An LAO Report

Higher Education "Compacts": An Assessment

Introduction

For budget years 1995-96 through 1998-99, Governor Wilson maintained a multiyear funding agreement with the California State University (CSU) and the University of California (UC). This agreement, known as the "compact," ensured UC and CSU minimum annual support budget increases and other funding guarantees. In return, UC and CSU agreed to pursue a number of program objectives. Now, the administration and the two segments are negotiating a new multiyear funding agreement.

LAO Findings

Our analysis indicates that a multiyear funding compact for higher education could negatively affect program performance and the state budget process. We find that:

- ❖ The proposed compact is unlikely to offer additional or better accountability mechanisms than are available under conventional annual budget agreements.
- ❖ Funding for CSU and UC has been no less stable than funding for most other state departments. In fact, it appears that UC and CSU have benefitted from policy and funding stability afforded by the *Master Plan for Higher Education in California*—a long-term planning document with few parallels in other state departments.

While it is understandable that UC and CSU would prefer guaranteed funding levels, this additional stability would come at a price to the state as a whole.

- ❖ Specifically, a multiyear funding commitment would reduce the Legislature's annual budgetary discretion, undermining its ability to respond to the state's policy needs in the face of changing fiscal conditions.
- ❖ Furthermore, by guaranteeing minimum budget increases the proposed compact could undermine incentive and accountability mechanisms, resulting in possible negative effects on program quality and cost-effectiveness.

LAO Recommendations

We recommend that the Legislature not endorse a multiyear funding plan for UC and CSU. Instead, we recommend that it continue to use mechanisms already present in the annual budget process to express its policy and budget priorities and hold the segments accountable for performance.

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BACKGROUND

The First Compact

In the *1995-96 Governor's Budget*, the administration proposed a four-year funding agreement for CSU and UC. In its proposal, the administration cited two objectives: restoring UC and CSU budgets following the fiscal difficulties of the early 1990s and stabilizing CSU and UC funding levels in future years. This plan, which came to be known as the "compact" (Compact I), provided the framework for the Governor's budget proposals for budget years 1995-96 through 1998-99. While the Legislature never formally endorsed Compact I in statute, it did pass budgets consistent with the agreement.

State's Commitments

Compact I's central component was a guaranteed minimum annual support budget increase for UC and CSU (see Figure 1). In 1995-96, the guaranteed minimum increase was 2 percent, followed by guaranteed minimum increases of 4 percent in each of the next three years. The *1995-96 Governor's Budget* stated that the first year's minimum guarantee was smaller due to the lingering fiscal effects of the recent recession, while future minimum guarantees were larger, anticipating improvements in the state's fiscal condition. Because Compact I did not limit maximum support budget increases, the agreement created a floor, but not a ceiling, for state appropriations to UC and CSU.

In addition, Compact I also established funding guidelines in several program areas. The major provisions are listed below.

Enrollment. Compact I called for the segments to accommodate enrollment growth averaging 1 percent per year using resources included in their guaranteed minimum support budget increases. If enrollment growth exceeded 1 percent, additional funds were to be provided.

Student Fees. On student fee policy, Compact I was relatively quiet, stating only that the administration would support the UC and CSU governing bodies in determining appropriate annual fee increases.

Capital Outlay. Compact I specified that the state would provide General Fund increases to pay for debt service on general obligation bonds and lease-payment bonds used to finance capital outlay projects. Available bond funds were to be split evenly among CSU, UC, and the California Community Colleges (CCC).

Segments' Commitments

In return for this multiyear funding guarantee, UC and CSU agreed to:

- Reduce students' time-to-degree by increasing the availability of required courses and improving the transferability of course credits among UC, CSU, and CCC.
- Maintain faculty workloads.
- Increase faculty salaries relative to faculty salaries at comparison institutions.
- Increase the share of employee compensation given as merit-based pay.

