ITEM 13
DRAFT

California Postsecondary Education Commission

Challenges Facing the 2007-08 California State Budget

December 2006

This report discusses the State's fiscal condition and guides the reader through the numerous factors that will influence State spending on higher education in the coming fiscal year.

It also offers insight and observations on challenging policy decisions the Governor, the Legislature, and higher education leaders face in the coming year.

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The Commission advises the Governor and Legislature on higher education policy and fiscal issues. Its primary focus is to ensure that the state's educational resources are used effectively to provide Californians with postsecondary education opportunities. More information about the Commission is available at www.cpec.ca.gov.

Draft Commission Report

Summary

On January 10, 2007, Governor Schwarzenegger will present his proposal for the 2007-08 State budget to the Legislature. In March, the Commission will prepare an analysis of the proposed budget's implications for postsecondary education. This report offers a preview of the possible issues that the Governor and the Legislature may address.

The upcoming 2007-08 State budget will address near-term and longer-term budgetary challenges. These challenges range from increasing expenditure requirements, limited revenue growth, and structural changes in how State government collects and commits resources. Current year (2006-07) state revenue collections are running slightly (1.8%) ahead of budget projections and, there have been no major unplanned increases reported in state program expenditures. This fairly predictable economic environment provides the opportunity to pursue needed policy changes. These changes could take the shape of commitments of new funds and redirection of current funding to improve the quality and return-on-investment of public services, including California postsecondary education.

The challenges to be dealt with in the development of the state budget are both financial and logistical. Some will require more immediate attention, while others are longer-term and could necessitate extensive changes in budgeting practices. Some of the major issues likely to dominate the financing debate include:

- A $4 - $5 billion ongoing "structural" deficit in the State's operating budget;
- Approximately $22 billion in outstanding debt, though only a small portion of this has to be paid in the coming year;
- The potential for major, unplanned swings in state tax collections due to shifts in the economy;

- Actions by the federal government, other states, and changes in the world economy;
- Constitutional, statutory, and other caseload-driven program cost increases reducing revenues available for education;
- Payments for Proposition 98 funding obligations;
- Debt service payments on past and present statewide general obligation bonds, 2003 deficit-financing bonds, and other outstanding debt;
- Revenue transfer-restricting provisions in Proposition 1A;
- Public higher education administrative issues and base budget, program improvement, facilities, and student services needs;
- Students' ability to pay for rising college costs and increased student debt;
- Budget year costs of current-year budget initiatives, including the community colleges' nursing initiative and fee revenue buy-out; and
- Potential costs from year-to-year budget decisions, such as continuance of the current year UC and CSU fee revenue buyout.

While many of these budget and policy issues are outside of higher education, action on these issues will have a direct impact on the funding available for postsecondary education and could impact access to higher education for years to come. Higher education has its share of outstanding issues for the coming 2007-08 fiscal year, including upgrading institutional programs and student services, funding shortfalls in capital construction and repair, improving State administrative oversight, and addressing the challenges students face in paying the increasing costs of college attendance.

However it evolves, the 2007-08 State budget will be an important opportunity for the advancement of CPEC policy recommendations for California higher education.

Statewide Issues

The State's Fiscal Condition

The 2006-07 Budget Act for the State of California authorizes total spending of $128 billion, $101 billion from the State General Fund and $27 billion from special funds. Total funding includes a $2 billion reserve for economic uncertainties.

This year's budget addressed many important issues of state finance but there are several ongoing areas of concern. The budget allocated nearly $5 billion to repay debt accumulated over the past two fiscal years. However, both the Legislative Analyst and Department of Finance project a continued State General Fund operating budget imbalance, or "structural deficit," of $4 to $5 billion over the next three years. It is estimated that the State will carry a total of around $22 billion of budgetary debt into the next fiscal year, although most of the payments of this debt are to be spread over one or more decades. This total includes repayment of March 2003 voter-approved Proposition 57 deficit-financing bonds, outstanding State-mandate claims by local government, and settlements of past Proposition 98 obligations.

Additional budget pressures will come from bond initiatives (discussed below), future year Proposition 98 funding commitments, and employee collective bargaining agreements. The budget presumes near-term moderate economic conditions and no shocks to the economy, such as an exacerbated housing slump or energy price spikes.

Ballot Initiatives and Court Decisions

A mixture of past and future policy decisions determined by the California electorate will make future State budgeting more complex. With the exception of property tax-cutting Proposition 13 decisions, Proposition 98 (school funding) is probably the most well-known ballot initiative enacted by the electorate that impacts State spending. Other recent voter-approved initiatives – Proposition 42 (transportation), Proposition 49 (after school programs), and Proposition 63 (mental health) – also mandate the allocation of billions of dollars. The debt service for voter-approved general obligation bonds on the November 2006 ballot could be as high as $100 million in the upcoming fiscal year and more than $2 billion per year before they are retired.

