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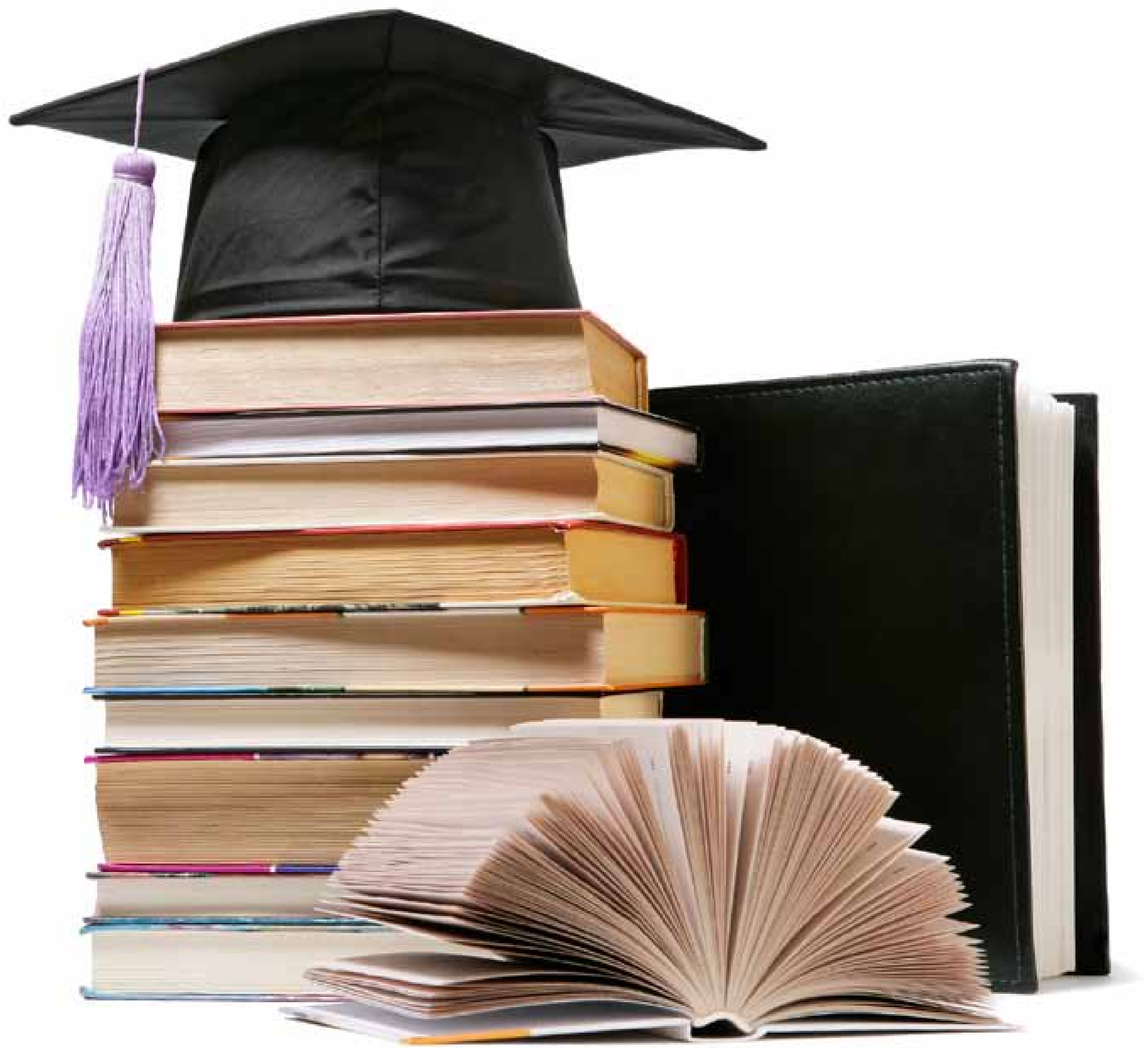
The 2012-13 Budget:

Analysis of the Governor's Higher Education Proposal



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EXECUTIVE SUMMARY

The Governor's budget provides $9.4 billion in General Fund support for higher education in 2012-13. This amount is $348 million, or 3.6 percent, less than the revised current-year level. When other core funding (primarily student tuition revenue, federal funds, and local property taxes) is included, higher education would receive about $17 billion, which reflects an increase of 2.4 percent.

We also compare the Governor's proposed funding level with that provided in 2007-08 (which was the last year that higher education received normal workload and inflation adjustments). While proposed General Fund support for higher education declines by 21 percent over the five-year period, total core funding for higher education would increase by 1.2 percent.

Governor's Proposals

The Governor's budget proposal for higher education reflects three broad themes:

New Approach to Segments' Budgets. The Governor's proposal reduces various restrictions on the three segments' budgets, including the elimination of enrollment targets and other requirements. At the same time, it promises funding increases in subsequent years, contingent on the segments' meeting as-yet-undefined performance standards. For the universities, the proposal also would change how bond debt service and retirement costs are funded.

Budget Solutions Concentrated in State Financial Aid Programs. Virtually all of the Governor's proposed General Fund savings in higher education—$1.1 billion—is concentrated in the state's financial aid programs. Almost two-thirds of this amount comes from replacing General Fund support with other fund sources, and thus would have no programmatic effect on students. The remaining one-third of his General Fund savings is achieved by tightening financial and academic requirements for receiving aid, reducing the size of some grants, and eliminating some smaller programs.

Segments' Budgets Linked to Fate of Tax Package. While the Governor seeks no General Fund savings from the segments in his main budget proposal, all three segments would be subject to midyear cuts if the Governor's proposed tax increases are rejected by voters in November 2012. Specifically, the University of California and California State University would each receive midyear General Fund reductions of $200 million, while general purpose funds for the California Community Colleges would be cut by almost $300 million.

LAO Findings and Recommendations

In addition to describing the Governor's proposals, this report includes various findings and recommendations for the Legislature. Key findings and recommendations include:

New Approach to Segments Would Undermine Legislature's Budget Role. While we can appreciate the Governor's attention to higher education accountability, we think 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.

Some Financial Aid Proposals Could Unduly Harm Access and Increase State's Long-Term Costs. We agree with several aspects of the Governor's financial aid proposals, including the need to refine some eligibility criteria and to phase out some unproductive programs. However, we believe some of the strengthened academic requirements, as well as reductions to Cal Grant awards for needy students at private institutions, would unreasonably harm access. Meanwhile, proposed cuts to Cal Grants at private institutions would end up costing the state more money in the long term if it leads to a significant shift of those students to public institutions.

Community College Aid Program Needs Improvement. The Governor does *not* propose any changes to the community colleges' fee waiver program, whose costs have been escalating. Well over half of all community college students receive fee waivers, and this number is expected to keep climbing. Meanwhile, the program places few academic or other requirements on students, resulting in low student success rates. We recommend specific changes to this program.

Legislature Has Options in Approaching Trigger Cuts. Given that a significant portion of the Governor's revenue assumptions is subject to voter approval, it makes sense to include a contingency plan in the event voters reject his tax proposal. However, the Legislature has choices as to how the contingency plans are structured. For example, the Legislature could allocate the trigger cuts differently among the state's education and non-education programs. The Legislature could also take the opposite approach from the Governor: building a budget that does *not* rely on the Governor's tax package, with contingency augmentations if the tax package is approved.

INTRODUCTION

California's publicly funded higher education system includes the University of California (UC), the California State University (CSU), the California Community Colleges (CCC), Hastings College of the Law, and the California Student Aid Commission (CSAC). For 2012-13, the Governor's proposed budget provides higher education with General Fund appropriations of $9.4 billion, which is $348 million, or 3.6 percent, less than the current-year amount (see Figure 1). However, this masks a number of significant changes to the higher education budget, including fund substitutions, programmatic reductions, and cost shifts. Most significantly, the budget includes about $300 million of cuts to the Cal Grant program. Moreover, if the Governor's proposed tax increases are rejected by the voters in November, higher education would sustain almost $700 million in "trigger" reductions.

OVERVIEW OF GOVERNOR'S HIGHER EDUCATION PROPOSAL

The Governor's budget proposal for higher education reflects three broad themes: (1) a new approach to funding that emphasizes greater budgetary freedom for the public colleges and universities, (2) a concentration of budget solutions in the state's financial aid programs, and (3) the potential for substantial, largely unallocated budget reductions for the three public segments if the Governor's tax package is rejected.

New Approach Proposed for Segments' Budgets

A centerpiece of the Governor's higher education budget proposal is a "long-term plan" that would (1) shift more control over higher education funding from the state to the segments and (2) promise to the segments annual General Fund augmentations in exchange for improvement in certain types of outcomes. Critical details of the

Figure 1

Governor's Budget Proposal for Higher Education

General Fund (Dollars in Millions)

	2011-12 Revised	2012-13 Proposed	Change	
			Amount	Percent
University of California[a]	$2,273.6	$2,570.8	$297.2	13.1%
California State University[a]	2,002.7	2,200.4	197.7	9.9
California Community College	3,276.7	3,740.2	463.5	14.1
Hastings College of the Law (Hastings)[a]	6.9	8.8	1.8	26.2
California Postsecondary Education Commission	0.9	—	-0.9	-100.0
California Student Aid Commission	1,481.7	567.9	-913.7	-61.7
General obligation bond debt[b]	724.9	330.8	-394.0	-54.4
Totals	**$9,767.3**	**$9,418.9**	**-$348.3**	**-3.6%**

[a] 2012-13 appropriations for UC, CSU, and Hastings include general obligation bond payments of $196.8 million, $189.8 million, and $1.8 million, respectively. General obligation bond debt service was funded outside of those segments' budgets in prior years.

[b] General obligation bond debt service for UC, CSU, CCC, Hastings, and Center for Regenerative Medicine. Does not include amounts for UC, CSU, and Hastings in 2012-13.

plan were not available at the time this report was prepared, but the basic elements of the plan include:

New Funding "Compact." Although the administration does not use the term "compact" to describe its proposed funding commitments, the proposal is similar to multiyear funding pacts developed between the segments and previous governors. Governor Brown's proposal includes no new cuts for the colleges or universities in 2012-13 (assuming passage of his tax package), and would provide annual General Fund increases of at least 4 percent for each of the segments beginning in 2013-14. These augmentations would be contingent on the segments' meeting improvement standards in such areas as graduation rates and enrollment of transfer students.

Affordability. The Governor proposes to "curtail" tuition and fee increases at the public segments. The budget assumes no such increases for 2012-13. However, the governing boards of UC and CSU have the authority to set tuition on their own.

Expanding the Base. The proposed budget moves into UC and CSU's base General Fund appropriations some costs that until now were treated separately. Specifically, in 2012-13 debt service payments for UC and CSU facilities, as well as the state's share of UC and CSU retirement costs, would be included in their respective base budgets. These amounts would *not* be separately adjusted in future years, although the entire, enlarged base budgets would be subject to the 4 percent annual increase described above.

Budgetary Flexibility. The Governor's budget seeks to increase flexibility for the segments in several ways. First, in moving retirement and debt service costs into the universities' base budgets, the Governor proposes to remove restrictions on those funds. In addition, the Governor's budget deletes longstanding provisional language and budgetary schedules that in prior budgets had tied portions of the universities' appropriations to specific programs or expenditures. Similarly, the budget consolidates over $400 million of CCC categorical funding into a single appropriation that can be used for a wide variety of purposes.

General Fund Solutions Concentrated In State Financial Aid Programs

The Governor's higher education budget focuses most of his proposed General Fund savings in the state Cal Grant programs. Figure 2 shows all the savings proposals, along with estimated savings and number of students affected.

Figure 2

Governor's Proposed General Fund Reductions to Financial Aid Programs

(Dollars in Millions)

Proposal	Savings	Estimated Number of Students Affected
Use federal Temporary Assistance for Needy Families funds to offset Cal Grant costs	$736	—
Use Student Loan Operating Fund to offset Cal Grant costs	30	—
Raise Cal Grant grade point average requirements	131	26,600
Change Cal Grant award amount for independent, nonprofit colleges and universities from $9,708 to $5,472	112	30,800
Change Cal Grant award amount for private, for-profit colleges and universities from $9,708 to $4,000	59	14,900
Restore uninterrupted enrollment requirement for transfer entitlement awards	70	9,000
Phase out loan assumption programs for teachers and nurses	7	2,670
Maintain maximum student loan default rate at 25 percent	Minimal	Minimal

Large Fund Shifts Would Have No Programmatic Impact on Financial Aid . . . The first two proposals in Figure 2 represent $766 million in General Fund savings. However, these proposals would simply replace part of the Cal Grant programs' General Fund support with alternative fund sources, and thus would have no programmatic impact on financial aid programs.

. . . But Cal Grant Changes Would Reduce or Eliminate Aid for Many Students. The Governor proposes several changes to the state Cal Grant program, which covers tuition and provides living stipends for eligible financially needy students. The proposed changes would save an estimated $372 million in 2012-13. They include:

- Raising GPA requirements for Cal Grant eligibility, which would reduce the number of eligible students and save an estimated $131 million.
- Reducing the Cal Grant award available to students at independent, nonprofit colleges and universities by 44 percent, for savings of $112 million.
- Reducing the Cal Grant award available to students at private, for-profit colleges and universities by 59 percent, for savings of $59 million.
- Restoring a requirement that recipients of transfer Cal Grant entitlement awards must enter a university within one year of completing their attendance at community college.

Several Other Financial Aid Proposals Provide Additional Savings. Other financial aid proposals in the Governor's budget include phasing out two loan assumption programs aimed at teachers and nurses, for estimated savings of $6.6 million in the budget year. The Governor also proposes to halt two anticipated changes in the administration of the Cal Grant programs.

Tuition Increases Could Increase Cal Grant Costs. The Governor's budget assumes neither UC nor CSU will raise their tuition for 2012-13. However, the CSU has already approved a 9.1 percent increase for fall 2012, and UC has not yet set a tuition level for fall. To the extent that the universities charge higher tuition in the budget year, Cal Grant costs will increase beyond the level assumed in the Governor's budget.

Trigger Cuts Could Reduce Higher Education Funding Almost 10 Percent

The Governor's overall budget package relies on a proposed November 2012 ballot initiative that would raise revenues through temporary income and sales tax increases. In the event that voters do not approve that proposal, the Governor proposes $5.4 billion in trigger cuts to take effect January 1, 2013. Included in that amount are $200 million unallocated reductions that would be imposed on both UC and CSU, as well as a nearly $300 million reduction in community college programs.

Tough Choices Ahead

The Governor's higher education proposal presents the Legislature with difficult choices as it balances the need for new budget balancing solutions with the state's longstanding principles of promoting access, affordability, and quality in higher education. The remainder of this report is intended to help the Legislature in making those choices. Specifically, the next section reviews how higher education has been affected to date by the state's recent budget challenges. After that, we offer our assessment and recommendations related to the Governor's key budget proposals for higher education.

RECENT FUNDING HISTORY

In recent years, confusion has surrounded the question of how the state's fiscal difficulties have affected higher education budgets. To a large extent, this confusion results from dissimilar characterizations that focus on different funding sources or use varying baselines for their comparisons. There is no single correct way to describe higher education funding. However, below we present what we consider to be the most relevant aspects of higher education funding changes since 2007-08. That year was the last time that higher education budgets received standard baseline adjustments—enrollment growth and cost-of-living increases were funded at all three public segments, no large unallocated reductions were imposed, and no payments for new costs were deferred to future years.

General Fund Change Since 2007-08

As shown in Figure 3, annual General Fund support for higher education has varied by several billion dollars since 2007-08. Under the Governor's budget proposal, total General Fund appropriations for higher education in 2012-13 would be $9.4 billion, which is 21 percent lower than the 2007-08 total. General Fund reductions to the various segments and agencies over the five-year period would range from 12 percent (for CCC) to 100 percent (for the California Postsecondary Education Commission [CPEC], which was eliminated in November 2011). However, these net reductions are affected by several significant accounting changes, described below.

Proposed Change to Treatment of Bond Debt Payments Skews Comparisons With Prior Years. As noted earlier, each year the state has funded general obligation bond debt service on facilities at the public segments through a General Fund appropriation that is not reflected in those segments' budgets. For UC, CSU, and Hastings College of the Law (Hastings) in the budget year, the Governor proposes to move that funding (totaling $388 million) into the segments' base budgets. Without this accounting change, reductions in direct General Fund appropriations over the period would be somewhat higher: 27 percent for UC, 32 percent for CSU, and 34 percent for Hastings.

Some CCC General Fund Costs Not Reflected in Annual Appropriations. For four of the fiscal years in Figure 3, the state deferred payment of additional CCC costs to the following fiscal year. In those years, the state achieved one-time General Fund savings ranging from $129 million to $340 million. However,

Figure 3

Higher Education General Fund Support

(Dollars in Millions)

	2007-08 Actual	2008-09 Actual	2009-10 Actual	2010-11 Actual	2011-12 Revised	2012-13 Proposed	Change From 2007-08 Amount	Change From 2007-08 Percent
UC	$3,257.4	$2,418.3	$2,591.2	$2,910.7	$2,273.6	$2,570.8	-$686.6	-21%
CSU	2,970.6	2,155.3	2,345.7	2,577.6	2,002.7	2,200.4	-770.2	-26
CCC	4,272.2	3,975.7	3,735.3	3,994.0	3,276.7	3,740.2	-532.0	-12
Hastings	10.6	10.1	8.3	8.4	6.9	8.8	-1.8	-17
CPEC	2.1	2.0	1.8	1.9	0.9	—	-2.1	-100
CSAC	866.7	888.3	1,043.5	1,251.0	1,481.7	567.9	-298.8	-34
GO bond debt service	496.2	591.4	762.0	809.3	724.9	330.8	-165.4	-33
Totals	**$11,875.8**	**$10,041.1**	**$10,487.8**	**$11,552.9**	**$9,767.3**	**$9,418.9**	**-$2,456.8**	**-21%**

Hastings = Hastings College of the Law; CPEC = California Postsecondary Education Commission; CSAC = California Student Aid Commission; and GO = general obligation.

those actions were not expected to affect CCC programs because funding was simply delayed to the next fiscal year, rather than eliminated.