Figure 1

Major Terms of Compact I and Proposed Compact II Funding Agreements

	Compact I 1995-96 through 1998-99	Compact II[a] Proposed by CSU and UC 1999-00 through 2002-03
Minimum Support Budget Increase	1995-96 — 2 percent 1996-97 — 4 percent 1997-98 — 4 percent 1998-99 — 4 percent	1999-00 — 4 percent 2000-01 — 4 percent 2001-02 — 4 percent 2002-03 — 4 percent
Student Fees	Increases as approved by UC and CSU governing boards.	Increases as approved by governing boards but no greater than the annual percentage change in California per capita income. The state would have the option to provide additional General Fund resources in lieu of student fee increases.
Enrollment	Average 1 percent annual growth to be funded from within the minimum support budget increase. Growth over 1 percent funded on top of this increase.	Growth estimated to range from 2 percent to 3 percent annually. It is not clear from available documentation whether any of this growth would be accommodated from within the minimum support budget increase.
Capital Outlay	General Fund increases to cover debt service on general obligation and lease-payment bonds used to finance capital outlay projects. Each segment to receive $150 million annually for capital outlay needs—an even three-way split of available bond money among CSU, UC, and CCC.	Same. Same—except each segment to receive $210 million annually.

[a] Terms of the Compact II proposal are taken from the *1999-00 Governor's Budget* and materials presented by CSU and UC at budget hearings. Compact II negotiations between the administration and the segments are ongoing at this time.

- Achieve productivity improvements resulting in annual cost savings of $10 million. The segments could then spend these savings at their own discretion.

Proposal for a New Compact

In the *1999-00 Governor's Budget*, the administration announced that UC and CSU had proposed a new multiyear funding compact (Compact II). Details of the proposal were included in the budget's A-pages as well as in materials presented by the segments during budget hearings. Based on these documents, it appears that the Compact II proposal is, in most regards, similar to the earlier funding agreement (see Figure 1). The proposal continues the original compact's guaranteed minimum annual support budget increases. Again, there would be no limit on maximum one-time or ongoing budget increases. Compact II's capital outlay plan is similar to the first agreement, differing only in the amount of funding provided. The compact proposal calls for enrollment growth averaging between 2 percent and 3 percent annually, but does not specify whether a portion of this growth would be accommodated from within the guaranteed minimum support budget increases, as under Compact I.

With regard to student fees, the proposed compact differs from Compact I by capping annual student fee increases at the annual percentage change in California per capita income.

In the *1999-00 Governor's Budget*, the administration stated that the Secretary of Education and the Director of Finance would attempt to negotiate a new funding compact with UC and CSU. While emphasizing the need to strengthen the accountability and performance measures proposed by CSU and UC, the administration voiced its support for a multiyear funding agreement. Recently, representatives of the administration, UC, and CSU have met to negotiate a new funding compact. At the time this report was being written, no agreement had been announced.

IS A MULTIYEAR FUNDING AGREEMENT NEEDED?

The proposal for a multiyear higher education funding compact suggests concerns with annual budgeting. In this section we consider the annual budget process as it relates to UC and CSU. In addition, we analyze the segments' budgets from the period prior to Compact I to determine how UC and CSU fared without a multiyear funding agreement.

The Annual Budget Is a Compact

The key features of the proposed multiyear compact—funding commitments and accountability mechanisms—are already present in the annual budget. Each year, the Legislature and the Governor, with the input of state agencies and other stakeholders, develop a state budget that expresses the state's policy priorities and goals.

This annual budget is a compact between the public, represented by the Legislature and Governor, and the various departments. In making appropriations, the Legislature and Governor commit resources to departments to accomplish specific state policy objectives. Departments are then accountable to the Legislature and the Governor for accomplishing these objectives. When departments return to seek appropriations for the following year, the Governor and Legislature can evaluate their performance and use their findings in making funding decisions. These annual funding agreements are fundamental to the operation of our state government.

The Master Plan Provides Long-Term Direction

Compact II proponents argue that a multiyear funding plan is needed in order to provide UC and CSU with greater budget and policy stability than the annual budget allows. This argument, however, neglects the crucial role of the *Master Plan for Higher Education in California* in guiding higher education policy.

The *Master Plan* has been the state's road map for higher education policy since its adoption in 1960. Developed by educators and policymakers from across the state, this document defines California's higher education goals and outlines strategies for achieving these goals. Policymakers have periodically reviewed and updated the *Master Plan* to reflect the state's changing needs. The *Master Plan* has proven to be a remarkably enduring planning document, enjoying bipartisan support.

The guiding principle expressed in the *Master Plan* is that all qualified Californians should have the opportunity to enroll in high-quality, affordable institutions of higher education. To achieve this goal of access, the *Master Plan* addresses overarching matters including governance structures and mission differentiation. It also recommends operational guidelines for eligibility pools, transfer policy, enrollment planning, facility utilization, financial aid, and other policy areas.

