate concern that recent budget reductions have made it more difficult for the segments to fulfill the public missions assigned to them. While they are able to absorb some budget reductions by drawing on funding reserves, increasing efficiencies, and dramatically increasing student fees, reductions of the magnitude sustained in 2011-12, when UC and CSU were cut by $750 million each, understandably require a prioritization and narrowing of some activities.

LAO Recommendation. It is reasonable for the Legislature to make some adjustments to the conditions it places on funding for UC and CSU, given recent budget reductions. Such adjustments should take into account the net change in UC's and CSU's programmatic funding, rather than simply the change in GF support. However, rather than simply abandoning all earmarks in the universities' budgets, the LAO recommends that the Legislature reevaluate budgetary earmarks on a case-by-case basis. In some cases, the Legislature may decide that a particular earmark is no longer a priority. In others, the Legislature may wish to keep or change or add an earmark. To help in evaluating potential earmarks, the Legislature may wish to develop guidelines that could be used for the budget year and beyond. For example, the Legislature might decide to approve only earmarks that serve a broader state purpose. To the extent that the Legislature chooses to retain any earmarks, the budget bill should be amended accordingly.

Subcommittee Questions. Based on the above comments, the Subcommittee may wish to raise the following questions:

1. Is there an operative difference between placing an earmark in a separately scheduled GF appropriation versus placing it in budget bill provisional language; i.e., under either scenario does the funding get expended as intended?
2. Absent the earmarks related to lease-revenue bond debt costs, earmarks represent roughly five and two percent, respectively, of UC's and CSU's GF appropriation. Given this, do these earmarks really constrain the segments?
3. In 2011-12, the Legislature approved up to five percent reductions to various earmarks, in recognition of overall budget reductions. Did this not provide sufficient flexibility?
4. With regard to the California Subject Matter Projects, the budget proposes to move this funding to the Department of Education and then transfer it back to UC for expenditure once it has been matched with federal funds. Why this approach? How will the Administration ensure that the entire amount will be transferred back to UC for program expenditures?

Staff Recommendation. Staff recommends that this issue be held open, pending the May Revision.

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Item 3b: Flexibility Provisions – Enrollment Targets

Governor's Budget Proposal. To provide UC and CSU with new flexibility, the January budget proposes to eliminate enrollment targets.

Background. In most years, UC's and CSU's budget is tied to a specified enrollment target. To the extent that the segments fail to meet those targets, the state funding associated with the missing enrollment is reverted. As part of the 2011 Budget Act, budget trailer bill language (Chapter 7, Statutes of 2011) provided enrollment targets for UC and CSU; companion budget bill provisional language stated that the state would not revert funds appropriated to the universities even if the universities did not meet their enrollment goal.

The Governor's 2012-13 proposal would allow UC and CSU to make their own decisions about how many students to enroll with the funding available to them.

Staff Comment. Enrollment levels are irrefutably a fundamental building block of higher education budgets. The number of students enrolled is a direct measurement of the "access" provided to higher education. Further, enrollment levels are a central cost driver for the segments and drive other costs, such as state financial aid. For these reasons, enrollment targets have been a major legislative concern in recent years.

However, given the significant reductions that have been made to UC's and CSU's budgets in recent fiscal years it is legitimate to ask what changes, if any, should be made to enrollment levels. In some years, the Legislature has reduced these enrollment targets in recognition of funding reductions. In other cases, the Legislature has directed the segments to accommodate funding reductions without reducing enrollment below budgeted levels.

Under the Governor's proposal, and in theory, the segments would have wide discretion with regard to enrollment. For example, they could significantly reduce the number of students served, thus raising the amount of funding available per student. This funding could be used to increase salaries for faculty, staff, and executives, a goal UC and CSU have expressed at various times. Or UC and CSU could reduce the number of undergraduates served, and use the funding to add a smaller number of higher-cost graduate students. Alternatively, UC and CSU could employ an enrollment reduction to shift a larger amount of their budgets away from direct education costs toward research or other non-instructional programs. UC and CSU could also limit the acceptance or receipt of community college transfer students, which is a long-identified state priority. These kinds of decisions have implications not just for educating students, but they could also have a profound effect on the level of access provided at each segment.

