FY 2004-2005 General Fund Operating Budget

July 15, 2004

Introduction

Our discussion of the budget that we presented for FY2004 began by noting that "the fiscal challenge faced by the University in FY2004 is the most difficult that we have seen in over 20 years." As FY2004 unfolded, it was even more difficult than we had believed when it was enacted, with the State rescinding 5% of its appropriation ($16.4 million) in the middle of the fiscal year. The challenges that we face in FY2005, taken alone, would constitute the second-worst year in over two decades. Taken in conjunction with FY2004, and a difficult budgeting environment in FY2003, we can say that the fiscal circumstances that the University is dealing with are the most difficult that we have experienced in at least 40 years.

This string of challenges came on the heels of a period of robust growth, roughly from 1997 to 2002, so that we have been able to effect considerable savings through consolidation and careful scrutiny of activities that had become less important and valuable in light of growth in other related areas. In normal years, we grow and change through a process that has been termed "innovation by substitution," in which we eliminate or reduce some activities in order to find resources to initiate new ones. Innovation is a defining characteristic of a great research university – we do not merely stay on the cutting edge – we help to define the cutting edge. Taking FY2004 and the proposed budget for FY2005 together, we will have removed over $57 million in recurring expense in the General Fund, as well as $29 million in one-time rescissions, in order to meet the challenges imposed by reductions in the State appropriation. Over and above these amounts, we have still found the resources to provide a superb set of undergraduate and graduate programs, and to provide, albeit at a reduced rate, the wherewithal necessary to sustain the excellence in research and scholarship that undergird the growth of the state and national economies.

Last winter, President Coleman and the Executive Officers articulated a set of principles that will allow us to sustain – to the best of our ability -- excellence in our teaching and scholarship even in the face of such significant reductions in the General Fund. Both reductions and growth have been guided by these principles:

1. The academic excellence at the University of Michigan is unparalleled and must remain so. The outstanding quality of academic programs, both teaching and research, and the contribution of non-academic programs to that quality, will be paramount in budget decisions. Restructuring of some programs may be necessary.

2. Financial aid will continue to be a University priority; we are committed to assuring that a University of Michigan education is affordable for students and their families.

3. Short-lived or illusory savings arising from cutting activities that are self-supporting and growing, such as clinical care, will be avoided.

4. Alternative revenue sources that may be enhanced, most notably fundraising, will be emphasized.

5. The costs and consequences of our activities must be evaluated so that the highest priority activities may be funded and, where necessary, lower priority activities eliminated. In doing so, resources will be generated to make new investments in vital areas of research and teaching and in our faculty and staff, as well as to meet current budgetary challenges.

6. Collaborative approaches will be encouraged to enhance quality, eliminate duplication, consolidate programs and services, ensure prudence in expenditures, examine cost effective purchase of services, and utilize all University resources efficiently and effectively.

In combination, the first two principles require that we assure that our students continue to have access to an excellent education – a Michigan education – in an environment where revenues from the State are being reduced to their approximate level of seven or eight years ago. In times of economic stress, our students and their families require more financial aid in order to attend Michigan, at the same time that the University's resources are squeezed. Notwithstanding this double bind, over the past several years we have increased financial aid by more than the growth in tuition, and, most importantly, we have reaffirmed our policy to meet the demonstrated financial need of all resident undergraduates. And in a year where many activities are being cut, we are increasing the number of sections in heavily-subscribed courses in LSA in order to be responsive to student demand and to enable students to complete their academic programs in a timely way.

Administrative units, and administrative activities within the academic units, have experienced a disproportionately large share of the cuts, consistent with our emphasis on education. Every unit has stepped up to the challenge and there are tangible instances of efficiencies being achieved in administrative units across the campus.

Most importantly, these principles assure that we continue to focus on the long-term essential quality of the institution while managing through our short-term budgetary difficulties. We have been able to achieve considerable savings through consolidation and careful scrutiny of activities that had become less important in light of growth in other areas. Michigan's ability to fuel innovation in new areas is a defining characteristic of a great university. Despite this difficult period, we pledge to enhance the academic excellence that has created the foundation for Michigan's greatness for over a century.

The Budgetary Challenge

We face challenges with respect to both revenues and costs.

We began FY2003 with a State appropriation of $363.6 million and a pledge from the State that the appropriation would not be reduced that year. Six months later, the State enacted a $12.7 million rescission.