The *Master Plan* has provided enduring policy goals and guidelines that the Legislature and the Governor have sought to fund to the extent possible within available resources. This combination of a strong planning document and a high level of support among policymakers gives UC and CSU the stability to plan for the long term.

Higher Education Fared Well Without a Compact

Our analysis of years prior to Compact I indicates that UC and CSU fared well. In good times, funding for the segments increased and, in bad times, the segments were not disproportionately affected. We find evidence of strong support whether we compare UC and CSU funding levels to those of other state programs, or to their own historical budgets. These findings lead us to conclude that UC and CSU do not require special budgetary protections, such as a multiyear funding agreement.

Support Relative to Other State Programs

One way to assess the level of state support for higher education is to compare UC and CSU General Fund appropriations to those of other state departments. Figure 2 (see page 6) shows state funding levels for UC, CSU, the California Department of Corrections (CDC), and the Supplemental Security Income/State Supplementary Program (SSI/SSP) from 1979-80 through 1994-95. The budgets are adjusted for inflation and depicted as a percentage of their 1979-80 funding level. Because caseload is a significant driver of costs in all of these programs, we display funding on a per capita basis using full-time equivalent students (FTES) for UC and CSU, inmates and parolees for CDC, and aid recipients for SSI/SSP.

We use these departments for comparison because, like UC and CSU, they perform important state functions and have significant budgets. The SSI/SSP is a social services program that provides cash assistance to eligible aged, blind, and disabled persons. The CDC is responsible for the incarceration, training, education, and care of adult felons and nonfelon narcotic addicts. Estimated 1998-99 General Fund appropriations for the departments were $2.5 billion for UC, $2.1 billion for CSU, $3.9 billion for CDC, and $2.3 billion for SSI/SSP.

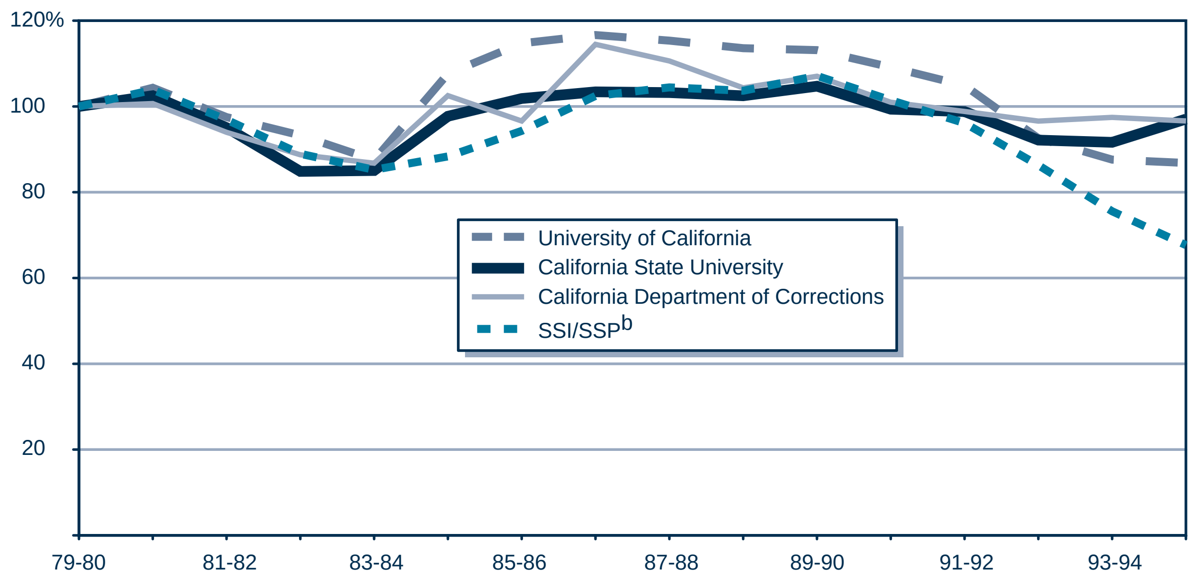
Figure 2 shows the funding levels for the four departments moving, generally, in tandem. In fiscally tight times such as the early 1980s and the early 1990s, per capita funding declined for all four departments. In fiscally better times, the departments tended to do better. This pattern appears to reflect the state's efforts to support these departments to the extent possible within available resources. An exception is funding for SSI/SSP, which continued a decline started in 1989-90, even after funding for the other departments leveled off or began to increase. We should note that while per capita CDC funding has declined slightly in the 1990s, total program costs grew dramatically during the period due to significant caseload increases.