Some General Fund Changes Result From Funding Swaps. In some cases, General Fund appropriations were simply replaced with other state appropriations, resulting in no net change in funding. This is a common occurrence in CCC's budget, as growth in local property taxes can offset General Fund costs. (Conversely, reductions in local property taxes can be backfilled with General Fund augmentations.) In addition, all three segments received federal stimulus funding that backfilled General Fund reductions for several years. For CSAC, General Fund support for the Cal Grant program has been offset by payments provided through the Student Loan Operating Fund. And for the budget year, the Governor has proposed to replace over $700 million in General Fund support for Cal Grants with federal funding redirected from the California Work Opportunity and Responsibility to Kids (CalWORKs) program.

Other Funding Sources Also Support Higher Education

Several other sources of funding—primarily student tuition payments and, for community colleges, local property taxes—also support higher education's core education functions. Figure 4 (see next page) shows all core funding for higher education. As shown in the figure, changes in total core funding during the period has varied considerably by segment. For example, under the Governor's 2012-13 proposal, UC's total core funding will have increased by about $400 million (9 percent) from 2007-08, while CSU's will have declined about $200 million (5 percent). As the figure shows, much of this difference results from tuition charges. (It should be noted that the proposed 2012-13 figures include general obligation bond debt service, which is not included for earlier years. If debt service is excluded from the universities' 2012-13 amounts, the change in core funding over the period would be an increase of 4 percent at UC and a reduction of 10 percent at CSU.) Overall, the Governor's 2012-13 budget proposal would increase total core funding for all of higher education about 1 percent above its 2007-08 level.

Larger Share of Costs Shifted to Students

Tuition Increases at All Public Segments. As a partial response to General Fund reductions, UC, CSU, and Hastings have increased student tuition charges, resulting in an increased share of total education costs being shifted to students. Community colleges fees are set in statute, and have also increased. These tuition and fee increases have resulted in additional revenue for the segments which partially backfills their General Fund reductions. (Increases in revenue from tuition and fees are reflected in Figure 4.) Figure 5 (see page 11) shows tuition and fee levels for resident and nonresident students at the public segments over the six-year period.

Students Paying Larger Share of Total Education Cost. The combined effect of reduced General Fund support and increased tuition and fees has been to shift a larger share of total education cost to students. Figure 6 (see page 11) shows our estimates of the share of education cost paid by undergraduate students at UC, CSU, and CCC. As shown in the figure, tuition represents about 57 percent of the UC's average cost to educate an undergraduate. The respective percentages for CSU and CCC are 48 percent and 20 percent. These shares are up from 2007-08, when UC and CSU students were paying less than a third of education cost, and CCC students were paying about a tenth. Still, the share of cost currently paid by California students remains at or below that paid by students at comparable institutions in other states. Undergraduate tuition at UC currently ranks

Figure 4

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	Change From 2007-08	
							Amount	Percent
University of California (UC)								
General Fund[a]	$3,257.4	$2,418.3	$2,591.2	$2,910.7	$2,273.6	$2,570.8	-$686.6	-21%
Net tuition[b]	1,365.3	1,437.4	1,751.4	1,793.1	2,403.7	2,444.1	1,078.8	79
ARRA	—	716.5	—	106.6	—	—	—	—
Lottery	25.5	24.9	26.1	27.0	32.9	32.9	7.4	29
Subtotals[a]	($4,648.2)	($4,597.1)	($4,368.6)	($4,837.3)	($4,710.2)	($5,047.8)	($399.6)	(9%)
California State University (CSU)								
General Fund[a]	$2,970.6	$2,155.3	$2,345.7	$2,577.6	$2,002.7	$2,200.4	-$770.2	-26%
Net tuition[b]	1,045.8	1,239.3	1,351.7	1,362.4	1,626.0	1,626.0	580.3	55
ARRA	—	716.5	—	106.6	—	—	—	—
Lottery	58.1	42.1	42.4	42.4	47.8	47.8	-10.3	-18
Subtotals[a]	($4,074.5)	($4,153.2)	($3,739.9)	($4,089.1)	($3,676.5)	($3,874.3)	(-$200.2)	(-5%)
California Community Colleges								
General Fund[a]	$4,272.2	$3,975.7	$3,735.3	$3,994.0	$3,276.7	$3,740.2	-532.0	-12%
Fees	281.4	302.7	353.6	316.9	353.9	359.2	77.7	28
LPT	1,970.8	2,028.8	1,992.6	1,959.3	2,107.3	2,101.1	130.3	7
ARRA	—	—	35.0	4.0	—	—	—	—
Lottery	168.7	148.7	163.0	172.8	178.6	178.6	9.9	6
Subtotals	($6,693.1)	($6,455.9)	($6,279.6)	($6,447.0)	($5,916.4)	($6,379.0)	(-$314.0)	(-5%)
Hastings College of the Law								
General Fund[a]	$10.6	$10.1	$8.3	$8.4	$6.9	$8.8	-$1.8	-17%
Net tuition[b]	21.6	26.6	30.7	36.8	36.5	34.8	13.2	61
Lottery	0.1	0.1	0.1	0.2	0.2	0.2	0.1	80
Subtotals[a]	($32.3)	($36.8)	($39.1)	($45.3)	($43.6)	($43.8)	($11.5)	(35%)
California Postsecondary Education Commission								
General Fund[a]	$2.1	$2.0	$1.8	$1.9	$0.9	—	-$2.1	100%
California Student Aid Commission (CSAC)								
General Fund[a]	$866.7	$888.3	$1,043.5	$1,251.0	$1,481.7	$567.9	-$298.8	-34%
Other[c]	—	24.0	32.0	100.0	62.3	766.4	766.4	N/A
Subtotals	($866.7)	($912.3)	($1,075.5)	($1,351.0)	($1,543.9)	($1,334.3)	($467.6)	(54%)
General obligation bond debt service[a]	$496.2	$591.4	$762.0	$809.3	$724.9	$330.8	-$165.4	33%
Grand Totals	**$16,813.0**	**$16,748.8**	**$16,266.5**	**$17,580.9**	**$16,616.4**	**$17,010.0**	**$197.0**	**1%**
General Fund	$11,875.8	$10,041.4	$10,487.8	$11,552.9	$9,767.3	$9,418.9	-$2,456.8	-21%
Fees/tuition	2,714.1	3,006.1	3,487.3	3,509.2	4,420.1	4,464.1	1,750.0	64
ARRA	—	1,433.0	35.0	217.2	—	—	—	—
LPT	1,970.8	2,028.8	1,992.6	1,959.3	2,107.3	2,101.1	130.3	7
Lottery	252.4	215.8	231.7	242.4	259.5	259.5	7.1	3
Other	—	24.0	32.0	100.0	62.3	766.4	766.4	N/A

[a] General obligation bond debt service for UC, CSU, and Hastings is added to their budgets in 2012-13. In all other years, it is funded separately.
[b] Includes systemwide and nonresident tuition and fee revenues less amounts redirected to institutional financial aid programs.
[c] Other funds for CSAC include Student Loan Operating Fund and Temporary Assistance for Needy Families reimbursements.
ARRA = American Recovery and Reinvestment Act; and LPT = Local Property Tax.

Figure 5

Higher Education Annual Tuition/Fees

Mandatory Charges per Full-Time Resident Student

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13 Proposed	Change From 2007-08 Amount	Change From 2007-08 Percent
University of California								
Undergraduate	$6,636	$7,126	$8,373[a]	$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[a]	5,472	5,472[b]	2,700	97
Teacher credential	3,216	3,540	4,674	5,154[a]	6,348	6,348[b]	3,132	97
Graduate	3,414	3,756	4,962	5,472[a]	6,738	6,738[b]	3,324	97
Doctoral	7,380	7,926	8,676	9,546	10,500	10,500[b]	3,120	42
CCC	600	600	780	780	1,080	1,380	780	130
Hastings College of the Law	21,303	26,003	29,383	36,000	37,747	43,486	22,183	104

[a] Amount reflects full effect of midyear increase.

[b] Although the Governor's proposal assumes no increase in CSU tuition for 2012-13, CSU has approved tuition increases of approximately 9 percent for fall 2012, which would result in tuition charges of $5,970 for undergraduates, $6,930 for teacher credential students, $7,356 for graduate students, and $11,118 for doctoral students.

in the middle of its group of five public comparison institutions. The CSU's tuition ranks second lowest among 16 public comparison institutions. And CCC fees remain the lowest in the nation.

Increased Spending On Financial Aid

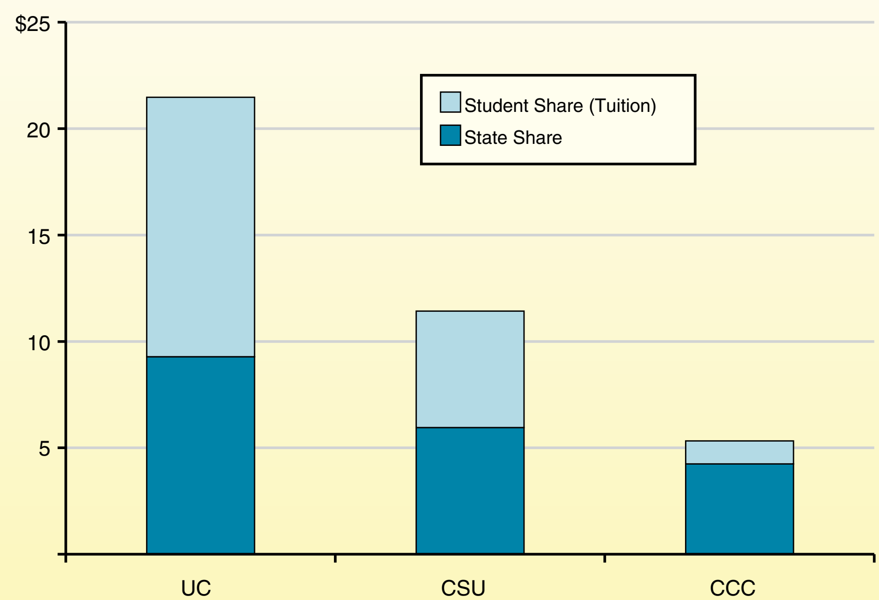
Number and Size of Cal Grants Have Increased. Unlike most of the rest of higher education, the state's financial aid programs have experienced significant *increases* in General Fund support. The state Cal Grant program in particular has been one of the fastest-growing programs in the state budget, increasing from $812 million in 2007-08 to $1.5 billion in 2011-12. Two primary factors account for this growth:

- Most Cal Grants cover the entire tuition charge for eligible students attending UC or CSU. As a result, the tuition increases noted above have driven a commensurate increase in Cal Grant costs.

Figure 6

Average Cost Per Full-Time Equivalent Undergraduate Student

2011-12 (In Thousands)



- The number of Cal Grants awarded has grown about 18 percent. Among other factors, the economic recession has increased the number of families that meet the program's financial need requirements.

Institutional Aid Also Increasing. In addition to Cal Grants, many financially needy students also receive institutional financial aid from their campuses. At UC and CSU, the total amount of institutional aid grows each time tuition is increased. Typically, of every $100 generated by a tuition increase, $33 is set aside for institutional aid. Overall, core funding for UC and CSU's institutional aid programs has increased from $822 million in 2007-08 to $1.6 billion in 2011-12.

The community colleges also provide a form of financial aid, which is the Board of Governors' (BOG) fee waiver program. This program waives community college fees for all students with financial need. Participation in this program has grown considerably, with well over half of all students paying no fees at all. (We discuss growth in BOG waivers in more detail in the "Financial Aid" section later in this publication.)

Enrollment Changes

The state Master Plan for Higher Education promises admission to all higher education applicants within defined eligibility pools. Specifically, the top one-eighth of high school graduates are eligible to attend UC, the top one-third are eligible to attend CSU, and all high school graduates (and others who can benefit from instruction) are eligible to attend CCC. However, demand for enrollment at the three segments depends on a number of factors, including the perceived cost and benefit of attendance versus other options. In addition, all three segments regularly seek to increase or decrease total enrollment to fit available capacity, using enrollment management tools such as application deadlines, program impaction, and course scheduling. Figure 7 shows annual full-time equivalent (FTE) resident enrollment at the three public segments.

In addition, a number of UC campuses have sought to increase their nonresident enrollment as

Figure 7

Higher Education Enrollment

Resident Full-Time Equivalent Students

	2007-08 Actual	2008-09 Actual	2009-10 Actual	2010-11 Actual	2011-12 Estimated	2012-13 Projected	Change From 2007-08	
							Amount	Percent
University of California								
Undergraduate	166,206	172,142	174,681	175,607	175,409	175,409	9,203	6%
Graduate	24,556	24,967	25,233	25,202	24,686	24,686	130	1
Health Sciences	13,144	13,449	13,675	13,883	14,017	14,017	873	7
Subtotals	(203,906)	(210,558)	(213,589)	(214,692)	(214,112)	(214,112)	(10,206)	(5%)
California State University								
Undergraduate	304,729	307,872	294,736	287,733	298,119	305,396	667	—
Graduate/post baccalaureate	49,185	49,351	45,553	40,422	41,881	42,904	-6,281	-13%
Subtotals	(353,914)	(357,223)	(340,289)	(328,155)	(340,000)	(348,300)	(-5,614)	(-2%)
CCC	1,182,627	1,260,498	1,258,718	1,230,649[a]	1,181,792[a]	1,158,156[a]	-24,471	-2%
Hastings	1,262	1,291	1,250	1,283	1,254	1,135	-127	-10
Totals	**1,741,709**	**1,829,570**	**1,813,846**	**1,774,779**	**1,737,158**	**1,721,703**	**-20,006**	**-1%**

[a] California Community Colleges enrollment for 2010-11 and later has not been finalized.
Hastings = Hastings College of the Law.

a way to increase revenue. Although UC receives no state funding for nonresident students, the amount of their tuition payment ($35,070 for a nonresident undergraduate) exceeds the additional costs these students impose on UC. As a result, UC receives excess revenue from these students that it redirects to other purposes. Since 2007-08, UC's nonresident enrollment has increased by about a third, from about 17,500 FTE students to over 23,000 in the current year.

Programmatic Funding Has Declined, But Not as Much as State Funding

Taking into account the various funding and workload issues discussed above, we can determine how much core funding was available to cover the costs imposed by the average student enrolled at each of the three public segments. To arrive at these estimates for each segment, we combined all the core sources of higher education funding received by that segment, corrected it for deferrals and other anomalies, and divided this amount by the number of FTE students enrolled. We present these estimates in Figure 8. As the figure shows, per-student funding for each of the three segments has declined, even after accounting for the tuition increases and enrollment limitations which have been part of their response to budget constraints. Under the Governor's budget proposal, the total decline in programmatic per-student funding over the period would range from 5 percent to 11 percent, depending on the segment. None of these figures accounts for inflation, which has been low during this period.

The segments have employed a variety of responses to contend with this reduced per-student funding. Among these responses have been limitations on employee salary increases, temporarily furloughing faculty and staff, tapping into budget reserves, reducing student support services, increasing class sizes and consolidating course sections, making greater use of part-time and adjunct faculty, streamlining administrative services, and other actions.

NEW APPROACH TO HIGHER EDUCATION BUDGETS

The Governor's budget proposal for higher education reflects a significantly revised approach in the relationship between the state and the higher education segments. In general, the proposed budget increases the segments' fiscal autonomy by reducing budgetary restrictions on their General Fund allocations. Alongside that increased autonomy the administration proposes annual augmentations to the segments' budgets in the out years, subject to as-yet-undefined performance standards. Below,

Figure 8

Programmatic Funding Per Full-Time Equivalent Student[a]

	2007-08 Actual	2008-09 Actual	2009-10 Actual	2010-11 Actual	2011-12 Estimated	2012-13 Proposed	Change From 2007-08 Amount	Change From 2007-08 Percent
UC	$21,253	$19,905	$18,556	$20,373	$19,636	$20,229[b]	-$1,023	-5%
CSU	11,306	11,062	10,445	11,867	10,303	10,088[b]	-1,217	-11
CCC	5,659	5,391	5,118	5,344	5,115	5,320	-340	-6

[a] Includes General Fund, net tuition and fees (excluding amount diverted to institutional aid), local property taxes, state Lottery funds, and federal funds that substitute for General Fund support.

[b] The UC and CSU amounts for 2012-13 reflect the Governor's proposal to include general obligation bond debt in their base budgets. This adds $830 per student at UC and $524 per student at CSU.

we discuss four key components to the Governor's new budgeting approach: (1) linking accountability to annual base increases, (2) removing budgetary restrictions, (3) moving general obligation bond debt service payments in the universities' base budgets, and (4) forgoing out-year budget adjustments for university retirement costs. Overall, while we share the Governor's attention to accountability for the higher education segments, we are concerned that many aspects of his proposal would diminish the Legislature's oversight role as well as undermine its budgetary discretion.

Accountability and Annual Increases

Proposal Would Commit Additional Funding And Require Improved Outcomes

A central component of the Governor's higher education proposal is the commitment of 4 percent annual base increases for the public segments in exchange for meeting performance standards. To the extent those standards are met, augmentations would be provided in 2013-14, 2014-15, and 2015-16.

A Centerpiece of Higher Education Budget. The Governor relies on this funding-and-accountability proposal as an integral element of his higher education budget package. For example, the cost of the base increases is affected by his separate proposals (discussed below) to move debt service and retirement payments into the universities' base budgets. And all of these proposals presume that the state will no longer make unallocated (or even targeted) reductions to the universities' budgets. Moreover, the development of accountability mechanisms could help the administration's effort to justify its proposal to remove restrictions on the segments' base funding (also described below).

