FY 2005-2006 General Fund Operating Budget

July 21, 2005

Introduction

Our discussion of the budget we are presenting for FY2006 is framed by the reality that we are facing, for a fourth consecutive year, a very difficult fiscal situation driven by anticipated cuts in the state appropriation. According to the Governor's proposed budget for the State of Michigan, the UM appropriation for FY2006 would fall to just over $314M from the figure of just over $363M that was appropriated in 2001 for FY2002. If the Governor's proposed budget for FY2006 is approved, we will have seen base reductions of $48.8M in the University of Michigan's appropriation with another $20.8M in one-time cuts, all occurring over a four-year period. During that same period, we agreed to restrain growth in resident undergraduate tuition. Meanwhile, market considerations constrain growth in non-resident undergraduate and graduate/professional tuitions.

This combination of circumstances has created a daunting challenge. It is difficult enough to deal with a significant reduction in state appropriation and constrained tuition growth for one year. Having worked through three consecutive years of reduced state appropriation with a looming fourth year of reduction puts us in some of the most difficult fiscal circumstances that the University has seen in at least 40 years.

The University is advancing in notable ways despite these challenges. Our academic units are launching exciting new research and teaching initiatives. The University continues to play a visible leadership role in many arenas with the ADVANCE initiative to increase representation of women in sciences and engineering, with the ambitious transformation of residential life to be achieved by the Residential Life Initiative and North Quad Project, with the M-Pact initiative that creates greater access for our most needy students and with the Michigan Digitization Project (collaboratively with Google) and other initiatives that put us at the forefront of realizing the library of the future. We remain competitive for the best faculty and students, with yields of freshman admits at historic highs over the last two years. External support is at an all-time high, not only for sponsored research but also in the form of gifts from foundations and individuals. This past year, the University was given the single largest gift in its history, leading to the naming of the Stephen M. Ross School of Business.

That we, as a University community, have achieved so much in the face of unprecedented budgetary challenges is remarkable, but unsustainable. We are in competition with the best universities in the world for top faculty, staff and students. Within both our academic and administrative units, the accumulated effect of three consecutive years of budget reductions, modest salary programs and reduced flexibility has been enormous. The resulting threat to faculty recruitment and retention, in particular, is very real. We cannot sustain another year of very low salary increases and minimal investments in our academic programs without threatening the quality of the institution in fundamental ways. We are at a crossroads, from which we will define the University of Michigan's future academic quality. In FY2006, we must take steps to boost morale across the University, to retain and attract the best faculty and enhance our units' abilities to innovate. The budget that we present to you goes a significant way towards achieving those ends.

Two years ago, President Coleman and the Executive Officers articulated a set of principles that will continue to direct us as we sustain – to the best of our ability – excellence in our teaching and scholarship even in the face of significant reductions in the General Fund.

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 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 important ways, these principles have served to guide our actions over the past year and our planning for the next few years. They highlight access as a core institutional value, and so we have reaffirmed our commitment to meet the full demonstrated need for resident undergraduates. As in past years, we have increased the funding of financial aid by at least the rate at which we have increased tuition. By tying funding levels of financial aid to changes in tuition in this way, we assure that increases in tuition will not compromise the ability of our most needy students to attend the University of Michigan.

In addition, this year the University launched the M-Pact program, which provides an additional \$3M per year in financial aid targeted at low to middle income families, bringing our projected expenditures for centrally funded financial aid to \$87.8M in FY2006. For eligible students, M-Pact will enhance the University's existing financial aid package with grants of \$1500, \$1000 or \$500 depending on the student's financial need. With M-Pact in place, grant assistance to resident students at the lowest income levels will rise to over \$12,000 per year, thousands of dollars more than tuition. Additionally, M-Pact will provide much-needed grant aid support to students whose families may earn a bit more – typically in the range of \$50K to \$70K. Our commitment to access, measured by expenditures for financial aid, places us as one of the leaders among Big Ten universities and a clear leader among the public universities in the State. Financial aid has been, and continues to be, one of the highest priorities of our institution.

We continue to seek alternative sources of funding to support our academic work. With the Michigan Difference Campaign, our fund-raising efforts have intensified and we are achieving success at unprecedented levels. In light of declining State funding, support from our donors is an essential ingredient that makes the difference between a good university and a university that excels as a leader in innovation and is one of the world's greatest universities. The Ross gift, for example, will allow us to transform education in our business school, an innovation that would have been all but impossible without such a generous external revenue source. Although use of endowment funds is restricted by donor intent and can be used only for the specific purpose for which the gift was made, there are instances in which gift funds support activities that allow us to stretch general fund dollars. In any given year, some amount of the general fund budget goes towards innovations and new initiatives. To the extent that gift funds can be used to support those same innovations, that much more general fund is available to support the University's other highest priorities. Usually, however, gift funds and endowment support innovations and activities that we would not have been able to support on general funds. Gift funds and the endowment create a margin of excellence, but they do not replace state funding support and student tuition dollars.