Similarly, California faces the possibility of hundreds of millions of dollars in additional, unbudgeted court-ordered expenditures for state prisons in the near term. These costs are in addition to the potential effect of various laws that could increase prison population in coming years.

State Revenue Volatility

Last year in May, the estimate of anticipated State revenues jumped nearly $8 billion above January projections. Should state, national, or international economic conditions deteriorate, California tax revenues could decline just as precipitously as they increased.

DISPLAY 1 "Actual" vs. "Forecasted" State General Fund Revenues for Fiscal Year 2006-07, through September 2006 (Dollars in Millions)

Sources	Forecast	Actual	Difference	Percent Change
Personal Income	$10,608	$10,996	$388	3.7%
Sales & Use	6,790	6,595	-195	-2.9%
Corporation	2,743	2,733	-10	-0.4%
Insurance	561	541	-20	-3.6%
Pooled $ Interest	107	173	66	61.7%
Alcohol, Tobacco	120	122	2	1.7%
All Other	258	403	145	56.2%
Total	$21,187	$21,563	$376	1.8%

Source: California Department of Finance, October 2006.

As shown in Display 1, the Department of Finance reports that General Fund revenues through the first quarter of the fiscal year are running slightly ahead of projections. Personal Income Tax revenues account for the bulk of this gain (even overcoming lower-than-expected sales taxes), accompanied by a variety of other, smaller revenue sources. Should the State's economy continue to perform at its current pace, tax and fee revenues might be sufficient to fund 2007-08 State budget increases up to the growth levels anticipated by caseload and cost increases. Coupled with the current budget's $2 billion reserve fund, these projections – though preliminary – represent potential good news for the upcoming budget.

The federal government also plays a major role in State financing. Faced with large deficits, officials in Washington D.C. are examining ways to reduce spending, including allocations to states and localities. California and most other states complain that the federal government fails to fully reimburse them for federally-mandated activities, including such national priorities as homeland security and the *No Child Left Behind* program.

Another potential jolt to the State General Fund are provisions in the recently-approved Proposition 1A – The Transportation Funding Protection Act. This measure severely restricts the transfer of gasoline sales tax revenues to the State General Fund. Proposition 1A requires that gas tax transfers be treated as loans that must be repaid with interest within three years. Proposition 1A also limits the number of times and the conditions under which the Proposition 42 gasoline tax revenues transfer prohibitions can be suspended.

Auto-Pilot Budgeting

Along with the constitutional Proposition 98 funding guarantee for K-14 education, many areas of the budget require some level of statutory or operational (caseload) funding. These include health and human services programs, state prison population growth, and federally and state mandated natural resources monitoring and improvement. While increased funding for these programs is not specifically mandated in law, limiting funding for them is not practical and can have severe ramifications.

California Higher Education Issues

Administrative Functions

Entering the budget year, open questions exist regarding state oversight of private schools that are not regionally accredited. Legislation that would have extended the "sunset" date for the Bureau for Private Postsecondary and Vocational Education was vetoed and the Bureau is scheduled to go out of existence on June 30, 2007. There are hundreds of education providers in the State that fall under the Bureau's oversight and scores of other schools that have never been regulated. Since this sector of postsecondary education provides training to hundreds of thousands of students, some level of state assurance of quality is essential.

Another unresolved issue of administrative functionality that will probably be addressed in the coming years is the interaction of the California Student Aid Commission (CSAC) and its student loan servicing auxiliary organization, EdFund. Student financial aid administration is complex and involves the private sector (mainly banks) and the federal government. The outstanding issues between CSAC and EdFund include those of oversight, administration, and the flexibility to operate in a nationally competitive marketplace. How these issues are resolved will impact EdFund's ability to continue to generate the hundreds of millions of dollars used to fund CSAC operations, including grant aid programs.

Base Budget Funding Pressures

Most of the anticipated funding increase for the CSU and UC are driven by the compact they established with the Governor in 2004. Student enrollment growth and rising costs for current operations (inflation) are the two highest-cost items for which funding increases are anticipated. Increased funding for these items alone could total $200 million for 2007-08. In the community colleges, funding for price inflation and enrollment growth could total $400 million.

Faculty in both the CSU and UC continue to complain of declines in their average salaries relative to their peers. Many other campus employee groups have also documented a decline. At the community colleges, employee compensation levels are collectively bargained at the local district level and provide their own cost pressures. For all three public systems, a large share of any inflation increases or cost-of-living adjustments for higher education is likely to be applied to adjusting employee compensation.