Key Details Lacking. At the time this report was prepared, the administration had not provided key details on its proposal. These include:

- ***Nature of the Agreement.*** Similar agreements between prior administrations and the segments generally took the form of uncodified agreements between the Governor and the universities. (The CCC generally has been excluded from these kinds of higher education compacts.) The Legislature has not been a party to those earlier agreements. In contrast, the Governor proposes that this agreement apply to all three public segments, and suggests that the Legislature would somehow be involved in its development. Meanwhile, it is our understanding that the Governor and the universities have already spent considerable time negotiating aspects of the proposal. It is not clear what role the Legislature would have at this point, and what form the agreement—if any—would take.

- ***Data and Data Collection.*** Under the Governor's proposal, higher education performance would be measured using "accountability metrics." The administration suggests as possible candidates a number of common higher education performance indictors: graduation rates, time to completion, enrollment of transfer students, faculty teaching workload, and course completion. However, it is not known which specific metrics would be used, how they would be defined, how data would be collected and by whom, what performance targets the segments would be expected to meet, and what level of overall performance would merit a base increase.

- ***Endurance of Accountability Provisions.*** The administration indicates that the proposed annual base increases would not be made if the Governor's proposed tax package were not approved by the voters. It is not clear whether the accountability provisions would also be suspended if the tax package failed. For the longer term, it is not clear whether the segments would be expected to maintain any particular performance levels once the final year of the proposed base increases had passed.

Legislature Has Shown Strong Interest in Accountability

The accountability proposal in the Governor's higher education budget is something of a departure from prior administrations, which have been notably resistant to the idea. In contrast, for the past decade the Legislature has spent considerable effort in trying to develop a higher education accountability framework. In fact, the Legislature has twice passed comprehensive higher education accountability legislation which was vetoed. More recently, the Legislature's Joint Committee on the Higher Education Master Plan identified serious shortcomings in the state's ability to oversee and set standards for the higher education system, and called for renewed efforts to develop goals and oversight mechanisms for higher education. A current legislative effort in this direction is SB 721 (Lowenthal), which 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.

Future of Statewide Higher Education Data Unclear. Higher education oversight relies to a large extent on objective data that allows policymakers to monitor performance. Last fall, however, the Governor vetoed funding for CPEC, which the Legislature had charged with annually collecting and analyzing key data on California's higher education system and its students. (See our recent publication, *Improving Higher Education Oversight*, for details on this and related issues.) The Legislature has held hearings and is considering possible legislative responses to address the data and oversight issues created by CPEC's demise.

Committing to Out-Year Base Increases Presents Problems

The higher education segments, like many state and local entities, have experienced unpredictable, significant changes to their budgets in recent years. It is understandable that those who receive state funding would desire greater budgetary stability and predictability. However, agreements such as the one proposed by the Governor have been tried before, and have proven unworkable. (For our assessment of earlier compacts, see *Higher Education Compacts: An Assessment*, August 26, 1999, and "Higher Education Compacts," pages E149 - E156 of our *Analysis of the 2005-06 Budget Bill*.) By promising base increases to the three higher education segments (contingent upon their meeting certain performance targets), the Governor's proposal would encounter or create a number of problems, described below.

Budget Volatility Would Be Redirected and Amplified in Other Areas. The budget uncertainty experienced by the segments in recent years stems from underlying revenue volatility that affects the entire state budget. By promising to insulate the segments from these effects through stabilized budgets and annual base increases, the Governor's proposal would in effect concentrate the effects of revenue volatility in other areas of the budget.

Legislative Discretion Would Be Constrained. To the extent that the Governor's proposal was followed, the Legislature would have less discretion in allocating funds toward its priorities. For example, under the Governor's proposal the three segments would receive General Fund increases totaling about $350 million in 2013-14, which would reduce the amount of available revenue the Legislature could appropriate for other purposes. Moreover, the Legislature would not be able to reallocate funding among the segments in response to differing needs. For example, if enrollment demand at CSU increased more rapidly than the growth at UC, the Legislature would not be able to redirect funding to accommodate the shift in demand.

Conflicts With Codified Legislative Intent. As part of the 2009-10 budget package, the Legislature amended statute expressing its intent that the public universities (as well as most other state departments and the courts) should not receive automatic cost-of-living adjustments. The Governor's proposed annual 4 percent base increases would appear to conflict with that intent. (To the extent that the Governor's proposed accountability provisions were developed and rigorous, it might be argued that the base increases were not "automatic.")

Builds in Cost Increases. The Governor's proposal would build in cost increases for the universities—irrespective of underlying inflation, enrollment growth, or other cost drivers. At a time when cost savings are being sought in most areas of government, it is unclear why the Legislature would want to build in cost *increases* for higher education.

Unique Concerns for Community College Funding. As noted earlier in this publication, community college funding is subject to Proposition 98. As a result, General Fund support for CCC is intertwined with local property tax revenues received by the colleges, since Proposition 98 counts the combination of these two fund sources together. This means that an increase in local property taxes would result in a reduction in the amount of General Fund needed for a given level of Proposition 98 support. For this reason, simply increasing CCC's General Fund support by 4 percent (as described in the Governor's budget proposal) does not ensure any particular level of Proposition 98 resources for CCC, since property tax revenues do not necessarily move in tandem with General Fund revenues.

In response to our questions, the administration has clarified that it intends for CCC's 4 percent base increases to be applied to its entire Proposition 98 base (including both General Fund and local property taxes). However, this raises a new set of concerns. For example, if property taxes were to increase by less than 4 percent from one year to the next, fulfilling the Governor's promise of a 4 percent increase in CCC's Proposition 98 funding could cost well more than a 4 percent increase in CCC's General Fund appropriation. This is because the General Fund would have to make up for the inability of property taxes to cover their share of the overall 4 percent augmentation.

Another difficulty arises because CCC and K-12 schools together share total Proposition 98 funding. If the overall Proposition 98 minimum guarantee were not to increase by at least 4 percent in a given year, meeting the Governor's proposed increase for CCC would require either shifting some of K-12's share to CCC, or appropriating above the minimum guarantee (which would increase overall state costs).

LAO Recommendation: Pursue Accountability Without Automatic Augmentations

We believe the Governor's proposal provides a good opportunity to move forward with the Legislature's accountability efforts. However, we recommend that accountability metrics be used to help the Legislature in identifying policy and budget priorities, rather than as a mechanism for triggering the preset 4 percent augmentations for the segments.

Invite Administration to Join Legislature's Accountability Efforts. As noted above, 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, we recommend that these efforts be directed through policy committees and the regular legislative process.

Reject Commitment to Base Increases. As noted above, promising out-year base augmentations to the segments would complicate budgeting in other areas, reduce the Legislature's discretion in allocating resources, and create particular difficulties within Proposition 98. For these reasons, we recommend that the Legislature reject the Governor's approach of promising base increases to the segments. Instead, we recommend the Legislature continue its current practice of making higher education funding decisions as part of each year's budget deliberations.

Flexibility Provisions

Somewhat related to the administration's accountability proposal are a variety of changes that would expand the segments' freedom to decide how their funding should be used. The administration asserts that these various proposals work together to give the segments the incentives and flexibility to make better use of their base funding.

Removal of UC and CSU Earmarks

Background. Typically, the annual budget act includes a number of restrictions on UC's and CSU's General Fund appropriations. For example, recent budget acts have required UC to spend a certain portion of its funding on specified research programs, and have required both UC and CSU to direct a portion of their funding to student outreach programs. Other provisions have linked a portion of the universities' General Fund support to start-up costs at particular campuses. These and other "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. Figure 9 (see next page) lists the various earmarks for UC and CSU in the *2011-12 Budget Act*. (We consider the setting of enrollment targets to be a special category and address it separately in a following section.)

Governor's Proposal. The Governor's budget eliminates virtually all earmarks from UC and CSU's budgets. The administration asserts that this will provide the universities with greater flexibility to manage recent unallocated budget reductions.

LAO Assessment. Unlike most state agencies, 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 that will be admitted; the number of faculty, executives, and other employees on the payroll; the salaries and benefits to be provided to those employees; tuition levels paid by students; the amount of tuition revenue redirected to financial aid; and other choices. Given the delegation of so much budgetary authority to UC and CSU, the state has relied on earmarks as one way to ensure that its key concerns and priorities are addressed with the funding it appropriates to the universities. The inclusion of earmarks in the budget bill also provides a clear public

Figure 9

UC and CSU General Fund Earmarks

From 2011-12 Budget Act (In Millions)

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

[a] Remains earmarked in Governor's 2012-13 budget proposal.

[b] Would be funded through State Department of Education in Governor's 2012-13 budget proposal.

COSMOS = California State Summer School for Mathematics and Science; PRIME = Program in Medical Education; and MOU memorandum of understanding.

record of budgetary allocations and expectations. The Governor's proposal would eliminate this budgetary tool, and thus would reduce the Legislature's ability to ensure that state funds are spent in a manner consistent with its intent.

Recent budget reductions have made it more difficult for the universities to fulfill the public missions assigned to them. While they are able to absorb some budget reductions by drawing on funding reserves and increasing efficiencies, reductions of the magnitude in the current year—$750 million per segment—require a prioritization and narrowing of some activities. In this context, the Governor's budget proposal would provide the universities with $4.8 billion of General Fund support, while deferring virtually all spending decisions to the universities.

Recommend Legislature Reevaluate Requirements for Universities' Spending. We think 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 General Fund support.) However, rather than simply abandoning all earmarks in the universities' budgets, we recommend 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.

CCC Categorical Flexibility

The Governor's budget proposal would move $412 million of CCC categorical funding into a single "flex item" that districts could use for a wide array of purposes. In recent years we have encouraged the Legislature to loosen categorical restrictions on CCC funding, while assigning broader yet defined purposes for some funding. Accordingly, we recommend that the Legislature consider alternative approaches to the Governor's proposal that would maintain somewhat more focus for this funding on key legislative priorities. (We discuss this proposal in detail later in the "Community Colleges" section of this report.)

Elimination of Enrollment Targets

Proposal. One of the key measures of workload at the higher education segments is FTE enrollment. In most years, each segment's budget is tied to a specified enrollment target. For UC and CSU, the budget act typically includes an enrollment target for each segment and provisional language that would reduce the segment's General Fund support in proportion to any enrollment shortfall relative to its target. For CCC, enrollment targets are somewhat more complicated. Specifically, the budget drives statutory formulas and calculations which result in enrollment targets for each of the state's 72 community college districts. The amount of apportionment funding received by each district depends on the number of students they enroll, up to (but generally not beyond) that enrollment target. Although not specifically included in the budget act, an overall enrollment target for the entire CCC system is calculated by the Department of Finance (DOF).

The Governor's budget proposal would eliminate enrollment targets for all three segments. For UC and CSU, this means simply omitting provisional language which typically would reference an enrollment target. For CCC, the administration has introduced trailer bill language that would suspend or eliminate existing formulas for allocating apportionment funding.

Assessment. Enrollment levels are a fundamental building block of higher education budgets. They bear a direct relationship to access provided to the higher education system; they are a central cost driver for the segments; and they affect other costs, such as state financial aid. For these reasons, enrollment targets have been a major concern of the Legislature in recent years.

Changes to the segments' overall funding raise the question of what changes, if any, should be made to their enrollment levels. In some cases, the Legislature has reduced 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.

The Governor's proposal would allow the segments to make their own decisions about how many students to enroll with the funding available to them. In theory, the segments could significantly reduce the number of students served, thus raising the average amount of funding available per student. This funding could be used to increase salaries for faculty, staff, and executives—a goal all three segments have expressed at various times. Or they could reduce the number of undergraduates served, and use the funding to add a smaller number of higher-cost graduate students. Alternatively, the segments could employ an enrollment reduction to shift a larger amount of their budgets away from direct education costs toward research or other noninstructional programs. These kinds of decisions have implications not just for the costs that the segments pay to educate students; they also could have a profound effect on the level of access provided at each segment.

Recommend Rejection of Governor's Proposal. We recommend the Legislature reject the Governor's proposal to eliminate enrollment targets. Instead, we recommend the Legislature restore provisional language that specifies enrollment targets for UC and CSU, and reject proposed trailer bill language that would decouple community college funding from enrollment. 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 segments' 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.

Debt Service Payments

The Governor proposes major changes to the manner in which both general obligation and lease-revenue bond debt is repaid for higher education. These changes would apply to UC, CSU, and Hastings, but not to CCC.

Background

General Obligation Bond Debt Service. The California Constitution requires that general obligation bonds be approved by a majority of the voters and sets repayment of this type of debt before all other obligations of the state except those related to K-14 education. State bond acts continuously appropriate this debt service from the General Fund. Funding to repay this debt is not included in direct budget appropriations for the higher education segments. Due to the varying debt service payment schedules related to different projects, general obligation bond debt payments the state makes on behalf of the segments fluctuate from year to year.

Lease-Revenue Bond Debt Service. Lease-revenue bonds are also used to finance infrastructure projects for the segments. These bonds may be authorized with a majority vote of the Legislature, and their debt service is covered from the future rental payments on the facilities that are built. Funding for these rental payments is included in the segments' budget appropriations. The funding, however, is restricted specifically for paying the debt service, and is adjusted each year in the Governor's budget to account for fluctuations in the amount of debt to be repaid.

Governor Proposes Major Modifications to Debt Payment Process

Funding for General Obligation Bond Debt Shifted Into Segments' Base Budgets. First, the Governor proposes to increase UC, CSU, and Hastings' base budget appropriations to reflect what the administration estimates would be the 2012-13 general obligation bond debt service payments related to each segment's capital projects. This means the segments would receive base budget augmentations of $196.8 million, $189.8 million, and $1.8 million, respectively. Debt service payments would still be continuously appropriated from the General Fund. However, proposed budget bill language would require that the segments reimburse the General Fund for making general obligation bond debt payments related to their capital projects. The State Controller would transfer the necessary amounts from the segments' General Fund support.

By design, the proposal does not result in increased General Fund costs in the budget year. For example, under the Governor's proposal, UC's budget would be increased by $196.8 million, whereas a similar amount would be transferred out of its budget appropriation by the State Controller. In effect, this part of the proposal merely subjects general obligation bond debt repayment to the process already in place for paying lease-revenue bond debt.

No Restrictions or Future Adjustments on Debt Funding. After making adjustments for 2012-13, the Governor further proposes not to adjust the segments' budget appropriations in the future to reflect any changes in lease-revenue and general obligation bond debt service costs, nor to restrict the funding provided to the segments for the purpose of repaying debt. The amount of funding provided to the segments in 2012-13 for both types of debt service, however, would grow in the out-years to the extent the segments receive general increases in their budgets. For example, the administration proposes minimum 4 percent annual increases to the segments' base budgets for 2013-14 through 2015-16. (These proposed annual increases are discussed in more detail in a separate section of this report.)

No Proposed Changes to State Review Process. According to the administration, the current process through which both the administration and the Legislature review and approve state-funded capital projects for the segments would remain the same under the Governor's proposal. The administration asserts that the segments would still have to request approval from the administration and the Legislature for any projects to be funded with general obligation bonds approved by the voters. Moreover, the administration and the Legislature would still need to review and approve any future lease-revenue projects. Figure 10 summarizes the key elements of the Governor's proposal.

Figure 10

Key Elements of Governor's Proposal

- ✓ All debt funding for 2012-13 included in universities' base appropriations.
- ✓ Funding not restricted for debt service.
- ✓ No future adjustments specifically for debt service.
- ✓ Base appropriations proposed to increase by 4 percent annually from 2013-14 though 2015-16.
- ✓ No proposed changes to state review process of capital projects.

Potential Effects on Debt Service Costs Unclear

Governor's Plan Could Provide Incentives for Segments to Economize on Projects. Because funding for debt service payments is currently budgeted separately from other operations and because their debt service payments are automatically adjusted each year, the segments' general-purpose base budgets are unaffected by debt costs. For this reason, the current approach provides no incentive for the segments to limit the number and scope of capital projects that they submit to the administration and the Legislature. In fact, in past budget analyses we have found that the scope of projects submitted by the segments often exceeds what we would consider to be necessary. For example, our reviews of the segments' capital outlay budget proposals in recent years have frequently identified what we believe are excessive requests for additional space compared to the stated needs.

By funding capital debt service and operating costs from a single, finite appropriation, the Governor's proposal attempts to create an incentive for the segments to prioritize and limit capital projects. In other words, a dollar from a segment's base budget that is spent on debt service would be one dollar less to spend on operations. This would highlight for the segments the trade-offs between spending on operations versus infrastructure—as well as highlight the fact that infrastructure spending can increase operational costs once projects are complete.

But Future Fiscal Implications Uncertain. As shown in Figure 11, annual debt service payments related to infrastructure projects for UC, CSU, and Hastings have more than doubled over the past ten years—growing from about $300 million in 2002-03 to an estimated $708 million for 2012-13. This means that debt service payments have risen on average by about 9 percent per year, although in recent years they have declined slightly. (At the time this analysis was prepared, estimates of general obligation bond debt payments by segment were not available prior to 2010-11—therefore, we could only analyze historical debt spending for all segments combined. Nevertheless, there could be important variations by segment.)

It is difficult to predict how the segments' state-funded debt payments could change in the future. As the figure indicates, annual debt service payments on *existing* bonds (including our estimates for bonds that have been authorized but not yet sold) are expected to increase slightly through 2015-16. Whether the segments' debt costs would further increase relative to these existing obligations would largely depend on what future capital projects the segments request, whether the Legislature approves those projects, or, as discussed further below, what actions UC takes to issue its own debt. For UC, there also could be some debt payment reductions under the Governor's plan. According to the university, it could potentially refinance some of the existing lease-revenue bond debt related to UC facilities and lower its debt service primarily by extending repayment periods. Given these actions cannot be predicted in advance, it is unclear what effect the Governor's proposal would have on debt service costs.