In keeping with the first principle above, educational and scholarly activities have been given the highest priority for funding in the budget that we are presenting. In particular, the academic units do significantly better than administrative units again in FY06 as can be seen from Table 1. Also, within academic units, academic activities have been given higher priority than administrative activities for funding. We are concerned, however, that we are at the point where further reductions in administrative services may begin to significantly impair our ability to carry out our academic mission.

Lastly, it should be emphasized that we continue to maintain an emphasis on the future. For example, the Residential Life Initiative and the plans for North Quad represent a multi-year program that will transform all aspects of residential life for our undergraduates. The Life Sciences Institute, one of the cornerstones of our strategy to build eminence in the life sciences, has had a very successful year of faculty recruiting which goes a long way towards positioning the Institute for leadership in the future. This budget proposal includes funds for an initiative to recruit and retain outstanding faculty. Our continued excellence hinges on our ability to expand the core of truly exceptional faculty who build vital research and instructional programs without which we cannot recruit additional outstanding faculty and students. Lastly, the University is greatly expanding its state-of-the-art facilities, with the construction of such buildings as Biomedical Sciences Research Building, Public Health, the new Computer Science and Engineering Building, Weill Hall (new home of the Gerald R. Ford School of Public Policy) and the Walgreen Drama Center. Advanced facilities serve as a foundation for the research and instruction that will allow the University of Michigan to remain competitive for the finest research faculty, students, and research staff in the years ahead. Without these facilities we cannot sustain the external research support and superb student quality that are essential to leadership.

The Budgetary Challenge

Both constraints on revenue growth and significant increases in costs contribute to our budgetary challenge. Revenue to the general fund comes from three main sources: state appropriation, tuition and indirect cost recovery. Changes in indirect cost recovery pay for changes in the indirect costs of research, implying that indirect cost recovery is not available for allocation on a discretionary basis. So, tuition and state appropriation constitute the main general fund sources that can be flexibly allocated. In the introduction we detailed the rapid decline in our state appropriation over the last several years. The appropriation was at $363M for FY2002 and is projected to be at $314M for FY2006. Thus, the major reductions in state appropriation that we have seen over the last three years represent a significant decline in one of the two main sources of generally allocable funding within the general fund.

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, except that universities face four sources of cost increase that tend to make our costs rise faster than those in the economy as a whole:

- 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.

- Substantial investments in technology, and the facilities to support that technology, 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.

- The total volume of our activity – in education, in research and in service – continues to rise. In FY2006, we will have more students and a higher volume of sponsored research than at any time in our history. While many businesses see reductions in cost 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 they experience an increase in the volume of activity.

- 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 invest in the future. We are both museum and laboratory. The costs of museums grow in part because their collections grow, and the cost of staying on the cutting edge is always high.

Beyond these general factors that drive up the cost of university business, two additional factors have significant impact on the budget presented here. The first is a sharp increase in natural gas prices, which have risen 28% in the past year, and result in double-digit percentage increases in utility costs for FY2006. The second factor is an increase in operating costs of facilities resulting from new space coming on line in FY06. Included in these new facilities are the Biomedical Sciences Research Building, the Undergraduate Science Building, the Advanced Technology Laboratories in Biomedical Engineering, and the Computer Science and Engineering Building. In each case, we have planned carefully to take on the new costs of operating these facilities. Although planned for, the new operating costs constitute substantial new expenses on the general fund which limit resources available for other priorities within the units occupying the buildings. However, these are critical facilities that will allow the units to further expand their important activities in education and research.

Combining reductions in state appropriation and increases in costs, we face a total budget challenge for FY2006 of $63.6M. In the FY2006 budget, we have reduced General Fund expenditures by approximately $20M, through consolidation of activities, reallocation of support and expansion of alternative sources of support for academic programs. Each of these mechanisms is discussed in some detail below.

Perspectives on the Budget

The first two figures in the <u>Appendix</u> show a 44-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. As noted earlier, these are the two large revenue sources in the General Fund that can be used flexibly by the University. The third large General Fund source – Indirect Cost Recovery – is not available to use flexibly as it is partial reimbursement to the General Fund for the indirect costs of sponsored research. It covers costs that are incurred in the General Fund for activities in support of sponsored research, including space, utilities, research administration and infrastructure, that are not paid for directly by the research sponsor.

Figures 1 and 2 show how unusual the three-year period FY2004 – FY2006 has been. If we do not adjust for inflation, then FY2004 – FY2006 provide the lowest combined three-year increase in percentage terms that we have seen in this history. Adjusting for inflation, we see that FY2004 – FY2006 is the worst three-year period since FY1980 – FY1982.

Another perspective on the past four years comes from comparing the state appropriation with what it would have been had it merely kept pace with inflation in consumer prices. In 2002, the appropriation was $363M. Had it kept pace with inflation, in 2006 it would be $396M. The Governor's recommendation that we use in this budget is $314M. The difference – some $80M – has been accommodated principally by expenditure reductions of a similar amount in the budgets from FY2004-FY2006.