The enacted appropriation the following year (FY2004) was $36.4 million less, a 10% base cut. During FY2004, we faced another 5% cut as a mid-year rescission of $16.4 million.

The Governor and legislature hope to restore 3% of the base funding for FY 2005 as outlined in the State budget proposal, but even under those circumstances the University of Michigan Ann Arbor appropriation will be 12% lower than it was two years ago, that is $43 million less every year, with an additional $29 million total in mid-year cuts. [1]

On the expenditure side, we continue to be subject to the normal forces of inflation. The cost of doing business in a university rises much as it does in the rest of the economy, but universities face four sources of cost increase that tend to make our costs rise faster than those in the economy as a whole:

1. We are labor-intensive in comparison to the economy overall, and it is generally the case that the costs of labor rise faster than other prices economy-wide.
2. The total volume of our activity - in education, in research, and in service – continues to rise. In FY2005, we will have more students and a higher volume of sponsored research than at any time in our history. While many businesses are seeing reductions in costs that flow directly from reductions in volume, universities in general, and the University of Michigan in particular, are under pressure to reduce costs at the same time that they experience an increase in volume of activity.
3. The sum of human knowledge and creative expression grows every year, and the University, unlike most private enterprises, has an obligation to preserve the past as well as to invent the future. We are both museum and laboratory. The cost of museums grows in part because the collection grows, and the cost of staying on the cutting edge is always high.
4. Substantial technology investments are crucial for universities to stay at the cutting edge of research and teaching. Generally such investments, although they improve the quality of academic and scholarly work, do not result in lower costs or increased revenues for the University. Businesses, by contrast, make technology investments that create efficiencies or enhance revenue flow.

In total, the increases in the costs of supporting the volume of activity that grew out of 2004, and a few essential new activities for the upcoming year will be $44.2 million. In addition to financial aid and improving course access in LSA, the cost drivers for FY2005 include increased utilities costs, a very modest salary program, union contracts, increases in staff benefits, insurance, financial aid, inflation on purchased supplies, completion of funding administrative infrastructure, and a small number of essential new commitments, including meeting increasingly stringent regulatory requirements with respect to research in the health sciences, and meeting growing security challenges in information technology.

Without a number of ongoing cost-cutting initiatives in purchasing, staff benefits, energy efficiency, and other areas, our costs would be growing far more rapidly. We discuss these and related initiatives later in this documen

Meeting the Challenge

Combining reductions in revenues and increases in costs, we face a total budget challenge for FY 2005 of $50.7 million. We have cut General Fund expenditures by $19.8 million in the FY2005 budget, on top of $37.5 million in cuts in the FY 2004 budget. The cuts will be effected in part by reductions in 122 regular staff positions and 40 faculty positions. There will also be reductions in overtime, temporary employees, and consultants, as well as reduced maintenance, equipment replacement, travel, printing, and virtually every type of expenditure that we undertake.

Most of the staff reductions, and all of the faculty reductions, will be via attrition and elimination of open positions, but there have already been a number of staff layoffs associated with our budget planning and there are sure to be more. Both administrative units and academic units will see their budgets grow by less than their increases in costs, for the second year in a row.

In short, this budget attempts to provide more with less. Unfortunately, there are inevitable negative consequences for the quality of the student experience, although we have made every effort to limit those consequences.

Perspectives on the Budget

Figures 1 and 2 show a 43-year history of the most important elements of the Ann Arbor General Fund budget – the sum of tuition revenues and revenues from the State appropriation. These are the two large revenue sources in the General Fund that can be used flexibly by the University. (The third large source – Indirect Cost Recovery – is not as available to use flexibly as it is partial reimbursement to the General Fund for the indirect costs of sponsored research. It is meant to cover costs that are incurred in the General Fund, including space, utilities, research administration and infrastructure, among others, that are not paid for directly by sponsored research.)

Besides their magnitude within the General Fund, tuition and the State appropriation are important because they come from the two constituencies that the University most directly serves as part of its core mission. The citizen taxpayers of Michigan provide funds for the State appropriation, and our students and their parents provide our tuition revenue.