LAO Recommendation. The Legislature should reject the Governor's proposal to eliminate enrollment targets. Instead, the Legislature should restore provisional language that specifies enrollment targets for UC and CSU. As a starting point, the Legislature may wish to consider maintaining each segment's enrollment at its current year level, given that the budget proposes roughly flat funding for each segment. To the extent that the Legislature chooses to significantly reduce or increase a segment's budget, it may wish to modify the enrollment targets. Alternatively, the Legislature may wish to require the segments to achieve greater efficiencies without reducing enrollment.

Subcommittee Questions. Based on the above comments, the Subcommittee may wish to raise the following questions:

1. What assurances does the Legislature have that UC and CSU will continue to serve all students eligible for their institutions under the Master Plan? What recourse would be available if the segments fail to do so?
2. UC and CSU, where are you in the fall 2012 admission process; how does the number of eligible applicants compare with this time last year?
3. UC and CSU, how could the Governor's proposed Cal Grant reductions affect enrollment?
4. UC and CSU, what are recent trends in the percentage of enrollment going to graduate students? To non-resident students?
5. UC and CSU, what are your projections about spring semester transfer admissions in the 2013 and 2014 academic years?

Staff Recommendation. Staff recommends that this issue be held open, pending the May Revision.

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Item 4: Debt Service Payments

Governor's Budget Proposal. The January budget proposes major changes to the manner in which both general obligation (GO bond) and lease-revenue bond (LRB) debt is repaid for UC, CSU, and Hastings facility projects.

For UC and CSU, the major components of the proposal include: (1) all debt funding for 2012-13 is included in the base appropriations; (2) funding provided is not restricted for debt service, yet the segments would still have to make the required payments; (3) no future adjustments will be provided for this purpose, but base appropriations could increase by four percent annually from 2013–14 through 2015–16, and (4) no changes to state review process of capital projects. In 2012-13, UC and CSU would receive base budget augmentations of $196.8 million and $189.8 million, respectively, related to GO bond debt. UC and CSU would also receive one final adjustment of $9.7 million and $5.5 million, respectively, related to LRB debt.

In 2012-13, Hastings' base budget would be augmented by $1.8 million related to GO bond debt; Hastings does not have any LRB debt. Hastings would receive no further adjustments for debt service payments; however, unlike UC and CSU, Hastings is not included in the "funding agreement."

Background. There are two major types of debt service in higher education: (1) GO bonds and (2) LRB.

- ✓ The California Constitution requires that GO bonds be approved by a majority of the voters and sets repayment of this debt before all other obligations except those related to K–14 education. The Budget Act continuously appropriates this debt service from the GF. Funding to repay this debt is not currently included in direct budget appropriations for UC, CSU, and Hastings. Rather, it resides on the state's budget. The state makes annual GO bond debt payments on the segments' behalf, the amount of which fluctuates from year to year due to the varying debt service payment schedules related to different projects.

- ✓ LRBs are also used to finance capital outlay projects for the segments. LRBs may be authorized with a majority vote of the Legislature with the debt service covered from the future rental payments on the facilities that are built. LRB debt is typically issued for 25 years, although there have been some 20 year bonds for UC projects. As opposed to how GO bond debt is currently handled, funding for these rental payments is currently included in UC's and CSU's budget appropriations. However, the funding is restricted specifically for paying the debt service and is adjusted each year to account for fluctuations in the amount of debt to be repaid.

With regard to GO bond debt, and under the Administration's proposal, the payments would still be continuously appropriated from the GF, but instead reside in the segments' base budget appropriation. Proposed budget bill language would require that the segments reimburse the GF for making GO bond debt payments related to their capital projects. In essence, the State Controller would simply transfer the necessary amounts. The proposal does not result in increased GF costs in 2012-13; rather, it merely subjects GO bond debt repayment to the process already in place for paying LRB debt.