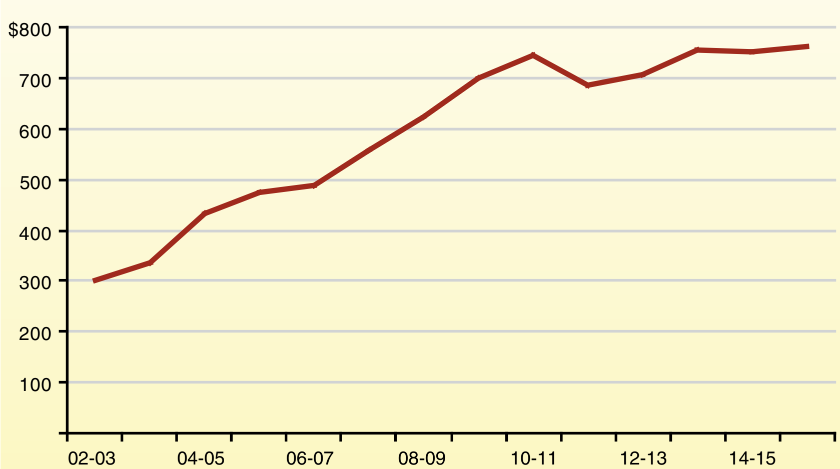
Legislature Would Lose Significant Control Over University Budgets and Projects

Shifting Funding Transfers Control Over Budgets to Universities. The Governor's proposal would relinquish significant control over the universities' budgets. In the future, the Legislature would no longer be responsible for allocating funding for support operations versus infrastructure debt service. This is particularly troublesome since it is not clear whether the amount of debt funding that would be shifted into the universities' budget is an appropriate amount to support the universities' long-term infrastructure needs. Rather, the Governor proposes to shift an amount that is related specifically to one fiscal year. It appears the administration did not perform an analysis to determine how this amount of funding relates to what the

Figure 11

Annual Debt Service Payments for UC, CSU and Hastings[a]

(In Millions)



[a] Includes both lease-revenue and general obligation debt service. Amounts for 2012-13 through 2015-16 include estimated payments for bonds authorized but not yet sold.
Hasting = Hasting College of the Law

universities might reasonably require in the long term. For UC, for example, the amount of funding would be equivalent to roughly $2,000 per student. Without additional information on reasonable debt costs per student, it is unclear whether this amount of funding is appropriate—or whether is is too low or too high. Shifting this amount of control over spending priorities to the universities raises serious questions given that they are statewide, public institutions.

No Guarantee That Projects Would Still Be Submitted for Legislative Review. The administration asserts that the segments would still request bond funding for capital projects from the Legislature. While this could be the case, it is also possible that the segments could circumvent the capital outlay budget request process. For instance, UC could potentially issue its own bonds for projects for which it currently requests state bond financing. This means that in the future UC might not submit many (or even any) state-related project proposals to the Legislature for it to review. (The CSU's ability to issue bonds appears more limited, so it would probably still request bond funding from the state.) Under such a scenario, the Legislature would not have any formal role in reviewing projects to ensure that they are consistent with its priorities. For example, the Legislature would not have the option of directing bond financing toward instructional facilities instead of research buildings. Instead, the choice of projects would be left entirely up to UC. Although it is unclear at this time whether UC could in fact take this approach, we find that the potential loss of Legislative oversight of state-related projects to be a serious concern.

Statewide Infrastructure Planning Could Be More Difficult

As we noted in our recent publication—*A Ten-Year Perspective: California Infrastructure Spending* (2011)—the Legislature's decision making process for all infrastructure projects remains fragmented. Proposals are reviewed and funded in isolation, and there is little examination of how competing proposals fit within the context of overall state infrastructure needs, priorities, and funding capabilities. In our view, the Legislature cannot effectively assess the trade-offs among different proposals without sufficient perspective on the infrastructure demands across various capital outlay programs. The Governor's proposal to devolve the responsibility for debt service payments for UC, CSU, and Hastings' capital projects to the respective segments would likely exacerbate this problem. Should the Legislature at some point in the future wish to prioritize construction projects at one segment (or another state program area) over projects for another segment, it could not easily shift General Fund support to account for the effect of that shift on debt service costs. This could occur, for example, if the Legislature were to enact new policies encouraging distance learning that would reduce the need for higher education facilities.

Recommend Rejecting Governor's Approach

While we agree with the administration that certain aspects of the current state debt financing system for the segments does not always provide the right incentives, overall we find 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, we find that some aspects of the Governor's proposal regarding Legislative oversight of the segments' state-related projects raise serious concerns. For these reasons, we recommend that the Legislature reject the Governor's proposed approach. Specifically, we recommend reducing the General Fund appropriations for UC, CSU, and Hastings by $196.8 million, $189.8 million, and $1.8 million, respectively to take debt service for general obligation bonds out of their budgets (as well as deleting the associated budget language). Further, we recommend restricting the amounts proposed for lease-revenue bond debt service in 2012-13 to that purpose only. These actions would result in no net changes in General Fund spending in 2012-13.

Retirement Costs

The Governor proposes major changes to the way in which some retirement costs are funded for higher education. For CSU, the Governor proposes to no longer make base adjustments to reflect changing retirement costs. For UC, the Governor proposes (1) a $90 million base augmentation that could be used for pension costs or other purposes, and (2) no out-year adjustments for retirement costs. The budget proposes no changes to the way retirement is funded for CCC.

Background

CSU Pension Benefits. CSU employees are members of the California Public Employees Retirement System (CalPERS)—the same retirement system to which most state employees belong. Funding for this system comes from both employer contributions and employee contributions. Each year, as is the case with other state departments, CSU's employer contributions to CalPERS are charged against its main General Fund appropriation. The employer contribution is based on a percent of employee salaries and wages that is determined by CalPERS and specified in the annual budget act. The Governor's budget annually adjusts CSU's main appropriation to reflect any estimated changes in the employer contribution. For example, the Governor's budget reduces CSU's main appropriation by $38 million due to a lower employer rate and lower payroll costs in the current year. The CSU is expected to contribute $404 million to CalPERS in 2012-13.

UC Pension Benefits. Employees of UC (and Hastings) are members of the University of California Retirement Plan (UCRP). This retirement plan is separate from CalPERS and under the control of UC. Prior to 1990, the state adjusted UC's General Fund 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 to UCRP because the pension plan had become "superfunded." Specifically, the plan at that time was enjoying exceptionally strong investment returns, resulting in assets that exceeded liabilities by more than 50 percent. 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.

Governor Proposes New Approach To Funding Retirement Costs

The Governor proposes two major changes related to funding for university retirement plans:

- A $90 million base budget augmentation for UC that, according to the administration, "can be used to address costs related to retirement program contributions." The administration emphasizes that this funding is *not* being provided specifically to fund costs for UCRP. Rather, UC could use it for any purpose related to its state-related programs—including, but not limited to, UCRP.

- A new policy that the segments' budgets no longer be adjusted for changes in retirement costs in the future. Instead, state-related retirement costs would be funded entirely from the segments' unrestricted base appropriations.

Unclear Which Retirement Costs Are Affected. The Governor's proposed language refers simply to "retirement costs." At the time this analysis was prepared, the administration had not provided sufficient clarity on whether this would include costs for retiree health and dental benefits. For example, funding for CSU's retiree health care costs are currently bundled together with funding for other CalPERS retiree health care costs. Since the administration has not yet indicated how it would split out funding for CSU, we are unsure whether the proposal applies to these costs. The administration also was unable to provide information regarding base funding for retiree health costs for UC. For these reasons, our budget analysis only focuses on funding for pension costs for UC and CSU.

CSU Proposal Raises Serious Concerns

Shifting Fiscal Responsibility Lacks Purpose Since CSU Has Little Control Over Costs. State law requires that CSU be part of CalPERS. The benefit structure for CalPERS members—such as the payment rates at various ages and the minimum retirement age—is also specified in state law. This means that the university has virtually no control over the pension benefits that its employees earn. In addition, state case law protects these benefits as contracts under the State and U.S. Constitutions. As a result, there are strict legal limits on even the state's ability to change these benefits for current employees in order to reduce government costs.

Given that the overall benefit structure is very difficult to change in the near term, the only significant lever CSU would have to control its pension costs is the employee contribution rate. For example, an increase in this rate would mean that the university's contribution rate could be lowered. The employee contribution rate for CSU employees, however, is also set in state law, as are contribution rates for other state employees. As a result, CSU is not able to change this rate without Legislative approval. For state employees, these rates also have recently been subject to collective bargaining. Recent negotiated changes in the employee contribution rate for other state employees suggest the university would also likely have to offer a benefit in exchange for increased employee contributions, such as increased salaries. This could offset any near-term pension savings.

The only way that we could identify for the university to reduce its pension costs would be through managing its payroll costs—either by reducing the number of employees or their salaries. But these are blunt tools at best, and unlikely to have a significant impact on reducing pension costs for the university.

Timing Not Right to Lock In Base Funding for Pensions. Even if the administration could make a case for the proposal, this is not the time for such a change. The Governor's proposal would lock in base funding for CSU's pension costs at their 2012-13 level, even though these costs could change significantly in the near and long term. Specifically, the Governor is separately proposing modifications to public employee pensions (including CSU employees) that could reduce pension costs significantly if these changes were approved by the Legislature. Under the Governor's budget proposal for CSU, however, there would be no General Fund savings from reducing CSU's retirement costs since the university's budget would no longer be adjusted for these costs. Given this other pension proposal's potential impact on CSU retirement costs, now would not be a good time to lock in a base funding level for the university.

UC Proposal Has More Merit, But Raises Several Questions

The request for pension-related funding for UC is more difficult and complicated than that for

CSU. This is because (1) the state currently is not providing any pension-related funding to UC, and (2) UC has full control over its pension system. To address the Governor's proposal, the Legislature should consider the following questions:

- What is the main justification for the state to provide funding for UC's retirement costs? In other words, why is funding for these costs a state responsibility?
- Given that UC controls its own pension plan, are UC's pension benefits reasonable? How do they compare to the pension benefits the state provides state employees?
- How much funding should the state provide UC in 2012-13? More specifically, what methodology or calculations support the request for $90 million?
- Finally, should the state lock in the pension amount provided UC at the 2012-13 contribution level or provide UC with budget adjustments for pension costs in future years?

Pension Costs Should Be Funded as Part of Workload Budget. The state currently provides funding for pension-related costs for all other state agencies as part of a normal, workload budget. In other words, the state provides funding to state agencies for the salaries and benefits (including pension benefits) related to their budgeted positions. Given that the state provides UC with funding for the salaries and benefits of some of its employees, it would make sense from a standard, workload budgeting perspective to also provide funding related to pension costs. As noted earlier, the state did provide such pension-related funding to UC for many years prior to the pension holiday that began in 1990. (As we discuss in the nearby text box, the state has repeatedly deferred a final budget increase for pension costs since that time.) Given that the university has had to restart its contributions to its pension plan in recent years, we find justification in its request that the state also resume providing pension-related funding.

UC Pension Benefits Similar to State Employee Pension Benefits. 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, as shown in Figure 12, 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

Final Budget Increase Related to UCRP Deferred Since 1990-91

In a related issue, each year since 1990-91, the University of California's (UC's) budget has included provisional language deferring a $55 million augmentation related to the University of California Retirement Plan (UCRP). The Legislature originally made this deferral as a budget solution in 1990, just as it was becoming evident that UCRP was superfunded. As a result of this maneuver, UC's budget contains a negative $55 million appropriation, along with language preventing the university from accessing the funding until the start of the following fiscal year. This appropriation appears to no longer serve any practical purpose and has been a source of confusion. As part of any agreement to provide funding related to UCRP, we recommend that the Legislature eliminate this appropriation. We believe that this could be done in a way that does not affect UC's overall General Fund support.

8 percent. (Some of UC's proposed employee contribution increases are still subject to collective bargaining.) Additional contribution increases beyond July 2013 will also likely be necessary to reduce the plan's significant unfunded liability that has accrued due to the decades-long pension funding holiday and recent market downturns.

Figure 12

University of California Retirement Plan Contributions Approved by the Regents

	Employee[a]	Employer	Total
April 2010	2.0-4.0%	4.0%	6.0-8.0%
July 2011	3.5	7.0	10.5
July 2012	5.0[b]	10.0	15.0
July 2013	6.5[b]	12.0	18.5

[a] For most employees. Safety and some other employees may pay a different rate.
[b] Not all employee unions have agreed to this rate yet.

UC's Estimate of State's Share of 2012-13 Pension Costs Is Overstated. The $90 million that UC requested from the administration is only a fraction of the $255.6 million that UC estimates to be the state's share for 2012-13. The UC states it requested the lower amount in recognition of the state's severe fiscal shortfall. The university further indicates that it will likely seek the full amount of what it estimates to be the state's share (which it calculates could rise to roughly $450 million) in future years. Figure 13 shows how UC calculates the state's share of retirement contributions.

We find two issues that the Legislature should carefully consider with respect to how the university has estimated the state's share of UC retirement costs.

- First, we find that the request for $90 million in 2012-13 is overstated. As Figure 8 shows, UC's estimate of the state's share of its 2012-13 retirement cost increase totals about $78 million. The UC appears to be requesting a greater amount because it believes that the state should provide contributions to account not only for incremental retirement costs in 2012-13, but also for part of the cost increases in the two prior years. We take a different view.

Figure 13

UC Calculation of State Retirement Contribution

(Dollars in Millions)

	2010-11	2011-12 (Increase)	2012-13 (Increase)
Calculate Employer Contribution			
Employer contribution rate	4%	3%	3%
Employee compensation cost[a]	$2,878	$2,878	$2,921
Employer contribution amount	**$115**	**$86**	**$88**
Calculate State Share[b]			
State General Fund	46%	41%	—
Student fee	41	47	—
Total State and Student Fee Share	**87%**	**89%**	**—[c]**
State contribution	$100	$77	$78

[a] For employees paid from "core funds" only—state General Fund, student fees, UC General Funds, and (for 2010-11 only) federal American Recovery and Reinvestment Act funds.
[b] Percent of core funded employee compensation from state and student fee sources.
[c] The UC used the same percent as 2011-12.

The UC has managed—by both redirecting internal resources as well as increasing student tuition—to fund all of its employer contributions in both 2010-11 and 2011-12. If the Legislature were to provide funding related to prior years, the funding would in effect free up existing UC base funding for other purposes. In our view, given the state's fiscal shortfall, such an augmentation would be unwise.

- Second, the university's calculation of the state's share of retirement contributions includes employer costs related to tuition-funded salaries. From a workload budgeting standpoint, the state portion of retirement costs should only be related to state-funded payroll costs. Given, however, that the Governor's budget assumes no increases for tuition in 2012-13, the Legislature may wish to consider providing the funding for pension costs related to tuition-funded salaries in 2012-13. In future years, higher pension costs—just like any other UC cost—presumably would be covered by the General Fund and tuition fees in proportion to their current funding levels.

Timing Not Right to Lock In Base Funding for Pensions. As with the CSU proposal, now would be a poor time to choose to lock in a base funding level for UC pensions, given that the Governor is separately proposing to modify public employee pensions to reduce costs in the long run. In addition, as noted earlier, UC intends to increase its employer contributions over the next few years, although it has not yet reached agreement with all of its union-represented employees on the employee contribution rate. In our view, the Legislature should carefully evaluate future requests from UC for pension funding on a year-by-year basis in the context of the university's current pension benefit and contribution structure. In the long term, however, it could make sense to expect UC to fund its pension costs out of its base budget, given that the university's retirement system is separate from the state's. This could only work once a reasonable funding level has been identified and contribution amounts have stabilized.

Recommendations

Recommend Rejecting CSU Retirement Funding Proposal. Given the statutory and other constraints that CSU faces, we find 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, we recommend that the Legislature reject the Governor's approach. Specifically, we recommend that the Legislature adopt intent language in the budget specifying that future budget adjustments shall be provided to CSU to reflect its pension costs.

Recommend Restarting Budget Adjustments for UC. As discussed above, we find that 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. We recommend, 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 we estimate to be $78 million. This would mean reducing the Governor's request for $90 million in General Fund support by $12 million. In addition, we recommend 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 pension costs incurred prior to 2012-13.

COMMUNITY COLLEGES

The state's community colleges are funded within Proposition 98 are locally governed, and are subject to greater legislation control than the universities. We examine several key aspects of the Governor's proposal for CCC below.

Overview of the Governor's Budget Proposal for Community Colleges

Major Budget Changes

Figure 14 summarizes the changes proposed for community college Proposition 98 spending in the current and budget years. The figure reflects the $102 million reduction to CCC's 2011-12 funding level as a result of the recent trigger cuts. The budget request for 2012-13 (which assumes voter approval of the Governor's tax initiative in November 2012) would increase Proposition 98 funding for CCC to $5.8 billion, which is $459 million (8.6 percent) over the revised current-year level. This net augmentation includes:

- A technical adjustment of $129 million, which restores base funding to CCC following a prior-year deferral.
- An increase of $218 million to pay down existing CCC deferrals.
- A base increase of $97 million to account for lower-than-expected fee revenues in the current year.
- An increase of $12.5 million to create a proposed CCC mandate block grant.
- A workload adjustment of $14.3 million for CCC financial aid programs.

Figure 15 (see next page) details Proposition 98 expenditures for CCC programs. As shown in the figure, 2012-13 apportionment funding would total $5.3 billion, which reflects an increase of $432 million, or 9 percent, from the revised current-year level. The Governor's budget would increase total funding for categorical programs by $14.3 million. As proposed by the Governor, CCC would receive 11 percent of total Proposition 98 funding in 2012-13.