It is important to remember that both UC and CSU share a crucial advantage over many state departments that is not reflected in Figure 2. For both segments, student fee revenues provide some insulation against the effects of lean General Fund appropriations experienced in fiscally tight periods, such as the early 1990s. This happens in two ways. First, because the base level of student

Figure 2

General Fund Appropriations Adjusted for Caseload[a]
UC, CSU, and Selected Programs

Percent of 1979-80 Funding Level Adjusted for Inflation
1979-80 Through 1994-95



[a] Caseload in FTES for UC and CSU, inmates and parolees for CDC, and aid recipients for SSI/SSP.
[b] Supplemental Security Income/State Supplementary Program.

fee revenues is independent of the General Fund, it provides a stable funding source that does not vary with state revenues. Second, when General Fund appropriations are lean, CSU and UC can raise student fees to fill all or part of the void. While many have questioned the wisdom of using student fee increases in this manner, UC and CSU have clearly used this practice to stabilize their budgets in the past. Of the other departments depicted in Figure 2, only SSI/SSP has a significant alternative revenue source—federal funds—and, therefore, shares a similar budgetary advantage.

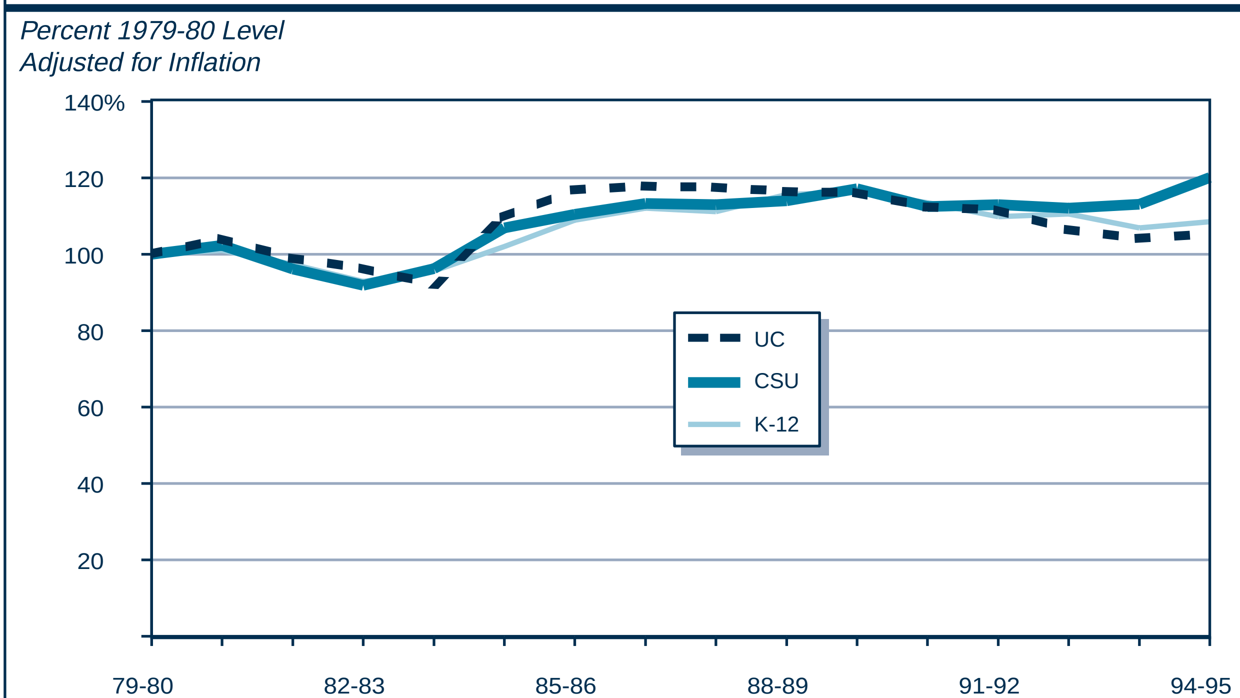
Support Relative to Historical Levels

Another way to measure support for higher education is to track the segments' available resources over time. Figure 3 shows inflation-adjusted resources (state funds and student fee revenues) for UC and CSU per FTES from 1979-80 through 1994-95. For comparison, funding per K-12 enrollment is also shown. Resources are depicted relative to enrollments in order to account for caseload changes over time.