UC has the ability to issue LRB debt for instructional facilities (CSU does not have this authority). Should this proposal be adopted, UC indicates that it would likely refinance its existing LRB debt and lower its short-term costs by lengthening the period of time (to 30 years) over which the debt would be repaid; i.e., restructuring 15-year debt to 30 year-debt by refinancing bonds that have an average of 15 years of payments remaining.

Staff Comment. Some of the details of this proposal remain unclear, including what, if any, budget trailer bill language the Administration will propose as well as applicability of the new approach to existing vs. future LRB debt service costs. It is also unclear, contrary to the Administration's assertions, if UC and CSU would be required to seek Administration and legislative approval for all projects in future years.

Regardless of these unknowns, this approach is a departure from how UC, CSU, and Hastings capital outlay has been historically addressed. Under the current system, and in the last ten years, the LAO reports that the state spent an estimated $10.1 billion on higher education infrastructure; 80 percent of that support came from GO bonds and an additional 19 percent from LRBs. Associated higher education debt-service costs more than doubled during this same time period, from about $516 million in 2000-01 to an estimated $1.1 billion in 2010-11. Most of the GO bond spending was from bonds approved by the voters in 1998, 2002, 2004, and 2006. In general, the state provides less funding for higher education projects when the balance of GO bonds is exhausted. In the case of UC and CSU, the state has typically offset some of this reduction by funding some projects with LRBs.

One meritorious aspect of the Governor's proposal is that it would provide incentives to the segments to economize on projects. Because of the current approach for both GO bonds and LRB debt, the segments' base budgets are largely insulated from any consideration of the debt costs associated with their respective capital outlay plans. However, it is difficult to predict how the segments' state-funded debt payments for existing debt obligations would otherwise change in future years absent this proposal. In addition, it is not clear that providing these adjustments to the base budget one last time, and then growing that base by four percent a year for three years, would result in the right level of resources to fund the segments' long-term capital outlay needs.

LAO Recommendation. While the LAO agrees with the Administration that certain aspects of the current state debt financing system for the segments does not always provide the right incentives, overall the LAO finds that the Governor's proposal does not fully address these issues and makes the Legislature's future capital outlay budgeting decisions for the segments (and the state as a whole) even more difficult. Moreover, the LAO finds that some aspects of the Governor's proposal regarding Legislative oversight of the segments' state-related projects raise serious concerns. For these reasons, the LAO recommends that the Legislature reject the Governor's proposed approach. Specifically, the LAO recommends reducing the GF appropriations for UC, CSU, and Hastings by $196.8 million, $189.8 million, and $1.8 million, respectively to take debt service for GO bonds out of their budgets (as well as deleting the associated budget bill language). Further, the LAO recommends restricting the amounts proposed for LRB debt service in 2012–13 to that purpose only. These actions would result in no net changes in GF spending in 2012–13.

Subcommittee Questions. Based on the above comments, the Subcommittee may wish to raise the following questions:

1. Is the proposed total base funding (which could grow by four percent annually over the next three fiscal years) reasonable to cover UC and CSU's various operational and existing bond-related costs, as well as long-term capital needs?
2. This proposal shifts a significant amount of control over spending priorities to the universities. Is this level of autonomy appropriate given that the dollars in question are state dollars and the UC and CSU are statewide, public institutions?
3. Are the universities in the best position to determine how much of their base budgets to devote to capital and non-capital costs?
4. To what extent, and in what ways, will the Legislature have a say in the segments' commitment of GF support toward capital projects? What if UC issues its own LRBs for projects, for which it would otherwise currently request state bond financing, thereby avoiding any state oversight?
5. For Hastings, the augmentation is $1.8 million for existing GO bond indebtedness. Hastings is excluded from the overall funding agreement, whereby UC and CSU base budgets could grow four percent a year for three years to, in theory, accommodate future debt service needs. Does this approach treat Hastings fairly, i.e., how will Hastings' capital needs be met?