Figure 14

California Community Colleges
Governor's Proposition 98 Budget Proposal

(Dollars in Millions)

2011-12 (Enacted)	**$5,414.6**
Trigger cuts	-$102.0
Technical adjustments	11.8
2011-12 (Revised)	**$5,324.4**
Restore one-time actions	$129.0
Pay down prior-year deferrals	218.3
Adjust for revised CCC fee revenue estimate	97.4
Create CCC mandates block grant	12.5
Adjustment for Financial Aid Administration	14.3
Technical adjustments	-12.2
2012-13 Proposal	**$5,783.6**
Change From 2011-12 Revised Budget	
Amount	$459.2
Percent	8.6%

Student Fees. In fall 2011, student fees (which are only charged for credit courses) increased from $26 to $36 per unit. In summer 2012, student fees are scheduled to increase to $46 per unit as part of the 2011-12 budget package's trigger solutions. The Governor proposes no additional changes to the fee level in 2012-13. (There continues to be no fee charged for *noncredit* courses.)

Governor Proposes Multiyear Funding Commitment, Additional Flexibility. As we discuss earlier in this report, the Governor proposes to provide annual General Fund augmentations of at least 4 percent for UC, CSU, and CCC beginning in 2013-14. These increases would be conditioned on the segments achieving certain

Figure 15

Community College Programs Funded by Proposition 98[a]

(In Millions)

	Revised 2010-11	Revised 2011-12	Proposed 2012-13	Change From 2011-12	
				Amount	Percent
Apportionments					
General Fund	$3,419.7	$2,745.9	$3,184.7	$438.7	16.0%
Local property taxes	1,959.3	2,107.3	2,101.1	-6.2	-0.3
Subtotals	($5,379.0)	($4,853.2)	($5,285.8)	($432.5)	(8.9%)
Categorical Programs					
Academic Senate	$0.3	$0.3			
Apprenticeships	7.2	7.2			
Basic skills initiative	20.0	20.0			
CalWORKs student services	26.7	26.7			
Campus child care support	3.4	3.4			
Career Technical Education Pathways[b]	—	—			
Disabled Students Program	69.2	69.2			
Economic and Workforce Development	22.9	22.9			
EOPS	73.6	73.6			
Equal Employment Opportunity	0.8	0.8			
Financial Aid Administration	55.0	56.7	→ $411.6[c]		
Foster Parent Education Program	5.3	5.3			
Fund for Student Success	3.8	3.8			
Matriculation	49.2	49.2			
Nursing grants	13.4	13.4			
Part-time Faculty Compensation	24.9	24.9			
Part-time Faculty Office Hours	3.5	3.5			
Part-time Faculty Health Insurance	0.5	0.5			
Physical Plant and Instructional Support	—	—			
Telecommunications and Technology Services	15.3	15.3			
Transfer Education and Articulation	0.7	0.7			
Subtotals	($395.6)	($397.3)	($411.6)	($14.3)	(3.6%)
Other Appropriations					
District financial-crisis oversight	$0.6	$0.6	$0.6	—	—
Lease revenue bond payments	68.8	63.7	63.7	—[d]	—
Mandates	—	9.5	22.0	$12.5	130.6%
Subtotals	($69.4)	($73.8)	($86.2)	($12.4)	(16.8%)
Totals	**$5,844.0**	**$5,324.4**	**$5,783.6**	**$459.2**	**8.6%**

[a] Excludes available funding appropriated in prior years.

[b] Annual funding of $48 million is provided for this program by the Quality Education Investment Act (non-Proposition 98 General Fund monies).

[c] The Governor proposes to replace the existing CCC categorical programs with a flex item and augment base support for it by $14.3 million, for total funding of $411.6 million in 2012-13.

[d] Difference of -$41,000.

CTE = Career Technical Education; and EOPS = Extended Opportunity Programs and Services.

performance targets (which are not yet defined). To help the segments reach these goals, the Governor proposes to expand significantly their fiscal and program flexibility. For CCC, the Governor proposes to:

- Repeal the current statutory funding model for apportionments, which is primarily based on student enrollment, and permit the BOG and statewide Chancellor's Office to adopt a new formula if they choose (subject to approval by DOF).

- Consolidate funding for all 21 categorical programs into one flex item, and, with few exceptions, give districts broad discretion in how they spend the funds.

- Eliminate a number of CCC mandates—thereby deleting certain statutory requirements on districts—and develop a mandate block grant that would encourage (without requiring) districts to continue carrying out certain other currently mandated activities.

Fee-Revenue Shortfall

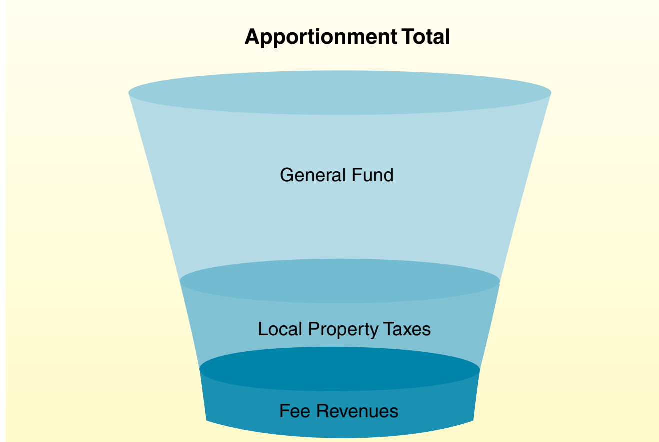
Overview of Budgeting for Fees

Fees Help to Cover Apportionment Obligations. Apportionment funding (which districts use for general purposes) comes from three main sources: enrollment-fee revenues, local property taxes, and the General Fund. (Local property taxes and the General Fund account for CCC's funding under Proposition 98.) For apportionments, each enacted budget assumes a specified amount of enrollment fees and local property taxes that will be collected and retained by community colleges that year. The assumption about fee revenue is based on estimates of the number of students who will pay fees and the number of students who, because of their financial need, will receive a BOG fee waiver. (The assumption about local property tax revenue is generally based on estimates provided by DOF at the May Revision.) As Figure 16 shows, based on these estimates of fee and local property tax revenues, the enacted budget provides the necessary General Fund support to meet the system's apportionment amount.

No Automatic Backfill in the Event of a Shortfall. When systemwide fee revenues or local property tax receipts fall short of what is assumed in the enacted budget, the total amount of apportionment funding available to districts that year similarly falls short. Because there is no automatic mechanism to backfill such a shortfall, the system must contend with lower total funding that year unless the Legislature and Governor decide to compensate the system with a General Fund backfill. Regardless of whether a backfill is provided, the following year's budget assumption of fee or local property tax revenues is adjusted to reflect the error (underestimate) so that the shortfall does not carry forward on an ongoing basis. (Similarly, there is no automatic mechanism for reducing General

Figure 16

CCC Fees Contribute to Apportionments



Fund expenditures in years in which fee or local property tax revenues *exceed* budget act assumptions. That is, the CCC system retains surplus General Fund monies unless the Legislature and Governor take action to redirect those funds to the Proposition 98 reversion account.)

Current-Year Fee Shortfall Projected

Higher Student Fees Were Intended to Mitigate 2011-12 Budget Cuts. As we discuss in *The Budget Package: 2011-12 California Spending Plan* (pages 29-30), the 2011-12 budget included a $400 million base reduction in Proposition 98 General Fund support for CCC apportionments. To mitigate the impact of this cut, the budget package increased fees from $26 per unit to $36 per unit. The budget assumed that these higher fees would generate $110 million in additional revenue for CCC—bringing the total amount of fees collected to about $460 million in 2011-12—thereby resulting in a *net* apportionment reduction of $290 million.

Significant Fee Shortfall Projected in Current Year; No Backfill Proposed. Preliminary data from CCC indicate that fee revenues could fall well short (by about $103 million) of the amount assumed in the enacted budget. This represents about 2 percent of CCC's apportionment funding in the enacted budget. (The $102 million in midyear trigger cuts mentioned earlier represents another 2 percent of CCC apportionments.) The primary reason for the projected shortfall is an unexpectedly high number of students receiving a fee waiver. Specifically, the budget assumed that about 52 percent of fee charges would be waived by the BOG waiver program. The DOF estimates the waiver take rate to be about 63 percent.

Due to the state's fiscal condition, the Governor does not propose a General Fund backfill of the shortfall for the current year. The Chancellor's Office has indicated that any resulting fee deficit would be spread across all districts statewide. To balance their budgets, districts would either have to reduce costs midyear or spend from reserves. The Chancellor's Office is currently obtaining updated fee-revenue data from districts. We recommend the Legislature have Chancellor's Office staff report on updated fee-revenue projections at budget hearings.

Governor's Budget-Year Proposal

Governor Proposes General Fund Increase. The current-year fee shortfall is estimated at $103 million. For 2012-13, fees are scheduled to increase by an additional $10 per unit (from $36 to $46 per unit) beginning in summer 2012. This action is projected by DOF to produce $5 million more in base fee revenues in the budget year. (This also is significantly below the level of revenues initially assumed from the fee increase, primarily due to DOF projections that the fee-waiver take rate will increase to 70 percent in the budget year.) Because CCC's estimated budget-year fee revenue will be a net $97 million less than the budgeted current-year amount, the Governor's budget provides a $97 million General Fund augmentation to prevent a reduction to base apportionments.

Recommend "Truing Up" CCC's Budget and Examining Fee Waiver Program. We agree with the need to adjust CCC's budget with accurate assumptions about fee revenues. The significant increase in the number of fee waivers over the past few years, however, raises questions about CCC's BOG fee waiver program. In the "Financial Aid" section of this report, we discuss the BOG waiver program in detail and make recommendations on how to better target public funds to meet student needs while fostering student success.

Governor's Back-up Plan for CCC

Proposed Trigger Actions Would Result in Midyear Programmatic Cuts. As discussed above, the Governor's requested Proposition 98 funding level of $5.8 billion for CCC is contingent on voter approval of his tax initiative in November 2012. If his tax measure is *not* adopted, the Governor proposes a back-up plan. The Governor's proposed midyear trigger cuts would reduce CCC's Proposition 98 funding level by about $249 million to $5.5 billion. Of that reduction, $218 million would be achieved by abandoning the proposal to buy down CCC's deferral "credit card." (This would have no programmatic impact on CCC.) Under the Governor's back-up plan, the remaining reduction would come in the form of $30 million in yet-to-be-determined programmatic cuts (either to apportionments, categorical programs, or a combination of the two).

The back-up plan's 2012-13 Proposition 98 funding level for CCC would technically be $5.5 billion. On a *programmatic basis*, however, community colleges would be cut more deeply. This is because the Governor's proposed trigger actions also include shifting responsibility for the funding of CCC's general obligation bond debt service obligations to Proposition 98. (Currently, CCC's annual general obligation bond debt service payments are covered by non-Proposition 98 General Fund monies.) Shifting $262 million of payment obligations into Proposition 98 would have the effect of displacing a like amount of CCC programmatic funds. Taken together, CCC's midyear programmatic cuts would total $292 million. (We discuss the overall Governor's back-up plan for Proposition 98 in more detail in our companion report, *The 2012-13 Budget: Proposition 98*. We also discuss his higher education backup plan at the end of this report.)

CCC Categorical Flexibility

The Governor proposes to consolidate funding for all CCC categorical programs into one flex item. With few exceptions, districts would have broad discretion in how they spend flex funding. Under the Governor's plan, this new flexibility is intended to be permanent, with implementation beginning in 2012-13. We agree that districts would benefit from more categorical flexibility. We have concerns, however, that the Governor's approach could result in local decisions that undermine the Legislature's original intent for these funds. We offer two alternative approaches for the Legislature to consider—both of which would enhance local flexibility while still ensuring that categorical funds continue to be spent on support services to students and faculty.

Background

The state provides two primary types of funding to the CCC system: (1) apportionments, which are intended to fund community colleges' basic operating costs (such as employee compensation, utilities, and supplies); and (2) categorical programs, which collectively support a wide range of supplemental activities—from child care to support services for underprepared students to financial aid advising. In 2011-12, the community colleges are receiving about $5.4 billion in apportionment funding and $397 million in categorical funding.

Funding for Categorical Programs Cut in 2009-10. The *2009-10 Budget Act* reduced ongoing Proposition 98 General Fund support for categorical programs by $263 million (about 37 percent) compared with 2008-09. One of CCC's 21 categorical programs was entirely defunded, 9 programs received a base cut of about 50 percent, and 8 programs were cut between 30 percent and roughly 40 percent (with three categorical programs subject to no reduction).

2009-10 Reductions Accompanied by Some Flexibility. In 2009-10, to help districts better accommodate these reductions, the state combined over half of CCC's categorical programs into a flex item (see Figure 17). Through 2014-15, districts are permitted to use funds from categorical programs in the flex item for any categorical purpose. (Such decisions must be made by local governing boards at publicly held meetings.) By contrast, funding for categorical programs that are excluded from the flex item must continue to be spent on specific associated statutory and regulatory requirements. For example, funds in the Economic and Workforce Development program (within the flex item) may instead be spent on the Basic Skills Initiative (outside the flex item), though Basic Skills Initiative funds can only be spent for that initiative.

Governor's Proposal

Significantly Expands Flexibility Over Use of Categorical Funds. As part of his emphasis on flexibility, the Governor proposes to place all 21 categorical programs into the flex item (see Figure 17). Funding in the flex item would total $412 million. (This is the sum of current-year funding for each categorical program, plus a proposed $14 million budget-year workload adjustment.) In contrast to current law, districts would not be restricted to spending these monies on existing categorical purposes. Instead, according to the administration, districts would have broad discretion to spend these monies on whatever they deem to be their local priorities.

Some Flex-Item Funding Would Remain Restricted. Though they would be in the flex item, three programs would effectively remain restricted. Specifically, the Governor proposes provisional language that would fully protect funding for the Foster Care Education Program ($5.3 million) and Telecommunications and Technology Services ($15.3 million). In addition, $12.6 million would continue to be appropriated for specified purposes in the Disabled Students Program. (A total of $69 million was appropriated for the program in the current year.)

Governor's Plan Moves in Right Direction

Current Categorical System Has Notable Drawbacks . . . Categorical programs are designed to ensure that districts address specific education priorities the state views as critical. However, CCC's categorical programs—like those of other

Figure 17

CCC Categorical Flexibility

Programs Currently Included in "Flex Item" ($113 Million)	
Academic Senate	Part-Time Faculty Compensation
Apprenticeship	Part-Time Faculty Health Insurance
Campus child care support	Part-Time Faculty Office Hours
Economic and Workforce Development	Physical Plant and Instructional Support
Equal Employment Opportunity	Transfer Education and Articulation
Matriculation	
Programs That Would Be Added to "Flex Item" ($298 Million)	
Basic skills initiative	Financial Aid Administration
CalWORKs student services	Foster Care Education Program[a]
Career Technical Education Pathways	Fund for Student Success
Disabled Students Program[b]	Nursing grants
Extended Opportunity Programs and Services	Telecommunications and Technology Services[a]

[a] Governor proposes to restrict all funding for these categorical programs.
[b] Governor proposes to partially protect funding for this categorical program.

state agencies—have notable drawbacks. As we have pointed out in past analyses, community college categorical programs tend to be highly prescriptive in terms of how funds can be spent. Yet, California's 112 colleges have different student populations and local resources, and thus the needs of students vary. By requiring districts to spend funds for a specific purpose, categorical programs limit local flexibility to direct and combine funding in ways that address student needs most effectively and efficiently. Categorical funds are also costly for districts and the CCC Chancellor's Office to administer. Districts must apply for, track, and monitor the appropriate use of categorical funds, and the Chancellor's Office must oversee districts' compliance with numerous statutory and regulatory requirements. For all these reasons, we agree with the Governor that additional categorical reform is needed.

. . . But Governor's Plan Provides Less Assurance Statewide Priorities Will Be Met. We have concerns, however, that the Governor's proposal would provide the state with too little assurance that student and faculty support services would continue to be provided at the local level. The Legislature originally created CCC categorical programs to ensure that certain statewide priorities—most notably, direct support services to students—are addressed. Yet, under the Governor's proposal, the Legislature would no longer have such an assurance. That is, categorical funds (with the exception of appropriations for the three programs noted above) would, in effect, become general purpose monies. Though some districts could continue to spend flexed monies for existing categorical program purposes, such as counseling and tutoring, other districts could choose to repurpose the funds in ways that would not necessarily benefit students, such as providing a general salary increase to faculty and staff. To the extent some districts made such decisions, legislative intent in creating categorical programs could be undercut.

Recommend Enhancing Flexibility While Still Preserving Legislative Priorities

Rather than providing sweeping spending authority to districts, we recommend the Legislature consider two alternative models of categorical flexibility.

Expand Flex Item, but Retain Focus on Support Services. One option would be for the Legislature to add the Governor's proposed categorical programs to the flex item, but include statutory language that limits spending to *existing categorical program purposes* (as is the case with the 11 categorical programs already in the CCC flex item). This would strike a better balance between allowing districts to select for themselves the best strategies for achieving results, while also providing the Legislature some assurance that its educational priorities are addressed.

Consider Block Grants. Another restructuring approach our office has recommended in the past is to consolidate categorical programs into broad thematic block grants. Block grants ensure that districts continue to invest in high educational priorities, while providing flexibility to districts to structure their programs in pursuit of those goals. For community colleges, the Legislature could create two block grants—one centered around student success and one around faculty support (see Figure 18, next page). These block grants would consolidate 15 programs and $294 million in associated funding, which is more than two-thirds of all CCC categorical programs and funding. (Because the remaining six existing categorical programs, including the three the Governor proposes to protect, serve various unrelated and specialized purposes, we recommend that they remain stand-alone programs.)

- ***Student Success Block Grant.*** As shown in Figure 18, the Legislature could consolidate ten programs and $264 million into a new Student Success block grant. By combining funding for these programs into one block grant, community colleges would be able to allocate student service funding in a way that best meets the needs of their students without being bound to specific existing programmatic requirements. With this funding, for example, districts could provide "wraparound" services such as assessment, orientation, counseling (academic and financial aid), tutoring, child care, and other activities designed to improve student completion.