Figures 1 and 2 show how unusual the recommended budget for FY2005 is, following upon an even more difficult situation in FY2004. If we do not adjust for inflation, one has to go back to FY1962 to find a year that is worse than FY2004, and only FY1962 and FY2004 are worse than this year. This year and last, in combination, are by far the worst contiguous years. Adjusting for inflation, Figure 2 shows that FY2004 and FY2005 are the worst in over 20 years, and shows that the small positive growth in FY2005 does not compensate for the real decline experienced in FY2004. Were we to use a price index that better reflects the cost pressures facing higher education this result would be even stronger – the reduction in real revenues would be even greater.

Figure 3 relates the two components of revenue that we have been discussing. There is a longstanding historical pattern in which tuition rate increases respond to changes in the State appropriation. In years when the appropriation grows more, tuition rates rise less; when the appropriation growth is stunted, tuition growth is greater. The pattern is quite clear over the recent period. In response to a lower increase in the State appropriation in 1998-99 than in 1997-98, tuition rose more sharply. When the trend reversed in the subsequent two years, tuition rose less. When the State appropriation increase fell to 1.5% in FY2002 and to zero in FY2003, tuition rate increases got larger. In this context, the budget for FY2004 and the proposed budget for FY2005 are quite remarkable. In the face of a 10% base cut in the State appropriation – only the second year-over-year cut in over 20 years, and the largest cut ever – last year we increased resident tuition by 6.5%. For FY2005, with an expected base cut in the appropriation of 2%, we are budgeting a 2.8% increase in resident undergraduate tuition. The comparison to 1981-82, which was the last year in which there was a base State cut, is instructive. In that year the budgeted State appropriation declined by a little less than 5%, and tuition was increased by 19%.

Expenditure Reductions and Cost Containment

The University of Michigan is highly decentralized, and its decentralization is a source of its academic strength because it allows those who are most familiar with teaching and research to make decisions about what should be studied and how. Decentralization poses special management challenges in times of expenditure reduction, because expenditure decisions are made in hundreds of departments and programs and in dozens of schools, colleges, institutes, centers, and administrative offices.

Our strategy of cost reduction reflects the organizational structure of the University. For areas where operations are centralized, such as purchasing, utilities, staff benefits, and financial management, we are continually looking for University-wide improvements that can save money. Over the past several years, we have undertaken significant cost reductions in all of these areas, and have been making continual improvements. Compared to what would have occurred had we not undertaken these improvements, the FY 2005 budget saves approximately $13 million in energy costs, $1.3 million in debt service, and over $2.9 million in pharmacy benefits. Substantial savings also accrue from the prime vendor purchasing activity which now saves over $7.5 million on all funds campus-wide. Additional General Fund savings include $3 million as a result of restructuring employee and employer premium-sharing in our health insurance offerings. These changes were the result of a study undertaken by a University-wide committee, leading to discussion and collaboration across the University. The structure of premium design that resulted from these efforts will allow the University to adapt to future changes in the market place, and to realize more savings in the years to come.

Savings in central operations of the kind that we have discussed in the preceding paragraph take years of planning to realize and arise not so much as a result of the specific budgetary challenges of any one year, but as a result of ongoing efforts to keep costs down. Such efforts are continuing and will yield more results in future years, especially in the areas of travel management and health benefits.

In most areas we are much less centralized, and cost containment and expenditure reduction are achieved unit by unit, person by person, course by course, and program by program. These savings add up to over $14 million in academic programs and academic support and over $5 million in administrative areas. We are working hard to ensure that these cuts do not put the essentials of the Michigan educational experience at risk, but we nevertheless have concerns. First, the current period of reduction is not allowing the University to move forward as effectively as some of our competitive peers. Second, we are frankly concerned that some of these reductions may prove to be difficult to sustain. We pledge to monitor them and their consequences carefully.

The breadth of our offerings is one of our greatest strengths, both in what we can accomplish and in how we are perceived by students. Michigan is one of the few places in the world where a student can be assured of having access to faculty and courses, at the highest level of expertise, in virtually any area of inquiry. Our scale, which makes this breadth possible, also presents challenges. Historically, we have been less able than we would like to provide opportunities for students – especially lower-division undergraduates – to have small-group interactions with faculty. Over the past decade we have made great improvements in this area, and LSA has developed a freshman seminar program that provides an opportunity for every first-year student to take a small course with a regular faculty member. The cuts undertaken in FY2004 eliminated several of these seminars, and also eliminated a number of other small and medium-sized courses. For FY2005, we are able to hold the line on freshman seminars, but have continued, across the University, to reduce our small-class offerings somewhat.