Staff Recommendation. Staff recommends that this issue be held open, pending the May Revision.

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Item 5: Retirement Costs

Governor's Budget Proposal. The January budget proposes major changes related to funding for UC and CSU retirement costs. For UC, the Administration proposes a $90 million base budget augmentation that "can be used to address costs related to retirement program contributions." For UC and CSU, base budgets would be adjusted one last time for retired annuitant health and dental benefit cost increases of $5.2 million, and retired annuitant dental benefit cost increases of $1.1 million, respectively. The budget then proposes a new policy that UC's and CSU's budgets will no longer be adjusted for changes in retirement costs beyond 2012-13; instead, state-related retirement costs would be funded entirely from within the segments' base budgets which, as previously mentioned, could grow four percent annually between 2013-14 and 2015-16.

For Hastings, the January budget proposes one last base budget adjustment of $49,000 for retired annuitant health and dental cost increases.

Background. There are substantive differences between CSU and UC (including Hastings) from the perspective of retirement benefits.

- ✓ CSU employees are members of the California Public Employees Retirement System (CalPERS), the same retirement system to which most state employees belong. Unlike most other state employees, the state does not collectively bargain with CSU employees (note, the 2010 statewide pension reforms that established reduced pension benefits for new hires effective January 15, 2011, includes new CSU hires as of that date). Funding for the CalPERS system comes from both employer and employee contributions. CSU's employees currently contribute either five or eight percent, depending on classification (most other state employees contribute eight to eleven percent, depending on bargaining unit). Each year, as is the case with other state departments, CSU's employer contributions to CalPERS are charged against its main GF appropriation; the employer contribution is based on a percent of employee salaries and wages that is determined by CalPERS. The budget annually adjusts CSU's main appropriation to reflect any estimated changes in the employer contribution. For example, the budget reduces CSU's main appropriation by $38 million due to a lower employer rate and lower payroll costs in 2011-12; CSU is expected to contribute $404 million to CalPERS in 2012–13.

- ✓ UC (and Hastings) employees are members of the University of California Retirement Plan (UCRP). This retirement plan is separate from CalPERS and under the control of UC; UC not only controls its pension costs but also sets benefits levels for its employees. Prior to 1990, the state adjusted UC's GF appropriation to reflect increases and decreases in the employer's share of retirement contributions for state-funded UC employees. Starting in 1990, however, UC halted both employer and employee contributions because the pension plan had become "super-funded." This funding "holiday" lasted nearly

20 years until the plan's assets had declined considerably and contributions once again became necessary. In April 2010, both UC and its employees resumed contributions to the plan. The state, however, has not provided UC with any additional funding specifically for that purpose. UC projects that annual total state costs would peak at around $450 million GF.

- ✓ Hastings funds the employer's share for its employees by making direct remittance to UC. Hastings does not commingle funds as it is entirely separate from UC. The amount that Hastings pays each year to UCRP is based on the annual payroll assessment rates as determined by the Regents. In this sense, Hastings is positioned similarly to CSU and its relationship with CalPERS.

Staff Comment. With regard to UC, and the state's share of the employer contribution to UCRP, the LAO has noted that these pension costs are real obligations that need to be paid, and it is reasonable for the state to cover the retirement costs of UC's state-funded employees, just as it does for other agencies. One over-arching challenge is that it is not readily clear what the "state share" should be given that UC also has non-state funded employees (such as through federal funds or patient revenues at the academic medical centers). Moreover, it is not clear to what extent the state should be expected to pay for retirement benefits that are defined by UC and not by the state. There are also questions about what legal obligations the state could incur by restarting contributions. Therefore, the LAO has advised that the Legislature proceed with caution and not simply pay whatever bill UC presents; i.e., the state may choose to re-start state contributions to UC under the right conditions. That the Administration does not tie its $90 million augmentation to UCRP contributions is indicative of these issues.