Figure 18

LAO Alternative: Two CCC Block Grants

(In Millions)

	2011-12 Funding Level
Student Success Block Grant	
Expanded Opportunity Programs and Services	$73.6
Financial Aid Administration	56.7
Matriculation	49.2
CalWORKs	26.7
Economic and Workforce Development	22.9
Basic skills initiative	20.0
Apprenticeship	7.2
Fund for Student Success	3.8
Campus child care support	3.4
Transfer Education and Articulation	0.7
Total	**$264.2**
Faculty Support Block Grant	
Part-Time Faculty Compensation	$24.9
Part-Time Faculty Office Hours	3.5
Equal Employment Opportunity	0.8
Part-Time Faculty Health Insurance	0.5
Academic Senate	0.3
Total	**$30.0**

- ***Faculty Support Block Grant.*** Also shown in Figure 18, the Legislature could consolidate five programs and $30 million into a new Faculty Support block grant. Under the block grant approach, districts would have flexibility to allocate faculty resources to meet local campus needs also without being bound by existing programmatic requirements. For example, districts could undertake professional development activities for instructors or offer faculty-leave time to develop new program curricula.

Allocating Block Grant Funding. Were the Legislature to decide to adopt the block grant approach, districts could retain the same amount of categorical funding in 2012-13 as they would have received absent a consolidation. Moving forward, we recommend that funds provided for these block grants be allocated to districts primarily on a per-student basis (with some allowance potentially made for districts with high percentages of financial aid recipients).

FINANCIAL AID

The Governor's major budget solutions in higher education include Cal Grant program reductions and funding offsets to reduce state costs. Cal Grant expenditures are expected to reach $1.5 billion this year—an increase of 85 percent over the past four years, closely following the rate of increase in public university tuition. Given the size and growth of this program, the Governor is justified in exploring options to reduce costs in targeted ways.

We think some of the Governor's proposals have merit and recommend adopting them. These generally involve forgoing scheduled program expansions and new commitments. Some of his other proposals, which involve eliminating eligibility for certain groups of students, could actually increase state costs while constraining access to postsecondary education. They would also do little to address the factors driving extraordinary growth in costs—namely, the ability of UC and CSU to independently increase Cal Grant spending. We offer recommendations to modify or reject these proposals, along with additional actions the Legislature could consider to replace some of the associated savings. These options include adopting alternative Cal Grant program changes and reforming the CCC BOG fee waiver program.

Governor's General Fund Solutions Centered on Cal Grants

The state's Cal Grant programs guarantee financial aid awards to California high school graduates and community college transfer students who meet financial, academic, and other eligibility criteria. Awards include full systemwide tuition and fee coverage at the public universities for up to four years, contributions toward tuition costs at nonpublic institutions, and cash stipends (known as access awards) for some students, depending on the program and type of award. Figure 19 shows the number of awards and total funding amounts for students in each higher education segment, and Figure 20 (see next page) describes the various Cal Grant programs and awards.

Figure 19

Cal Grant Recipients and Funding Amounts by Segment, 2011-12 Estimates

(Dollars in Millions)

	Recipients		Funding	
	Number	Percent	Amount	Percent
California State University	74,524	31%	$382	25%
California Community Colleges	72,248	30	87	6
University of California	55,759	23	680	45
Private non-profit institutions	26,854	11	246	16
Private for-profit institutions	14,664	6	112	7
Totals	**244,049**	**100%**	**$1,506**	**100%**

The Governor's Cal Grant proposals include $766 million in fund transfers and $372 million in program reductions. While fund transfers would have no programmatic effect on financial aid, proposed program reductions would affect more than one-third of potential new Cal Grant entitlement recipients.

Funding Shifts

Governor Proposes Shifts From Federal Funds and SLOF to Offset Cal Grant Costs. The Governor proposes steep reductions in support for CalWORKs, which uses federal Temporary

Assistance for Needy Families (TANF) funds. He proposes to redirect freed-up TANF funds from the Department of Social Services to CSAC to offset $736 million in General Fund Cal Grant expenditures.

The budget also includes a $30 million General Fund offset from the SLOF, which receives proceeds of the federal guaranteed student loan program. The federal government transferred management of this program from CSAC to ECMC, a national loan servicing organization, in 2010. The organization has agreed to contribute SLOF support to offset Cal Grant costs for several years, but the number and amount of transfers are unspecified. In the current year, ECMC contributed $62 million for this purpose.

Fund Shift Depends on Proposed Reductions in Social Services. The amount of TANF funding available to offset Cal Grant costs will depend on the Legislature's decisions regarding cuts in social services. To the extent the Legislature rejects some or all of the proposed cuts, the General Fund offset for Cal Grants would need to be adjusted accordingly. Likewise, the General Fund offset from SLOF would need to conform to the available funding from ECMC, which will be determined in May. From a Cal Grant perspective, we view both of these adjustments as technical issues having no programmatic effect.

Halting Scheduled Eligibility Expansions

Two recent policy changes would result in expanded student and institution eligibility for Cal Grants.

Figure 20

Summary of Cal Grant Program Requirements and Awards

High School Entitlement Program	Under this program, lower- and middle-income graduating high school seniors who meet eligibility criteria and apply by the deadline in the year of graduation or the following year are guaranteed a Cal Grant A or B award. Students must have a grade point average (GPA) of at least 3.0 for a Cal Grant A award, which covers full systemwide tuition at the University of California and California State University, and provides up to $9,708 in tuition support at private California colleges and universities. Cal Grant B awards are for students with greater financial need who have at least a 2.0 GPA, and provide up to $1,551 toward books and living expenses in the first year, and this amount plus tuition support (in the same amounts as Cal Grant A awards) beginning in the second year.
Transfer Entitlement Program	This program is for graduates of California high schools who transfer from a California Community College to a qualifying baccalaureate degree granting institution. Students must also meet financial and academic eligibility criteria, and be under the age of 28 at the end of the year in which they first receive an award. As under the high school entitlement, transfer entitlements include both A and B awards, with the same maximum awards for tuition, books, and living expenses.
Competitive Program	The Cal Grant Competitive Award Program is for students who meet the basic eligibility criteria of the entitlement program (such as income and GPA), but do not qualify for those awards. This may be because of age, or a delay in attending college following high school graduation. Recipients are selected for A and B awards from the applicant pool through a competitive process based largely on family income and GPA, with special consideration for disadvantaged students. Because of limited funding, only about 9 percent of qualified applicants receive awards.
Cal Grant C	This program provides up to $2,592 for tuition and fees and up to $576 for other costs for eligible low- and middle-income students enrolled in an occupational, technical, or vocational program that is at least four months long. Funding is available for up to two years, depending on the length of the program.

- Recent legislation prohibits certain institutions with federal student loan default rates of 24.6 percent or more from fully participating in Cal Grant programs. The default limit is scheduled to rise to 30 percent for the 2012-13 academic year.

- Under current practice a student must attend a baccalaureate institution in the year immediately after leaving a community college to qualify for a transfer entitlement award. A recent CSAC decision would remove that restriction, potentially adding 9,000 students and $70 million in new Cal Grant awards.

Governor Proposes to Maintain Current Limits. The administration proposes to freeze the default rate limit at the current-year level. This would limit somewhat the pool of eligible schools where students can use their Cal Grants. The Governor also proposes to stop implementation of CSAC's expansion of transfer entitlement eligibility in light of its significant budgetary impact.

Recommend Adopting Proposals to Block Expansions . . . Avoiding new costs makes sense in the current budget environment. We therefore recommend the Legislature approve the Governor's proposals to halt the raising of the default limit and the removal of the transfer time limit. In the future when the state fiscal condition has improved, the Legislature could consider whether to prioritize these two program expansions.

. . . But Correct Unintended Consequence of a Recent Eligibility Change. There is, however, one area in which we think the Legislature should consider incurring new costs to address a significant unintended consequence of a recent policy change. Last year the Legislature adopted several changes to Cal Grant eligibility, including a requirement that students meet income, asset, and financial need thresholds to renew awards. Previously, students had to meet these financial criteria only for initial awards. Nearly 16,000 Cal Grant recipients were disqualified for renewals this year due as a result of the new policy.

As shown in Figure 21, Cal Grant A and B awards have different income ceilings. They also have different academic requirements—students must attain a high school grade point average (GPA) of 3.0 for an A award and 2.0 for a B award. Some students are co-eligible—they qualify for both types of awards. For these students, CSAC selects the award that would give each student the greatest benefit over four years depending on the student's choice of institution. Students at UC and private institutions benefit more from Cal Grant A's four years of tuition coverage, for example, while students at CSU benefit more from Cal Grant B's four years of access awards plus three years of tuition coverage.

Under the new rules, a co-eligible student who is assigned a Cal Grant B may become ineligible for a renewal award due to increased family income, even if that student remains well within the eligibility range for Cal Grant A. This is because current CSAC policy does not permit students to switch to a different award type once they have received a grant payment. As a result, this year, 4,800 students who initially qualified for both an A and B award and received a B award lost their Cal Grant entitlement awards, even though many of them

Figure 21

2011-12 Cal Grant Renewal Income Ceilings for Dependent Students

	Cal Grant Award Type	
Family Size	A	B
Six or more	$92,700	$50,900
Five	85,900	47,200
Four	80,200	42,200
Three	73,800	37,900
Two	72,100	33,600

continue to meet the eligibility requirements for Cal Grant A. This is an unintended consequence of the new requirement resulting from a technical issue that was not evident when the Legislature approved the new policy. At the time of writing this report, CSAC was in the process of revising its policy to correct this oversight. We recommend the Legislature adopt statute to ensure that co-eligible students can switch from Cal Grant B to Cal Grant A if they meet all eligibility requirements for Cal Grant A awards. This policy change will reduce Cal Grant savings by about $29 million based on current-year tuition levels.

Eliminating Loan Assumption Awards

The commission operates several loan assumption programs that were developed in response to workforce shortages in certain occupations and work settings (for example, teachers in low-performing public schools and nurses in state prisons). Under these programs, the state agrees to make loan payments on behalf of eligible students who borrow federal loans and work in specified occupations and settings after graduation. Payments are made for three or four years, as students complete years of qualifying employment. Teachers and college faculty can receive from $6,000 to $19,000 and nurses can receive from $20,000 to $25,000 in total loan payments, depending on a participant's subject area, position, and work setting. The budget annually specifies the number of new loan assumption agreements (or "warrants") that CSAC may issue to current students. The *2011-12 Budget Act* authorized 7,400 new warrants and includes $40 million for payments on warrants issued in previous years.

Governor Proposes to Phase Out Loan Assumption Programs. The proposed budget would authorize no new program participants. The state would continue payments for students who have already received at least one payment and who complete additional years of qualifying employment. Participants who have been approved for the program but have not yet received their first payment, however, would receive no benefits under the Governor's proposal.

Canceling Programs Makes Sense . . . Legitimate concerns have been raised regarding the cost-effectiveness of the state's loan assumption programs. In particular, it is unclear whether these incentives lead to behavioral change or simply reward participants for what they would have otherwise done. Our recent evaluation of the State Nursing Assumption Program of Loans for Education found that direct compensation (such as signing bonuses and other incentives) can be a more effective employee recruitment and retention tool than promises of future loan payments. Additionally, the targeted workforce shortages have largely abated in the current economy (though some shortages may return once the economy recovers).

. . . But Not Retroactively. If the programs worked at all as intended, however, it is possible that some current participants entered a lower-paying occupation, assumed more debt, accepted a lower-paying or more difficult job, or otherwise changed their behavior from what they may have done absent the promise of loan repayment. We are concerned with the prospect of canceling payments these students have already earned by completing a portion of their qualifying employment obligation.

Recommend Ending Programs but Fulfilling Current Agreements. We recommend adopting the Governor's proposal to eliminate the programs, with one modification. We recommend honoring existing agreements for all students who have begun their qualifying employment prior to enactment of statutory changes. This would reduce estimated General Fund savings by about $7 million in 2012-13 and delay the phase-out of loan assumption programs by one year.

Reducing Award for Private Cal Grants

Students may use Cal Grant awards at qualifying private nonprofit and for-profit colleges, universities, and trade schools. (In fact, the Cal Grant program was created in 1955 specifically to help financially needy students attend private institutions as a way of expanding the state's enrollment capacity in a time of growing demand.) The maximum private-student Cal Grant award amount has been fixed at $9,708 since 2000, with the exception of two years (2004-2006) in which it was reduced to $8,322.

Proposal Would Reduce Maximum Awards at Nonprofit and For-Profit Colleges and Universities. The administration proposes to reduce the maximum Cal Grant award for students attending private nonprofit institutions to $5,472—the same amount financially needy CSU students receive from Cal Grants for tuition and fees—and to $4,000 for students attending for-profit schools. This proposal would affect about 46,000 students. The administration estimates this proposal would save $171 million.

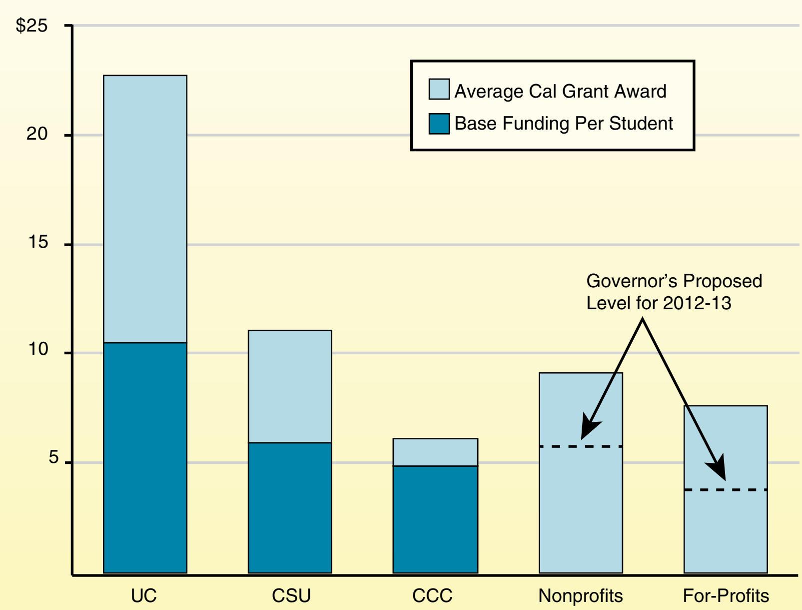
No Policy Basis for Current or Proposed Award Limits. Prior to 2001, the state had a long-standing statutory policy that linked the maximum Cal Grant award for financially needy students attending private colleges to the estimated average General Fund costs of educating a financially needy student at UC and CSU. This cost includes the average General Fund the state provides for all UC and CSU students through the segments' base budgets plus the tuition Cal Grants cover for financially needy students. This parity formula, with some adjustments to approximate the state's incremental costs, was the basis for the 2000-01 award level of $9,708. Beginning in 2001-02, this statutory policy was replaced with a new provision linking the maximum award to whatever amount was specified in the annual budget act. Under the parity formula, the current Cal Grant award would be about $14,500. Figure 22 illustrates the components of the average subsidy for students in each segment.

Proposal Raises Important Policy Questions. The Governor's linking of the maximum Cal Grant award for students attending private nonprofit institutions to the CSU tuition amount is overly simplistic. The comparison should not be to tuition alone, but to the state's *entire* cost for a Cal Grant student at UC or CSU—base funding plus tuition. Nevertheless, it raises legitimate questions about what the relevant comparisons should be.

Figure 22

Governor's Proposal Would Result in Large Differences in Total Support Per Needy Student

2011-12 Average State Subsidy Per Cal Grant Recipient (In Thousands)



For example, should students receive the same average subsidy regardless of which type of college they attend? The Governor distinguishes between nonprofit and for-profit colleges, but these categories mask large variations in quality and types of programs. Some private colleges offer primarily vocational and associate degree programs like CCC, while others are leading research universities more comparable to UC campuses. Similarly, there are variations in admissions standards, persistence and graduation rates, and other institutional outcome measures. While California maintains three distinct public higher education segments to meet students' differing academic, financial, and practical needs, the Cal Grant program treats private institutions as homogeneous.

Savings Are Overstated. The administration's savings estimates assume Cal Grant recipients will continue to attend private institutions in roughly the same numbers with reduced awards. To the extent some students opt instead to attend public institutions, the state's costs for those students (including base funding and tuition awards) would increase, as illustrated in Figure 22. For a student switching from a private college to UC or CSU, for example, state costs would increase by several thousand dollars per student. For a student attending a community college in place of a private one, the state's cost would increase slightly or remain about the same.

Predicting how students' choices would change in response to lower grant amounts is difficult, but we would expect some shift from private to public institutions. This would erode the administration's savings estimate. Over time, it is possible that increased costs at the public institutions could outstrip Cal Grant savings from students at the private institutions, resulting in an overall increase in state costs. To the extent the state receives reasonably similar outcomes from public and private institutions, these higher costs could bring no additional benefit. (As one indicator of outcomes, California's nonprofit colleges and universities have average five-year graduation rates that are equivalent to those at our public universities. For-profit colleges in the state have average completion rates between those for our public universities and community colleges.)

Proposal Could Reduce Access and Depress Overall Graduation Rates. To the extent students seek to shift to public institutions, they will be competing for scarce seats. Sixteen of CSU's 23 campuses are impacted for freshman admission, and 15 are impacted for transfer students. This means students who meet CSU's statewide eligibility criteria no longer automatically qualify for admission to these campuses. Qualified local students are still guaranteed admission to most (19) of these campuses, but not to their chosen majors or degree programs. Likewise, many CCC campuses are highly impacted, and students are having difficulty enrolling in the courses they need. Under these circumstances, reducing students' access to private institutions could depress overall college attendance and completion rates.