Like the previous figure, Figure 3 illustrates how the level of resources available to the segments has varied over time. In the early 1990s, both CSU and UC experienced slight declines in available resources. By 1994-95 (just prior to the time Compact I was implemented), however, resources per enrollment for CSU had reached an historically high level. Resources per enrollment for UC

Figure 3

Growth in Resources Per College and K-12 Enrollment[a]



[a] UC and CSU resources include state support and student fee revenues. K-12 resources include federal, state, and local support.

were near the 16-year average for the segment. For both segments, resources per enrollment were trending upward. Thus, prior to Compact I, the Legislature and the Governor were already directing additional resources to CSU and UC budgets as the state economy strengthened and more state revenues became available.

It is also interesting to compare in Figure 3 the relative funding levels for K-12 and higher education. Spending per K-12 enrollment, which is governed by a constitutional "compact" (Proposition 98), grew at a rate similar to UC and much slower than CSU.

CONCERNS ABOUT COMPACT II

Our analysis of the proposed compact raises serious concerns about possible negative effects on both the state budget process and program performance. Specifically, we identify a risk that a multiyear funding agreement could both reduce legislative budgetary discretion and fail to provide proper performance incentives to the segments.

A Multiyear Compact Would Reduce Legislative Discretion

The Legislature makes budget decisions within a context of changing fiscal and policy conditions. Unanticipated challenges, including natural disasters and economic downturns, frequently present obstacles to budget plans. Providing a multiyear funding commitment to UC and CSU would reduce legislative discretion and make balancing its budget priorities an even more difficult task.

Support Budget Implications

Making a multiyear funding commitment to UC and CSU would further decrease the portion of the state budget available to the Legislature to address the state's overall needs. Estimated UC and CSU General Fund expenditures for 1998-99 totaled $4.6 billion and accounted for 8 percent of total General Fund expenditures. Reducing legislative control over this share of the budget could have significant negative effects, especially during a fiscal crisis.

Guaranteed minimum increases to UC and CSU support budgets would be most problematic during years in which General Fund revenues grow less than 4 percent. This was the case in four of the past ten years. In three of these years, revenues actually declined. In years such as these, the Legislature already faces tough budget choices. Compact II would exacerbate these difficulties by requiring the Legislature to redirect resources from other priorities in order to fund the guarantee to UC and CSU. It is precisely in these fiscally lean periods that the Legislature most needs budgetary discretion. In the illustration below, we estimate how a compact could affect legislative budget options.

An Illustration

To demonstrate the possible effects of a multiyear compact in the future, we analyzed how the Compact II funding formula would have affected funding for UC and CSU had it been in effect in prior years. We applied the Compact II rules to 1984-85 through 1994-95, the ten-year period just prior to Compact I, and compared the results to actual funding in that period. This time period is an appropriate test for the compact because it includes the recession of the early 1990s. It is in such fiscally tight years that appropriations would be leanest and a compact's minimum guarantee would have its greatest impact.

Figure 4 (see page 10) compares the modeled Compact II funding levels for CSU and UC to the actual funding levels from the period. As the graphs illustrate, the effect of the Compact II funding formula would have been relatively minor until 1991-92, when actual General Fund appropriations dropped due to the state's fiscal difficulties. Under the Compact II model, however, funding levels for CSU and UC would have continued to rise. Had Compact II been in effect during that time period, total annual General Fund appropriations for UC and CSU would have reached $4.9 billion by 1994-95. This would have been $1.7 billion, or 52 percent, more than actual appropriations for that year.

This figure shows that, if a compact like that proposed by CSU and UC had been followed between 1984-85 and 1994-95, then the Legislature would have had to provide an additional $1.7 billion to UC and CSU in 1994-95. The Legislature would have had to find this funding either by redirecting it from other programs or by increasing taxes.

Capital Outlay Budget Implications

Our analysis of Compact II's capital outlay funding model raises serious concerns about its ability to target resources to the state's most pressing needs. The proposed compact would continue the current practice of providing an equal amount of bond funds to each segment, without regard to the condition of the physical facilities on individual campuses or the merits or priority of individual projects. This approach can result in lower-priority projects in one segment receiving funds, while a higher-priority project in another segment goes unfunded. As a result, the state's current practice of equal bond fund allocations neither addresses the highest-priority needs throughout higher education nor provides the Legislature the information it needs to ensure that its actions in appropriating funds are meeting statewide needs (for more on this topic, see the *Analysis of the 1999-00 Budget Bill*, page G-28).