We have built this budget placing the highest priority on minimizing negative effects on our educational programs. Even so, there certainly will be an impact, both direct and indirect, and we will pay close attention to this in the coming year. We are especially concerned about the qualitative impact arising from two consecutive years of cuts.

The General Fund Budget Recommendation

The attached Table 1 summarizes the General Fund Budget Recommendation for FY2005. The most striking element of Table 1 is the difference between the academic units and the administrative units. Even after making cuts in activities and so reducing costs, the academic units on average experience a modest increase in their General Fund budgets (most of which is accounted for by increased numbers of students and increased volume of indirect cost recovery from sponsored research) reflecting our emphasis on supporting, as far as possible, the direct educational offerings. About half of the administrative units, on the other hand, experience an actual reduction in their General Fund budgets year to year. The modest growth in the budget for Student Affairs is in support of increased student demand, and is consistent with our principle that the student experience be compromised as little as possible by budget reductions. The increases in the CFO area are principally due to the operating costs of new space – much of it research space that will generate new revenue -- the requirements of IT security, and regulatory requirements in research.

There is considerable variation in the rates of growth of General Fund budgets in the academic units. In most cases, units that are growing rapidly (e.g., the College of Pharmacy, the School of Public Health, the School of Nursing, the Ford School of Public Policy) are doing so because they are experiencing rapidly growing volumes of research or instruction or both. It is a feature of our budgeting system that General Fund resources wax and wane with the volume of activity. Of course, changes in activity bring with them changes in costs. LSA is experiencing growth in numbers of students and in sponsored research, and is also the recipient of funds that will permit it to add to the curriculum in areas where students have had difficulty in finding open courses that are essential to their programs of study.

The growth in expenditure on University Items is driven by one policy choice – financial aid – and two sets of unavoidable cost increases – utilities and insurance. We continue our longstanding policy to meet the financial need of all resident undergraduates, and our first priority has been to assure that financial aid rises at least as rapidly as tuition. And, of course, we continue to meet our contractual obligations such as utilities, insurance, and collective bargaining agreements.

As noted above, this budget is built on the assumption of a 2 % ($6.5 million) cut in the State appropriation relative to the budgeted amount in FY2004. In light of the fact that over the past two fiscal years, we have experienced three mid-year rescissions, totaling $29 million, we believe it prudent to outline how we would respond were there to be any such rescissions in FY2005. If there are mid-year reductions in the State appropriation, we would ask the Board to approve mid-year tuition increases to offset those reductions. After two years in base and one-time reductions, we simply do not have sufficient budgetary or program flexibility to sustain another cut without a new source of revenue.

Conclusion

We end this discussion as we began it. In the face of budgetary challenges, our primary obligation is to maintain the excellence of this University in the coming year and in the years to follow. Our focus is on academic programs, which means that it is first and foremost on the women and men, faculty and staff who enable the teaching, learning, and discovering by our students, as well as the economic growth, patient care, and other vital contributions that the University makes to the State, to the region, and to the world.

The size of the faculty and staff will again be reduced in the coming fiscal year; some of the elements of the Michigan experience will be leaner, and will be experienced as such by our students. But the essential breadth and depth of excellence in our academic offerings will be maintained. We are grateful for the efforts of thousands of faculty and staff across the University who have stepped up to the challenge of finding innovative ways to eliminate tens of millions of dollars of recurring expenditures with minimum impact on teaching, learning and tuition rates.

The value of higher education has never been greater. In straightforward economic terms, the return on investment in a college education continues to grow and is at its highest level since economists started making such calculations. Less tangibly, but at least as important, education is the key instrument for understanding, engaging with, and negotiating in an increasingly complicated and interesting world. As institutions go, universities return the greatest value to their students and to society as a whole and the University of Michigan contributes mightily to this social value.

Our missions of teaching, research, and service continue to be deeply significant. The budget we recommend here allows us to accomplish those missions, relying on the dedication and support of our faculty, staff and students, the people of the State, and the Board of Regents.

]1 Throughout the year, there have been a series of discussions involving the Governor, the Legislature, and the leadership of the State's public universities. As we prepare this budget, those discussions are not yet complete, and the Higher Education Appropriation for FY 2005 has not yet been enacted. Our current expectation is that the appropriation will be $320.7 million, as discussed above, provided that we do not increase resident undergraduate tuition and required fees by more than 2.8%. Should these conditions change, we would propose appropriate revisions for the Board's consideration.