Recommend Legislature Reject Proposed Cuts to Private Grants, Consider Alternative Approaches. We recommend the Legislature consider a more nuanced approach to setting Cal Grant award amounts for students at different types of institutions. This would involve reestablishing a rational policy basis for award amounts and recognizing differences within each sector. For example, awards could reflect a student's qualifications and choice of academic program (such as baccalaureate or associate degree). However, significantly more work is needed to examine the effects of various changes on total state costs and overall access to postsecondary education. We suggest that, rather than adopting the Governor's proposal in its current form, the Legislature explore alternative approaches as part of its budget deliberations.

Limiting Eligibility by Requiring Better Grades

Proposal Would Increase Required GPA. The most far-reaching of the Governor's financial aid proposals would raise the minimum GPA for students to qualify for Cal Grant entitlement programs. Figure 23 shows current and proposed GPA requirements as well as the number of students expected to be affected by the change. The Governor estimates this proposal would reduce Cal Grant expenditures by $131 million. (Subsequent estimates from CSAC suggest savings may be somewhat lower, around $97 million.)

Constitutes Sweeping Change in State's Financial Aid Approach. The proposed requirements would change the mix of students eligible for Cal Grant awards, eliminating one-third of entitlement recipients. The greatest reductions would be in Cal Grant B awards, designed to assist the lowest-income students.

Currently the Cal Grant program is a need-based program with some merit requirements. The administration's proposal increases the emphasis on merit. While the program would still serve only financially needy students, it would target aid within that group to those with higher grades.

Focus on Students Most Likely to Succeed. The Governor's rationale for raising GPA requirements is to focus limited financial aid resources on those students who are most likely to complete degrees. It is true that college persistence and completion rates are strongly correlated with high school GPA. Figure 24 (see next page) illustrates this relationship. (The figure reflects estimates for one cohort of first time, full time CSU freshmen, and does not reflect completion rates for other institutions, groups of students, or time periods. The general relationship it illustrates, however, has been documented across many institution types and groups of students.) The figure shows, for example, that a student entering CSU with a 2.25 GPA has about a 25 percent likelihood of graduating within six years. This likelihood increases to more than 70 percent for a student entering with a GPA of 3.25 or higher. There is also evidence that performance requirements for financial aid can increase student achievement in some circumstances, as students alter their behavior to qualify for awards.

Increasing the Cal Grant B GPA requirement above 2.0 would refocus awards on students who are better prepared for college and have a greater likelihood of persisting and completing an educational program. Raising Cal Grant A requirements would likewise direct a greater proportion of awards to students with even higher completion rates, but would also exclude many students who are likely to graduate.

Figure 23

Proposed Cal Grant Grade Point Average Requirements Would Eliminate One Third of New Entitlement Awards[a]

	Current Requirement	Proposed Requirement	Estimated Students Affected	
			Number	Percent[b]
High School Entitlement Awards				
Cal Grant A	3.00	3.25	7,000	25%
Cal Grant B	2.00	2.75	17,000	43
CCC Transfer Entitlement Awards				
Cal Grant A and B	2.40	2.75	2,000	17
Totals	—	—	**26,000**	**33%**

[a] Estimate reflects 2010-11 recipients who would have been disqualified under the proposed requirement.
[b] Percent of recipients for each program and award type.

Improvements Are Needed, but Overhaul of Cal Grants Should Not Focus on GPA. There is significant room for improvement in the design of Cal Grant programs, and we recommend some directions for reform later in this section. A major overhaul of the program based solely on GPAs, however, is problematic. The Governor's proposal could have several unintended consequences. For example, completion of a rigorous college preparatory curriculum is also an important factor in college success, and undue focus on GPA could discourage students from taking rigorous courses. In addition, depending on the state's goals for its aid programs, targeting aid to the best-prepared students does not necessarily improve the impact of the programs. Recent research suggests that financial aid has greater effect on college performance for students who are not as well prepared, than for higher-achieving students who would succeed in larger numbers with or without aid.

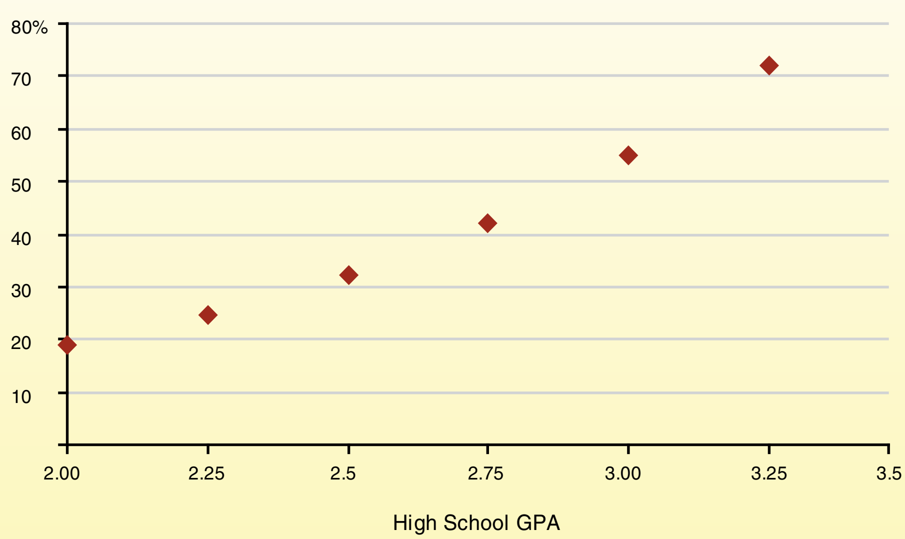
At the same time, some students are so unprepared for postsecondary education that even with aid, they have little chance of making progress. Where to draw the line on both ends is a judgment call that requires balancing access and effectiveness concerns. California currently does not have data linking financial aid to student outcomes to assist policymakers in making these judgments.

Recommend Legislature Instead Consider More Modest GPA Adjustments in Context of Broader Reforms. The Governor's proposal has some merit, but we think it goes too far. It would result in eliminating one third of entitlement awards and would have disproportionate impact on students with the greatest financial need. Instead, we recommend making more modest changes to GPA requirements. Specifically, we recommend raising the GPA requirement for Cal Grant B awards to no higher than 2.5, and phasing in any changes. An increase from 2.0 to 2.25 in one year would affect about 8,000 students and save about $8 million. A subsequent increase to 2.5 would affect another 9,000 students and increase the annual savings to about $21 million. These changes would eliminate aid primarily to low-income students at the community colleges who receive a maximum access award of $1,551 annually. Under current policies these students would continue to receive full fee waivers and any other aid, including federal Pell Grants and tax credits for which they qualify.

Figure 24

Grade Point Average (GPA) Is a Strong Predictor of College Completion

Estimated Sixth Year Graduation and Retention Rates at CSU



[a] Estimates based on CSU analysis of first-time, full-time freshmen enrolled in 2001.

Alternatives to Proposed Financial Aid Reductions

We have recommended rejecting some of the Governor's major financial aid savings proposals because they need significantly more work or would likely have serious unintended consequences. We present here several alternative actions for the Legislature to consider if it wishes to achieve some or all of the Governor's proposed savings through financial aid reductions. The Legislature is not bound by the Governor's allocation of budget reductions to financial aid programs and will need to weigh these options and their impacts against alternative reductions across state government and additional revenue solutions.

Budget-Year Savings. To address the state's current need for budget solutions, we offer a number of immediate changes for the Legislature to consider. Additional information on these options can be found in our *Summary of Budget Recommendations* on the LAO website.

- ***Increase General Fund Offset From SLOF.*** The administration's estimate of available SLOF funds is conservative. Although the annual contribution from ECMC will not be determined until May, we think the current-year contribution of $62 million provides a reasonable estimate. This estimate would increase savings by $32 million and could be adjusted up or down during the May Revision process.

- ***Eliminate Non-Need-Based Tuition Waivers.*** All three public higher education segments are required by state law to waive enrollment fees for spouses and children of certain disabled or deceased veterans and deceased law enforcement and fire suppression personnel. In some cases, fees must be waived without regard to financial need. Because there are federal assistance programs for the same groups, the state's requirement to waive fees equates to using state and institutional funds for costs the federal government would otherwise pay. Because they provide benefits to non-needy students or duplicate existing benefits, these fee waiver programs do not improve affordability or access to higher education. Given the magnitude of the state's budget problems, we recommend eliminating non-need-based waiver programs and directing eligible students to the corresponding federal benefits and need-based state programs. This could reduce state and institutional costs by more than $30 million annually, net of any increases in need-based aid. We also recommend revisiting a recent change in state law that permits institutions not to count veterans education benefits as resources when evaluating Cal Grant eligibility.

- ***Limit New Competitive Cal Grant Awards to Stipends Only.*** Community college students receive three-quarters of new competitive Cal Grant awards but only one-third of new funding. This is largely because CCC Cal Grant recipients (who all qualify for BOG fee waivers) receive only the $1,551 access awards, while students in other segments also receive tuition payments. Restricting all new first-year competitive awards to this amount would not affect the three-quarters of new recipients who are CCC students. Other students would have the option to attend a community college with fee waivers and access awards, or seek additional financial aid at other institutions. This would create about $30 million in ongoing General Fund savings beginning in 2012-13. Extending this policy for the first two years of undergraduate studies would result in additional savings in 2013-14 and beyond.

- ***Adjust Cal Grant Financial Eligibility Criteria.*** For 2012-13, a dependent student from a family of four may qualify for a new Cal Grant A and C award with parent income up to $80,100. (The threshold is lower for Cal Grant B awards.) The Legislature could adjust financial eligibility criteria to reduce the number of students who qualify for Cal Grants. For example, it could set maximum income levels at a lower amount, using a percent of median family income (such as 80 percent) or a multiple of the federal poverty guideline (such as 250 percent), and could include student income in addition to parent income. Alternatively, it could eliminate income and asset ceilings and use only the Expected Family Contribution (EFC), calculated through the federal aid formulas, which reflects student and parent resources (income and assets) as well as costs (including the number of family members attending college). Cal Grant eligibility could be based on a maximum EFC, ensuring that funds are targeted to the students with the fewest financial resources and the greatest need. The savings from such actions would depend on the particular income or EFC level selected.

- ***Reduce All Awards.*** The Legislature could reduce all award amounts. This would be an alternative to eliminating some awards entirely while fully preserving others, and would be less likely to result in reduced college access. A 10 percent reduction in the tuition portion of award amounts (preserving access awards at $1,551) would provide more than $100 million in savings.

- ***Modify CCC BOG Fee Waiver Program Requirements.*** The next section includes a thorough discussion and recommendations for reforming the state's BOG fee waiver program.

Longer-Term Reforms. In addition to options that would provide immediate budgetary savings, we have identified some longer-term reforms for the Legislature to consider. These are more extensive changes that would reshape the state's financial aid programs. All require further development, analysis, and deliberation to determine their long-term costs and impacts for California. We include them here so that the Legislature can maintain a longer view of the changes needed in its financial aid programs, in addition to stopgap changes it may need to implement in the short-term.

- ***Instituting a More Consistent and Comprehensive Approach to Financial Aid Across Postsecondary Segments.*** Under this approach, the state would consider federal, institutional, and state aid along with student and family responsibility to meet a targeted level of student financial need. Rather than focusing mainly on tuition costs, as the current Cal Grant program does, this approach would consider total costs of attendance. Oregon and Minnesota are among states that have recently instituted more holistic strategies for meeting financial need. This reform would not necessarily reduce costs, but could improve allocation of financial aid resources whatever the level of state funding.

- ***Changing the Award From a Flat Tuition and Fee Amount at the Public Institutions to a Varying Amount That Is More Sensitive to Student Need Levels.*** As part of a more comprehensive approach, the state could make Cal Grant award amounts more flexible. For example, several states have a maximum award for students with the greatest financial need, and the awards decline with higher family income or lower student need. Although such a change could have significant drawbacks—it could complicate the financial aid outreach message and hamper campuses' ability to fully protect financially needy students from tuition increases—it would also have clear benefits. This approach could help to avoid a cliff effect whereby a student may receive more than $12,000 in one year and zero the following year because of a very small increase in income. It could also help to control automatic spending growth driven by tuition increases and facilitate the comprehensive approach described in the first item.

- ***Establishing a Rational Policy Basis for Maximum Award Levels at Different Types of Institutions.*** As discussed earlier, the state could link award caps to average subsidy levels, as was done in the past. Another option is to differentiate among institutions within each sector based on program types, program outcomes, or other objective factors. A related change could involve tightening requirements for institutions that participate in Cal Grants, perhaps incorporating measures of educational outcomes.

- ***Establishing a Limit on Awards for Lower-Division Studies.*** Currently a student can use all four years of Cal Grant eligibility at a community college, leaving none for the junior and senior years at a university. Restricting utilization to the first two years at a community college could create an incentive for students to complete their lower-division studies and move on to a senior institution. While this change could increase costs in the short term, it could also reduce state spending on students who are taking excess course units and improve program completion rates and time to degree.

- ***Improving Delivery of Cal Grants.*** We have previously recommended decentralizing Cal Grant delivery to campus financial aid offices to improve service to students without increasing costs. (Please see our recent publication, *Report on Cal Grant Alternative Delivery Pilot*.)

- ***Learning From Ongoing Research and Evaluation.*** Current research in selected community colleges in the state is testing various strategies for improving the effectiveness of financial aid, including performance incentives and alternative payment schedules. Similarly, studies in other states are exploring various aspects of financial aid policy and practice. Policymakers should continue to monitor the results of these studies and consider their implications for Cal Grant programs. The state should also continue to pursue improvements in its longitudinal data system, including developing the ability to analyze the effects of financial aid and other factors on student outcomes.

We will continue to develop these ideas, and provide information and assistance to the

Legislature as it explores them. We believe these more fundamental reforms could improve the effectiveness of state financial aid, and better align it with the state's overall goals for postsecondary education.

Rethinking the Community College Fee Waiver Program to Better Promote Student Success and Assess Need

Summary

The BOG Fee Waiver program waives enrollment fees for community college students who demonstrate financial need. The cost of the program, which is covered by Proposition 98 General Fund monies, has grown rapidly in recent years, and waiver costs are projected to total more than $850 million in the budget year. Our review identifies several opportunities to change the program in ways that promote student achievement while ensuring that state resources are targeted to actual student need.

Background on BOG Fee Waiver Program

In contrast to his Cal Grant proposals, the Governor does *not* propose to change eligibility standards for another large state-funded financial aid program: the BOG Fee Waiver program. This entitlement program is designed to ensure that CCC fees do not pose a financial barrier to California residents. It accomplishes this by waiving enrollment fees for residents who demonstrate financial need. The program is widely used by students. In recent years, about one-third of all CCC students have received BOG fee waivers (representing roughly 50 percent of all units taken). As discussed below, the program is projected to grow substantially in the current and budget years.

Proposition 98 General Fund Pays for Program. As discussed earlier in "Overview of the Governor's Budget proposal for Community Colleges," each year the Legislature and Governor decide on the total amount of apportionments (general-purpose monies) to be provided to the community colleges. The enacted budget assumes a specified amount of local property taxes and enrollment fees that will be collected and retained by community colleges that year. The assumption about enrollment-fee revenue is based on estimates of the number of students who will pay fees and the number of students who will receive a waiver. Based on estimates of local property taxes and fees, the enacted budget provides the necessary Proposition 98 General Fund support to meet the system's apportionment amount. The General Fund thus pays for the BOG waiver program by backfilling districts for their foregone fee revenue.

Substantial Increase in Waiver Program Costs in Past Few Years. Figure 25 shows the annual amount of fees collected and waived over the past decade. Between 2003-04 and 2008-09, less than half of potential fees were waived each year. In fact, though fee levels fluctuated between $18 and $26 per unit during that period, the percentage of fee charges that were waived remained relatively steady (between 40 percent to 45 percent). By 2008-09, the cost of the program was $253 million. In 2009-10, however, more fee revenue was waived than collected. That trend increased in 2010-11, and is on track to grow further in the current year. Specifically, an estimated $361 million in fees will be collected in 2011-12, while $614 million (representing 63 percent of all units taken by students) will be waived. There appear to be two main reasons for this recent increase: (1) declining personal income during the recent recession has made more students financially eligible for fee waivers; and (2) rising fee levels have spurred waiver applications from financially needy students who otherwise would not have applied.

Despite a scheduled fee increase from $36 to $46 per unit beginning in summer 2012, the

Governor assumes total fee revenue will remain virtually unchanged in the budget year. This is primarily because the administration projects fee waivers will expand by $240 million to a total of *$855 million in waiver costs* (representing 70 percent of units taken by students).

Eligibility and Application Requirements

Three Ways to Qualify for Waiver. The BOG fee waiver program is available to California residents who meet one of three financial eligibility criteria. (Recent legislation will soon permit some *nonresident* students to receive a fee waiver, as discussed in the text box on page 50. Also, as discussed in the previous section on "Financial Aid," state law requires CCC to provide *non-need-based* fee waivers to specified groups of students.) These criteria are referred to by the CCC system as "Part A," "Part B," and "Part C."

- ***Part A.*** Under current law, students are eligible for a Part A fee waiver if they or their parents receive cash assistance from other need-based programs (such as CalWORKs and general assistance).

- ***Part B.*** Current law also requires community colleges to waive fees for students who are below income standards as determined by the BOG. Community college regulations deem students eligible for a Part B waiver if they or their family have an adjusted gross income at or below 150 percent of the federal poverty level. (For a family of four, this level is $33,075 in 2011-12.)