Possible Impact on Program Quality and Cost-Effectiveness

Providing a multiyear funding guarantee to UC and CSU risks undermining incentive and accountability mechanisms present in an annual budget process. Over the long term, such changes may erode program quality and cost-effectiveness. If meaningful accountability mechanisms are negotiated as part of a new compact, this might help mitigate these problems. However, such mechanisms were not present in the predecessor to the proposed compact.

Multiyear Guarantee Takes Focus Off Performance

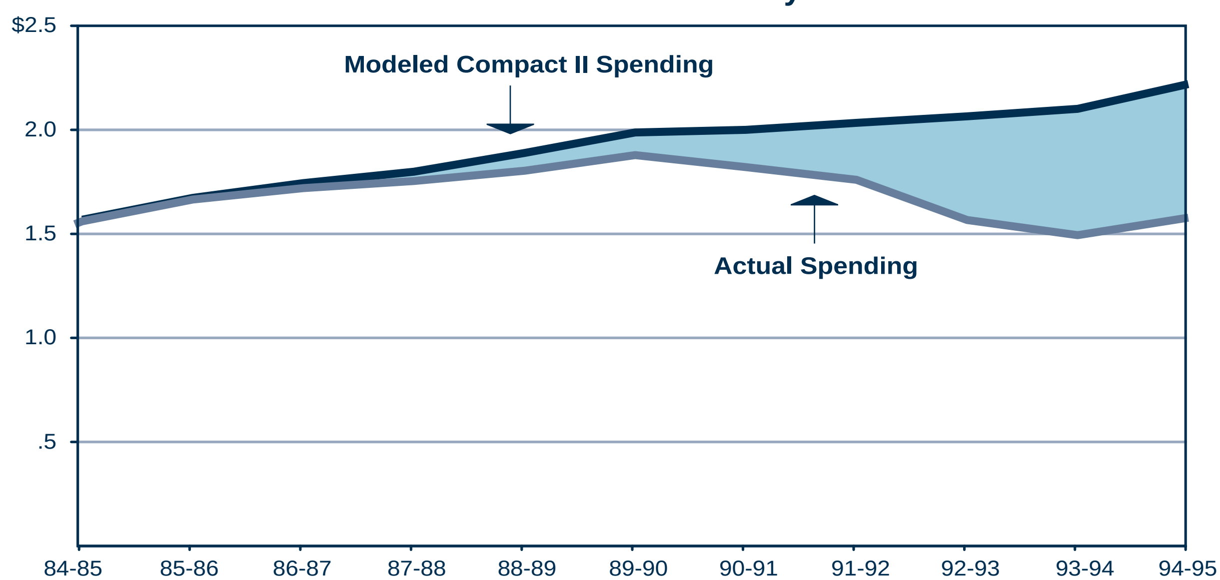
As noted earlier, the annual budget process provides an important opportunity for the Legislature to review CSU and UC performance and use its findings to inform its budget decisions. A

Figure 4

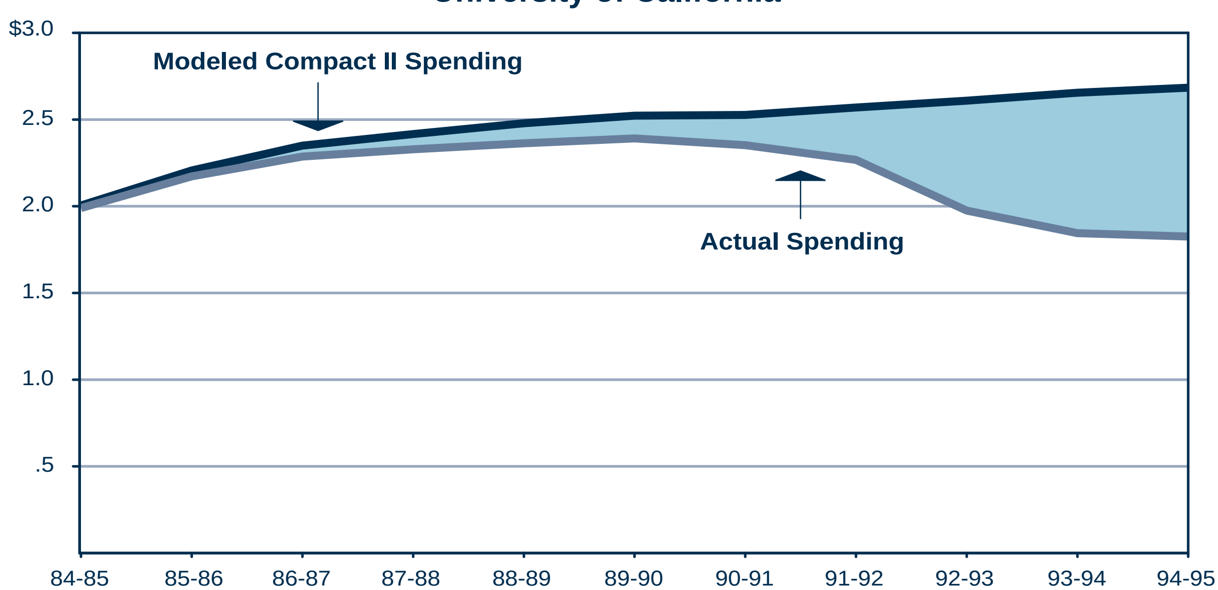
Higher Education General Fund Spending
Actual Versus Modeled Compact II