Program Improvements

Improvements in performance and measured outcomes in the state's higher education enterprise is a primary objective of many recent initiatives. The systems undertake a variety of efforts to improve student learning and persistence to program completion and the Governor and Legislature often put forth new initiatives to address evolving needs. One identified area of need, from the segments' perspective, is student support services for undergraduates. Such services include student orientation, academic tutoring and skills development, and transitional support for students preparing to leave one system (or educational level) and move into another one. Academic preparation programs directed towards middle and high school students are services that have been a point of contention in recent years. With increas-

ing concern about preparation for college, the push to identify and fund successful and effective academic preparation programs has intensified. Student financial aid services and the development of course articulation by campus faculty and staff are also services that help students achieve educational goals in a timely and efficient manner.

Deferred Maintenance

In prior economic recessions, as State fund availability shrank, lower priority work has been deferred and remaining resources concentrated on activities deemed most necessary for campuses to function. This is most evident in building maintenance programs. From minor structural repairs (painting and plumbing) to the replacement of major operating systems (electrical and environmental), the challenge of "deferred maintenance" has grown for more than two decades. The public higher education systems have estimated that their combined total backlog of current deferred maintenance is in excess of $1 billion.

The deferral of regular, scheduled plant maintenance shortens the life cycle of existing structures and operating systems, leading to unplanned and costly breakdowns. The extended utilization of worn-out infrastructure also denies the state cost savings that would be generated by upgrading and replacing antiquated systems. Newer systems are more efficient and user-friendly and are designed to last longer, run better, and to operate at lower per-unit costs. While the deferral of maintenance is understandable during times of fiscal stringency, over-reliance on this reasoning has a "pennywise, pound foolish" effect on the physical plant and necessitates far more costly emergency repairs and replacements. Recent state budgets have attempted to lower the backlog of maintenance, however the problem persists and continues to impact the functionality of state facilities.

Student Fee Levels

The current budget contains substantial funding increases for the community colleges and solid increases for the CSU and for UC. Some of the items funded in the budget – such as the intersegmental nursing education initiative – represent long-term commitments and will likely be funded accordingly. Others, like the buy-out of CSU and UC revenues that would have been generated by a student fee increase, are year-to-year decisions. Another ongoing student fee issue is providing continued funding for the current year budget agreement to reduce the community colleges statewide enrollment fee from $26 per unit down to $20 per unit, effective spring 2007. The budget allocated $40 million to replace estimated forfeited student fee revenues; this accounts for half a year of replacement funding. Thus, the 2007-08 budget will need an additional $40 million (for a total of $80 million) if this fee reduction offset is to be maintained in 2007-08.

Affordability

As the State and institutions struggle with rising expenditures in the operation of the postsecondary education sector, so do students wrestle with their share of these costs. Resident California students will pay a combined $3 billion in mandatory student fees in 2006, whereas students paid less than $140 million in 1976. The accompanying costs of college attendance – educational materials, housing, transportation, living expenses – have also risen steadily over the years. To pay these bills, students and their parents have increasingly turned to loans and have accumulated greater levels of personal debt than in the past.

It is still not clear what tipping point of increased student debt will drive Californians to make alternative decisions regarding their pursuit of a college education. California cannot continue its 15-year trend of cyclical and substantial student fee increases, coupled with steady increases in other college costs, without severely impacting access, choice and public support for higher education laid out in the 1960s

Master Plan. As is the case in so many areas of state finance, the upcoming budget presents an opportunity for both initial action and long-term planning to help maintain higher education affordability to Californians.

Building Renovations

Another major budget issue for all of higher education is funding for the segments' building renovation and construction programs. The capital outlay program is the most costly aspect of higher education, accounting for many billions of dollars. Proposition 1D on the November 2006 ballot allocates $3.1 billion to public higher education facilities. The three systems expect that this funding will carry their capital construction programs through both the current and budget years. With no other steady source of funding, statewide general obligation bond initiatives have become the default funding source for capital construction. However, the continued reliance on voter-approved bond funding is not without risk. They are short term in nature, generally funding only two to four years of construction, while being financed over 30 years. There is also the risk that future bond initiatives could be defeated, as occurred in June 1994 when state voters rejected a higher education facilities bond and a separate K-12 facilities bond.

Summary

If state revenues continue at the current rate, California higher education should receive a share sufficient to fund its core needs. The challenge will be increasing funding for targeted program improvements and for broader issues, such as student financial aid. The next legislative session will also see the introduction of new initiatives for higher education, likely in the areas of access and affordability.

As the 2007-08 State budget moves forward, policymakers will gradually develop priorities for the use of limited state funds and those decisions will be affected by the many challenges summarized in this report. At the Commission's March 2007 meeting, an analysis of the Governor's January budget proposal and the Legislature's budget analysis will be presented. At that time, the Commission may consider adopting positions on specific items in the Governor's budget.