With regard to benefit levels, although the state does not control UC's pension system, actions taken to date by the Regents have largely mirrored recent changes to state employee pension benefits. For example, the Regents have taken action to reduce pension costs in the long term by increasing the minimum retirement age for new employees. In addition, the Regents have approved increases to employee contribution rates that are beginning to bring them in line with state employee contribution rates, which are now generally 8 percent (some of UC's proposed employee contribution increases are still subject to collective bargaining).

With regard to CSU's retirement costs, by bringing these costs onto CSU's base budget, the Administration intends for CSU to consider them in its budget and fiscal outlook. From CSU's perspective, the Administration's proposal adds costs that have been historically covered by the state budget and, further, are not completely within the employer's control. For instance, CSU notes that the CalPERS Board sets the employer contribution rate. However, this is not unique to CSU as an employer; this also applies to the state as well as every other public employer who contracts with CalPERS. Employee pension contributions are negotiable; however, as the LAO has reported, there are strict legal protections that limit government's flexibility to impose increased employee contributions. Rather, for many current employees such contribution increases would be implemented only through negotiations, and in any event, would result in many employers providing comparable offsetting advantages, such as increasing pay or other compensation, to offset the financial effect of the higher pension contributions. This would tend to erode any savings from increased employee pension contributions.

LAO Recommendation. There is sufficient justification on a workload budget basis to provide UC with an augmentation that the university could use to address its pension costs. The LAO recommends, however, that the Legislature only provide funding for the incremental change in 2012-13 in UC's pension costs for state- and tuition-funded employees, which is estimated to be $78 million; this would mean reducing the Governor's request for $90 million GF by $12 million. In addition, the LAO recommends that the Legislature adopt intent language in the budget specifying that in the future funding for UC retirement costs: (1) shall be determined annually by the Legislature, (2) shall be contingent on such factors as the comparability of UC's pension benefits and contributions to those of state employees, and (3) shall not necessarily include funding for tuition-supported employee pension costs or for pension costs incurred prior to 2012-13.

Given the statutory and other constraints that CSU faces, the LAO finds that, overall, the Governor's proposal would place on CSU a level of responsibility for funding pension costs that is out of proportion with its ability to control those costs. For this reason, the LAO recommends that the Legislature reject the Governor's approach and instead adopt intent language in the budget specifying that future budget adjustments shall be provided to CSU to reflect its pension costs.

Subcommittee Questions. Based on the above comments, the Subcommittee may wish to raise the following questions:

1. What happens if retirement costs rise by more than four percent annually? If that occurs, wouldn't this proposal require those retirement-related expenditures at the cost of academic programs, since the retirement-related expenditures are a mandatory first call on resources?
2. The Governor's proposed language refers simply to "retirement costs." This appears to not include adjustments for CSU retired annuitant <u>health</u> benefit costs. Will there be additional proposals regarding these CSU-related costs?
3. Due to a host of statutory requirements and legal precedence, the LAO has reported that the only way CSU can reduce its pension costs would be through managing its payroll costs – either by reducing the number of employees or their salaries. Is this an avenue the CSU has pursued or is planning on pursuing? Given these dynamics, is the Administration considering other changes to assist CSU in managing its retirement costs?
4. What percentage of UC's payroll is comprised of state GF-funded employees? How many UC employees are state GF-funded?
5. Instead of $90 million, the LAO recommends providing $78 million, of which $34 million is attributable to state-funded employees. The remaining $44 million is for tuition-funded employees. What is the justification for the full $90 million?
6. Has UC included Hastings' employer's share in the $90 million calculation of needed funding, were it to be provided for the state's share of UCRP costs? If not, why not, as Hastings' also has state-supported payroll similar to the larger university?

Staff Recommendation. Staff recommends that this issue be held open, pending the May Revision.