1984-85 Through 1994-95
Constant 1994 Dollars
(In Billions)

California State University



University of California



multiyear funding agreement would reduce the importance of this annual review and oversight process and, as a result, make segmental funding less closely linked to performance. Weakening the link between performance and funding would reduce the segments' incentive to increase program quality and productivity.

We are particularly concerned that Compact II would reduce incentives for UC and CSU to operate more cost-effectively. The proposed compact would increase UC and CSU support budgets by *at least* 4 percent annually and provide additional funding for the costs associated with enrollment growth and debt service. If the marginal cost associated with enrollment growth is entirely covered on top of the base increase, then the net effect is to grow the segments' base budgets at a *minimum* rate of 4 percent[1]. Given that the general rate of inflation has averaged slightly above 2.5 percent over the past 10 years, a 4 percent rate of growth would represent a real increase in these costs beyond inflation and enrollment growth. Automatic 4 percent guaranteed minimum funding increases therefore place little pressure on the segments to increase productivity.

Need for Stronger Accountability Mechanisms

A major weakness of Compact I was its lack of effective accountability mechanisms. The few performance goals included in the agreement were vaguely defined—for example, "improved transferability of credits" and "placing a high priority on improved graduation times." Compact I contained no specific performance measurements or performance targets. Furthermore, there were no consequences for UC or CSU if they failed to improve their performance.

The Davis administration appropriately called attention to these shortcomings in the *1999-00 Governor's Budget*. Should the Legislature choose to adopt a multiyear funding commitment, it should at least require that UC and CSU achieve specific, significant improvements in quality and efficiency. For example, the Legislature might require CSU and UC to:

- Lower the average cost of instructing a student.
- Implement year-round operation to more efficiently use instructional space and avoid capital outlay costs.
- Increase use of distance education in order to avoid capital outlay costs and increase student access.

For each goal, clearly defined performance measures and targets should be established with predetermined budgetary consequences if the segments fail to achieve them. Such changes, however, need not be contingent on the adoption of a multiyear compact. The Legislature can and should require the segments to improve quality and increase efficiency under the traditional annual budget process.

[1]Available information on the Compact II proposal does not specify if any enrollment growth would be funded from within the base increase. Compact I required that the segments accommodate 1 percent enrollment growth in this manner and provided additional funding for enrollment growth in excess of 1 percent.

LAO RECOMMENDATIONS

The push for a multiyear funding agreement for UC and CSU is largely a reaction to the budgets experienced by the segments during the state's fiscal difficulties of the early 1990s. What Compact II proponents fail to recognize is that these budgets declined, not for lack of legislative deliberation, but rather because the state faced difficult choices. Furthermore, UC and CSU were not alone in experiencing declining budgets, as most departments shouldered a portion of the state's fiscal hardship.

Had a multiyear funding plan, such as the proposed Compact II, been in place and adhered to, the Legislature would have been even more constrained in making the tough decisions it faced.

While we appreciate the benefit of predictable funding increases, we recommend that the Legislature continue to use mechanisms already present in the annual budget process to express policy and budget priorities and hold the segments accountable for performance. Using the *Master Plan* as its road map and the annual budgetary process as its compass, the Legislature has the flexibility to address the state's diverse needs—in higher education as well as other program areas.

Acknowledgments

This report was prepared by Erik Skinner. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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