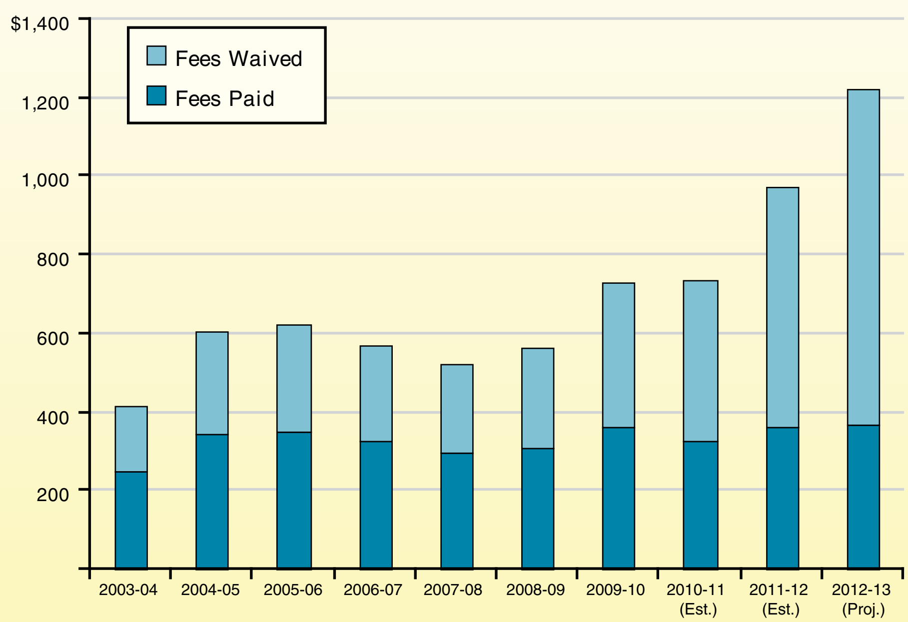
- ***Part C.*** In addition, statute authorizes CCC to establish a methodology for "determining the expected family contribution of students seeking financial aid." The statewide Chancellor's Office has defined this to mean that individuals are eligible for full fee coverage if they have *any* financial need—that is, their cost of attendance exceeds their federally determined ability to pay (expected family contribution) by $1 or more.

Two Ways to Apply for a Fee Waiver. Any student can apply for a BOG fee waiver by completing the Free Application for Federal Student Aid (FAFSA). Students who complete the FAFSA also are evaluated to determine whether they qualify for federal or other state financial aid.

Figure 25

Fee Waiver Program Costs on the Rise

Total Potential Revenue (In Millions)



Alternatively, students can apply for a Part A or Part B (but not a Part C) fee waiver using a separate BOG fee waiver application. Though the BOG fee waiver form typically takes less time to complete than the FAFSA, students using the BOG form are only assessed to determine their eligibility for a fee waiver (as opposed to the full range of federal and other state financial aid).

Verification Policies Vary. A combination of federal rules, CCC regulations, Chancellor's Office guidelines, and campus policies influence how income and other student information are verified for purposes of determining eligibility for a fee-waiver award. First, any student who receives federal financial aid may be subject to verification of information submitted on the FAFSA. For students applying for a fee waiver using the BOG application form, CCC regulations require students to "provide documentation" that they are on public assistance (Part A) or meet CCC's income standards under Part B. Chancellor's Office guidelines specify that for Part A applicants, appropriate documentation includes copies of a student's benefits check or benefits letter. (The documentation must provide evidence that the student received the type of benefit claimed within the past 60 days from the time of the BOG fee waiver application.)

By contrast, for Part B applicants, Chancellor's Office guidelines give campus financial aid offices flexibility to define what "documentation" means. Acceptable methods include verifying the tax records of all or a sample of applicants, and can also include "self-certification," whereby students are taken at their word about their or their family's income level. (All students completing the BOG fee waiver application must sign under penalty of perjury and acknowledge that they could lose or be required to repay their waiver if they give false information or, if asked by CCC, fail to provide proof.)

Few Nonfinancial Requirements to Receive or Renew Fee Waiver . . . Other than the financial eligibility requirements discussed above, current law and regulations impose very few other criteria on students to receive or retain a fee waiver. In fact:

- Students may receive a fee waiver regardless of their reason for attending CCC. For example, a student could be pursuing a degree or certificate, or simply be taking a CCC class (such as yoga or art appreciation) for purposes of personal enrichment.

- Students may earn failing or otherwise substandard marks for two or more academic years before they are dismissed from CCC and lose their fee waiver (the same academic-standing requirements as all other CCC students, as discussed in the nearby text box).

Recent Legislation Affecting BOG Fee Waivers

Since the early 2000s, students who are not legal residents of California have been exempt from paying nonresident fees at the state's public colleges and universities if they (1) attended California high schools for at least three years, and (2) graduated from a California high school. Students who meet these criteria may be legal residents of other states or undocumented immigrants to California. Chapter 604, Statutes of 2011 (AB 131, Cedillo)—also known as the Dream Act—makes these students eligible to receive state-funded financial aid, including the Board of Governors (BOG) fee waiver. This provision goes into effect on January 1, 2013.

- There is no limit to the number of years students may receive a fee waiver, nor is there any limit on the number of CCC credit units they can accumulate.

. . . Unlike Federal and Other State Financial Aid Programs. The generally open-ended nature of the BOG fee-waiver program rules differs significantly from restrictions governing federal and other state financial aid programs. In particular, both state Cal Grants and federally administered programs such as Pell Grants require recipients to make satisfactory academic progress (SAP) toward completion of an educational program (degree, certificate, or transfer) to retain financial aid. Generally, this means that students must maintain a minimum GPA of 2.0 (or at least have a 2.0 GPA by the time they graduate) and complete at least two-thirds of all attempted units each academic year. (Colleges are authorized to permit appeals as well as a probation period for students who fail to make SAP.) Eligibility for financial aid ends if the student's total number of attempted units exceeds 150 percent of the program's unit requirement. For example, students pursuing an associate's degree that requires 60 units of coursework can receive a Cal Grant and federal financial aid until they have attempted 90 units (with additional units permitted for remedial or English-as-a-second-language coursework).

Student Success Task Force and BOG's Newly Adopted Plan

Legislation Requires CCC to Implement Plan for Improving Student Outcomes. To address concerns about low CCC completion rates, the Legislature passed Chapter 409, Statutes of 2010 (SB 1143, Liu). The legislation requires BOG to adopt and implement a plan for improving student success. It also required BOG to create a task force to develop recommendations for inclusion in the plan. The BOG must report on its adopted plan at a joint hearing of the Senate Education and Assembly Higher Education committees by March 1, 2012.

Recently Adopted Plan Calls for Satisfactory Academic Progress Requirements for Fee Waiver Recipients. In response to the legislation, the board created the Student Success Task Force,

Community College Academic-Standing Policies

Regulations adopted by the statewide Board of Governors set minimum academic standards that students must meet to stay enrolled at California Community Colleges (CCC). The standards for students with a fee waiver are the same as the standards for all other students. Specifically, community colleges are required to place students on probation who, after attempting at least 12 units (equivalent to about four courses) either: (1) have a grade point average (GPA) below 2.0 or (2) receive a "withdrawal," "incomplete," or "no pass" mark on 50 percent or more of total attempted units.

Once on probation, students are subject to *dismissal* if for three semesters in a row, they either (1) earn a cumulative GPA below 1.75 or (2) do not complete 50 percent or more of total attempted units. (Regulations permit districts to adopt stricter standards for probation and dismissal. Our review of local academic policies finds that many colleges use 2.0 as the GPA threshold for dismissal rather than 1.75.) These probation and dismissal standards mean that a failing student can attend CCC for at least *two academic years* before being expelled.

comprised of 21 members from inside and outside the CCC system. After meeting for nearly one year, the task force released *Advancing Student Success in California Community Colleges* in December 2011. The report contains a number of recommendations, including creation of a common assessment test that is aligned with K-12 standards; mandatory student participation in orientation and other support services; and development of statewide enrollment (registration) priorities that reflect CCC's core educational missions of transfer, basic skills, and workforce training.

One of the key recommendations concerns the BOG fee waiver program. The report notes that, in placing few conditions on students' ability to renew their fee waiver, the program "is an underutilized mechanism for incentivizing successful student behaviors." The report recommends that satisfactory academic progress toward a declared goal be required of students renewing their BOG fee waiver. Under this recommended policy, students would lose their fee waiver (and, along with all other students, eligibility to register early for courses) if they do any of the following:

- Are placed on probation for two consecutive terms (GPA below 2.0 or failure to complete at least 50 percent of attempted units).
- Fail to declare a "program of study" (such as a major for students seeking an associate's degree) by the end of their third term at CCC.
- Earn more than 110 units (with additional coursework allowed for remedial and English-as-a-second-language instruction).

Students not making SAP would be permitted to appeal to their college if they have extenuating circumstances.

The board endorsed the Student Success Task Force's report recommendations, including the recommendation on BOG fee waivers, in January 2012. The board recently presented its plan to the Legislature for consideration. Statutory authority is needed to add the above SAP conditions to the fee waiver.

Chancellor's Office Plans to Increase Need Threshold

As discussed above, under Part C, students with just $1 of need are eligible to receive a full fee waiver. This Chancellor's Office policy allows certain students to receive a BOG award in excess of their demonstrated financial need. As we have noted in past publications (see, for example, *The 2011-12 Budget: California Community College Fees*, January 2011), this policy also results in relatively high income cut-offs to qualify for a waiver.

New Policy Will Ensure That Waiver Awards Do Not Exceed Need. In January 2012, the Chancellor's Office announced an administrative change that raises the fee waiver's need threshold to reflect actual student financial need. Under the new policy, which will go into effect in fall 2012, the minimum need standard will be tied to the amount of fees charged to a full-time student taking 24 units in an academic year. Since fees are scheduled to be $46 per unit in 2012-13, the minimum need threshold for next year will be $1,104 (rather than $1). Students who demonstrate less than this amount of need will not qualify for a fee waiver. This policy is consistent with that of the Cal Grant program, which also requires that a student's demonstrated need be at least as much as the maximum amount of the award.

This new minimum threshold will reduce slightly the income cut-off for students to qualify for a fee waiver. For example, the Chancellor's Office estimates that under the new policy, the income cut-off for a student living at home, with a younger sibling and married parents with $12,000 in savings will decrease from $85,000 to $83,000. The Chancellor's Office estimates that the new policy will affect about 20,000 students, resulting in savings to the BOG fee waiver program of approximately $7 million in 2012-13.

LAO Assessment and Recommendations

Adopt Satisfactory Academic Progress Requirements. We find merit with the Student Success Task Force and BOG recommendation to establish SAP requirements for students. Enacting these changes would help the state better target resources toward CCC's core missions, as well as create a strong incentive for students to achieve their educational goals within a reasonable time period. We thus recommend the Legislature enact these proposals. The Legislature may want to make a few minor modifications to the recommended policy. For example, instead of requiring all students to declare a program of study by the end of their third term, the Legislature may wish to also specify a unit-count threshold (such as 36 units) so that part-time students taking only one or two courses per term will have a sufficient opportunity to determine their specific degree, certificate, or transfer goals.

It is unknown precisely how much in savings would be generated from adopting BOG's recommendation. The amount would vary over time depending on the extent to which SAP requirements change student behavior and academic performance. Based on our analysis of CCC student data, we estimate savings to the fee waiver program of between $50 million to $100 million.

Require Colleges to Count Dependent Students' Income to Assess Need. We also agree with the Chancellor's Office decision to increase the need threshold on the BOG fee waiver program. The decision to align eligibility with actual student need makes sense in any fiscal environment—particularly so at a time of scarce state resources. In addition, we recommend the Chancellor's Office make a change to its policy with regard to students who are classified as "dependent" (typically unmarried students who are under age 24). Currently, in determining dependent students' eligibility for a Part B fee waiver, Chancellor's Office guidelines require campuses to consider only the parents' income. This deviates from federal financial aid policies for dependent students, which includes both the parents' and students' income for purposes of determining financial need. We recommend the Legislature require CCC to also count dependent students' income for purposes of determining eligibility for the BOG fee waiver.

Require Students to Apply for a Waiver Using Federal Financial Aid Application. As noted earlier, students can apply for a Part A or Part B fee waiver using either a FAFSA or separate BOG fee waiver form. Our review finds that allowing students to complete the BOG-only form works at cross purposes with both student and state interests. We recommend instead the enactment of legislation that requires students to use only the FAFSA to apply for a fee waiver. There would be some important benefits of such an approach. For example, by requiring students to complete the FAFSA, students would be considered for the full spectrum of federal and state aid—as opposed to just relief from CCC fee charges. While a precise total is unknown, based on data from the Institute for College Access and Success, we estimate that this could result in students obtaining roughly $50 million in federal Pell Grants that are currently left on the table. (While undocumented immigrants are not eligible for federal financial aid, CSAC is currently developing a new FAFSA-like form so that financially needy students covered under the Dream Act can be considered for the full range of state financial aid funds, such as Cal Grants.) In addition, by requiring all students to complete a

FAFSA form, campus financial aid offices could incorporate eligibility verification for BOG waivers into existing verification programs for state and federal aid (rather than relying on self-certification as a verification method, as many do now for Part B applicants). This, in turn, would provide CCC and the state with better assurance with regard to the students' claims about income level and other information.

The turnaround time for the federal government to process FAFSA forms is typically about 72 hours. Thus, campus financial aid offices should have sufficient time to award a fee waiver even to students who complete their FAFSA form shortly before the academic term begins. For students whose eligibility is not established until after the term begins, campuses already have the authority to either (1) waive students' fees pending verification of eligibility (with an agreement that the student must pay the fees back if they are found to be ineligible for a waiver) or (2) require students to pay the enrollment fee and reimburse the student as soon as eligibility is confirmed.

TRIGGER PLAN

The Governor's budget proposal relies on revenue from a tax package to be placed before voters in November. In the event voters reject that plan, the Governor proposes a number of automatic reductions ("trigger cuts") to General Fund appropriations, primarily in the areas of Proposition 98 and the universities, which would take effect January 1, 2013.

Proposed Higher Education Triggers

At the time this analysis was prepared, the Governor had not submitted specific language related to the triggers. In general, however, the administration proposes midyear trigger adjustments for all three public segments, as described below.

\$400 Million Total Unallocated Reductions for the Universities. UC's and CSU's 2012-13 General Fund appropriations would each be reduced by \$200 million. This represents General Fund reductions of 7.8 percent and 9.1 percent, respectively.

\$292 Million Reduction in CCC's Programmatic Support. The CCC would experience a programmatic reduction of 4.7 percent. As noted earlier, the Governor's proposed trigger plan for CCC involve several pieces. Specific adjustments include:

- ***Reducing Apportionment Funding by \$262 Million.*** This Proposition 98 funding would be redirected to CCC's general obligation debt service, which currently is funded outside Proposition 98.

- ***Reducing Base Funding by \$30 Million.*** It is unclear how this cut would be allocated among CCC apportionments, the flex item, and other costs.

- ***Eliminating a \$218 Million Augmentation That Would Have Been Provided to Pay Down CCC Deferrals.*** This would have no programmatic impact on CCC.

Trigger Plan Affects Planning, Resource Allocation

The Governor's trigger plan attempts to address the potential for imbalance in the state budget in the event that his proposed revenue package is rejected by voters. Even if the triggers were not ultimately pulled, they could have negative impacts on higher education to the extent the segments hedge their bets and make preparations for the academic year on the assumption the cuts will be made. For instance, the segments face the following key decisions before they would know whether the Governor's proposed trigger cuts will be made.

- ***Setting Enrollment Levels.*** As discussed earlier, the Governor's budget proposal includes no enrollment targets for higher education. This spring the universities will be making decisions on enrollment applications for the 2012-13 academic year. These decisions which will help determine their enrollment levels—a key driver of cost—in the budget year. Although the Master Plan specifies the size of the universities' eligibility pools, the universities have some ability to manage their enrollment levels by restricting eligible students' admission to particular campuses or programs. In contrast, community colleges are open access institutions that are to accept all adults who can benefit from instruction. However, the colleges attempt to manage enrollment by altering the number and type of course sections offered (as opposed to directly controlling which students they admit).

- ***Making Staffing Decisions.*** Colleges and universities also must make faculty and staff hiring decisions in order to accommodate their planned enrollment in the budget year. Campuses and departments have varying degrees of flexibility in making these decisions, depending on tenure rules, collective bargaining, and other factors.

- ***Setting Tuition Levels.*** The universities have the authority to set their own tuition levels. (The CCC fees are set in statute, rather than by the colleges.) 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 assumes CSU will rescind that increase. While there is no strict deadline for approving fall tuition levels, many students and their families need to know what costs they face in order to plan for the fall.

Cautious Approach to Trigger Cuts Could Have Same Effect as Up Front Cuts. Given the budget uncertainty that would be presented by the proposed trigger reductions, the colleges and universities will have to decide whether to base their enrollment and hiring decisions in part on the likelihood of midyear budget reductions. They may have a strong incentive to plan cautiously, constraining their costs so they would be able to absorb the trigger cuts if they were to happen. Given that all three segments already experienced trigger cuts in the current year, such an approach would be understandable. However, to the extent they prepare for trigger cuts, the segments' enrollment decisions may look very much the same as if the cuts were imposed up front as part of the state budget.

Less Cautious Approach Could Make Midyear Actions More Disruptive. If the segments take a more optimistic approach and make enrollment decisions assuming the triggers will not be pulled, they would have limited options if those assumptions turned out to be wrong. The universities may turn to midyear tuition increases as a way to at least partially backfill the lost General Fund revenue. This could create difficulty for students and their families without ready access to additional funds to cover a midyear tuition increase. Community colleges lack the authority to increase fees, but they have greater ability to reduce course sections for the spring term. This could disrupts students' plans to finish degree programs, transfer, or otherwise achieve their education goals.

Contingency Planning Is a Balancing Act

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:

- ***Allocating Contingency Cuts Among Programs.*** 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.
- ***Building Core Budget Without Triggers.*** The Governor's approach is to build a budget that assumes his tax package is adopted, with contingency cuts that would reduce operating budgets midyear if needed. 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 General Fund support to expect for their core programs, thus helping in their planning for the academic year.

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