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Item 6: Accountability and Annual Increases – A New "Funding Agreement"

Governor's Budget Proposal. A central component of the Governor's long-term plan for higher education is a new funding agreement in years 2013-14, 2014-15, and 2015-16, committing four percent annual base budget increases for UC and CSU, contingent upon the passage of the Governor's tax initiative in November 2012 and in exchange for the segments meeting certain performance metrics.

Staff Comment. "Funding agreements," or "compacts" as they have been previously called, are not a new idea or approach. Similar agreements between prior administrations and UC and CSU generally took the form of uncodified agreements between the Governor and the universities. The Legislature was not a party to those earlier agreements. Those prior agreements also largely proved themselves to be unworkable. While the desire for budgetary stability and predictability is understandable, the state budgets on a one-year cycle. In this vein, one Legislature cannot tie the hands of another; therefore, and as in the past, any budget decision made one year about a future year is at best a statement of legislative intent.

At this juncture, more questions than answers are available about this "new" funding agreement. For instance, what performance metrics will be used – graduation rates, time to degree, faculty teaching workload, etc.? It is also unclear how these metrics would be defined much less measured. In short, no specifics are yet available about the Administration's new funding agreement. Staff is aware that negotiations between the Administration and UC and CSU have been ongoing; word of this approach first started to surface as early as fall of last year. Staff also notes that it is understandable that the segments would engage in these negotiations; having some certainty about budgets is a preferred approach. However, it is difficult at best to grasp how the Legislature will be involved in the development of this agreement. It is also unclear whether the Legislature would want to make such out-year funding commitments. To date, the Legislature has had no role in the development of the agreement. It is entirely possible that the Legislature will simply be handed a funding agreement reached between the Administration and UC and CSU.

LAO Recommendation. The Legislature has shown a strong interest in accountability over the past decade. While prior attempts to adopt a framework have failed, the Legislature is currently considering SB 721 (Lowenthal). This bill would establish higher education goals and create a working group of representatives of the Legislature, Administration, segments, and others to develop specific accountability metrics. Other current and recent legislative efforts have focused on similar objectives.

The Governor's proposal provides a good opportunity to move forward with the Legislature's accountability efforts. However, the LAO recommends that accountability metrics be used to help the Legislature in identifying policy and budget priorities, rather than as a mechanism for triggering the preset four percent augmentations for the segments.

The Legislature has spent over a decade pursuing higher education accountability efforts. It has been part of a national dialogue on the topic, and its legislative efforts have taken advantage of lessons learned along the way. At the same time, it has become clear that the most successful accountability systems in other states have had strong engagement and support from both the executive and legislative branches. The Governor's interest in accountability, therefore, provides a good opportunity for the Legislature and Administration to jointly make progress in developing a statewide higher education accountability system. At the same time, accountability remains a difficult and elusive goal, so it would be unrealistic to expect to complete such an effort as part of this year's budget process. Instead, the LAO recommends that these efforts be directed through policy committees and the regular legislative process.

Finally, promising out-year base augmentations to the segments would complicate budgeting in other areas and reduce the Legislature's discretion in allocating resources. For these reasons, the LAO recommends that the Legislature reject the Governor's approach of promising base increases to the segments. Instead, the LAO recommends that the Legislature continue its current practice of making higher education funding decisions as part of each year's budget deliberations.

Subcommittee Questions. Based on the above comments, the Subcommittee may wish to raise the Administration the following questions:

1. How does the Administration view the Legislature’s role in the development of the funding agreement?
2. What is the timing of the funding agreement?
3. Are the accountability metrics only proposed if the tax package is approved; i.e., if taxes fail, does the Administration still support implementing an accountability framework?
4. The LAO has raised a concern that the funding agreement would take away key budget tools that the Legislature uses to guide UC and CSU, while plugging in automatic spending increases disconnected from actual costs and the state’s fiscal condition. How does the Administration respond to this?

Staff Recommendation. Staff recommends that this issue be held open, pending the May Revision.

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Item 7: 2012-13 Budgetary Triggers

Governor's Budget Proposal. The January budget relies on revenue from a tax package to be placed before voters in November 2012. In the event voters reject that plan, the January budget proposes a number of automatic reductions ("trigger cuts") to GF appropriations, primarily in the areas of Proposition 98 and the universities, which would take effect January 1, 2013. For UC and CSU, the segments' GF appropriations would be reduced by $200 million each, reductions of 7.8 percent and 9.1 percent, respectively.

Prior Budgetary Triggers. The 2011 Budget Act included $100 million reductions for both UC and CSU to be triggered if estimates of state revenues as of December 2011 were $1 billion or below the forecasted amount. This trigger was pulled effective January 1, 2012.

Staff Comment. Should the voters reject the Governor's tax initiative, the "trigger" reductions for UC and CSU would total $200 million each. All of these reductions would come at the end of the fall semester, making the reductions so disruptive that the segments likely would feel compelled to adopt budgets assuming the reductions will happen. This is largely the approach taken in 2011-12; in January 2012, UC and CSU were cut by $100 million each. The segments generally included these "worst case scenario" cuts in their budget planning so as to avoid dramatic mid-year cuts.

However, taking the same approach in 2012-13 will be even more challenging for the segments. In absorbing potential trigger cuts of this magnitude, staff notes that there are primarily four operational areas where UC and CSU have the requisite flexibility to make fiscal changes: (1) employee salaries and wages; (2) student services; (3) enrollments; and (4) student tuition fees. However, after years of reduced state funding, it is appropriate to question what budgetary levers actually remain for the segments in planning for further reductions. This question is especially crucial in light of the budget proposal to cede autonomy to the segments, including allowing UC or CSU to set their own enrollment targets.

It is also worth noting that of the four operational areas identified above, one serves as a primary driver for the others; i.e., enrollment levels, which are a key driver of costs, as they dictate faculty and staff hiring decisions. However, campuses and departments have only varying degrees of flexibility in making these decisions, depending on tenure rules, collective bargaining, and other factors. There is also a timing consideration. Fall 2012 enrollment decisions have already been made; the window for fall 2013 enrollment decisions is between October 1, 2012 – November 30, 2012. Therefore, the reality is that a January 1, 2013, trigger reduction would necessarily impact Fall 2013 enrollment.

With regard to tuition fees, UC and CSU have the authority to set their own tuition levels. The UC has not yet made a decision on its fall 2012 tuition, while CSU has already approved a 9.1 percent increase for the fall. However, the Governor's budget does not recognize that increase. While there is no strict deadline for approving fall tuition fee levels, many students and their families need to know what costs they face in order to plan for the fall.

LAO Comment. Given that a significant portion of the Governor's revenue assumptions is subject to voter approval in November, it makes sense to include a contingency plan in the event voters reject the tax proposal. However, the Legislature has choices as to how the contingency plans are structured. For example, the Governor places almost all the trigger cuts in K–14 education and higher education. The Legislature could instead allocate the cuts differently among the state's education and non–education programs. For example, the cuts could be targeted to programs most able to respond to a midyear reduction, or they could be spread across more programs to reduce their impact on any one program.

In the alternative, the Legislature could instead take the opposite approach: build a budget that does not rely on the Governor's tax package, with contingency augmentations if the tax package is approved. This might mean, for example, appropriating less funding for higher education or other agencies than the Governor proposes. In the event tax increases are approved in November, the Legislature could direct the resulting revenues to critical one-time investments, such as paying down debt or funding deferred facilities maintenance. In this way, the higher education segments would know at the outset what level of GF support to expect for their core programs, thus helping in their planning for the academic year.

Subcommittee Questions. Based on the above comments, the Subcommittee may wish to raise the following questions:

1. Does your budget planning for 2012-13 taken into account the possibility of trigger cuts? If so, how?
2. How do UC and CSU intend to "manage" or "limit" student enrollments in the coming year? Will spring transfer enrollments be curtailed? What is the practical effect of these strategies on students?

Staff Recommendation. Staff recommends that this issue be held open, pending the May Revision.