Figure 3 compares percent change in undergraduate resident tuition to percent change in state appropriation. There is a long-standing historical pattern in which tuition rate increases respond to changes in the State appropriation. Not surprisingly, in years when the appropriation has grown more, tuition rates have risen less and conversely, when growth in the state appropriation has been robust, tuition increases have been small. We broke that pattern in FY2004 and FY2005 by raising tuition only modestly in the face of significant declines in the state appropriation – in FY2004 we responded to a 10% reduction in state appropriation when we increased tuition by 6.5% and in FY2005 we responded to a 2% cut in the state appropriation with a 2.8% increase in tuition. These changes led to the modest growth of the General Fund budget that occurred in those two fiscal years. This year, we return to something closer to the historical pattern. With an anticipated 1.85% cut in the state appropriation, we are proposing a 12.3% increase in resident undergraduate tuition. Despite the significant increase this year, the University of Michigan has engaged in remarkably measured growth in resident undergraduate tuition by comparison to other universities over the most recent several years. For example, the University of Michigan has had the lowest average annual increase in resident undergraduate tuition among all public universities in the Big Ten over the most recent five-year period (including FY2006). Among public universities in the State, the University of Michigan has had the lowest average annual increase in resident undergraduate tuition over the prior four-year period (not including FY2006 as tuition increases for FY2006 are at this point unknown for several of the other public universities in Michigan).

Expenditure Reductions and Cost Containment

As noted earlier, this proposal incorporates the requirement that we reduce expenditures on the General Fund by approximately $20M, which constitutes a reduction in expenditures from FY2005 of approximately 1.75%. The practice of reducing expenditures on the General Fund by somewhere between 1% and 2% to enable innovation is one that we intend to continue in our budget planning in subsequent years. There are a variety of ways that we can achieve that level of expenditure reduction, including reallocation of funds from lower priority activities to new initiatives, consolidation of activities so as to eliminate duplication, and increased support for academic programs from gift funds and other funds. We believe that we can achieve this level of reduction, on an on-going basis, through a combination of those means. We note that this year's reductions are in addition to $37.5M in FY 2004 and about $19.8M in FY 2005.

In constructing the FY2006 General Fund budget, our strategy of cost reduction reflects the organizational structure of the University. For areas where operations are centralized, such as within the units reporting to the Executive Vice President and Chief Financial Officer, we have continued to look for University-wide improvements that can save money and we report on the most significant successes below. In other areas, such as within the academic units, we are much less centralized and cost containment and expenditure reduction are often achieved through a collection of individualized actions taken unit by unit, program by program and course by course.

Examples of expenditure reduction and cost containment steps put in place for FY2006 include:

- The Ross School of Business is increasing its offering of custom programs in its Executive Education program, the result of which will be to expand revenues. These new auxiliary revenues will help support costs currently on the general fund.

- LSA has teamed with MAIS to put in place an electronic waitlist system with advanced features that will allow LSA to more effectively fill sections of its most heavily enrolled courses. The resulting efficiencies will allow LSA to serve more students at lower costs.

- The University is moving forward on plans to construct a large machine room facility to house advanced computing hardware, in particular “computer clusters”, which are becoming important research tools across the University. Currently machine rooms to house clusters are being constructed in buildings across campus, often with costly specialized construction to serve their power and cooling needs. A centralized machine room will provide efficient space that will reduce duplication and increase the cost-effectiveness over the current situation.

- The School of Dentistry is making organizational changes (including the merger of two of its departments). Taken together, these organizational steps will lead to the reduction of two 50% faculty administrator positions and three full-time staff positions.

- The CFO organization has achieved over $4.4 million of reduction in general fund expenditures that included more efficient processes, minimal service reductions and successful completion of restructuring initiatives. These reductions were achieved through a variety of steps that included more efficient processes leading to reductions in staff, moving selected work in-house thereby eliminating the costs of third party vendors, reductions in reserves for hardware replacement and software upgrades, and renegotiating hardware and software maintenance contracts to give the University more favorable terms. Additional expenditures were reduced by extending repair, replacement and cleaning cycles on some equipment and facilities, use of advanced technology to reduce personnel costs related to building services, introduction of paperless business processes in some areas and negotiation of cooperative agreements with local businesses and industry that move work currently done at UM to those businesses. Examples of recent restructuring initiatives include both Sponsored Programs and Purchasing. In each case, changes permitted them to absorb significantly more work with fewer FTE’s through better organization, new policies and improved tracking software to predict and manage workload through better operational metrics.

Beyond steps such as those above, which reduce general fund expenditures, it is also worth mentioning that health benefits costs are expected to rise moderately in FY2006 at a rate that is well below the double-digit increases we have experienced in the prior few years. This success is due in large part to the actions taken over the past several years to reduce aggregate costs through actions which increase employee awareness of costs and to achieve a more equitable sharing of the costs of health benefits between the University and the employee.

In seeking reductions in General Fund expenditures from our units, we have emphasized the need to avoid negative impacts on our educational and research missions. In some units this has become increasingly difficult, especially as this is the third consecutive year of cuts. We are closely monitoring the impact of these cuts on a unit by unit basis, and have offered relief in some cases where further cuts will seriously hamper their ability to carry out or support the core missions of the University.

The General Fund Budget Recommendation

The attached Table 1 summarizes the General Fund Budget Recommendation for FY2006. The most striking element of Table 1 is the difference between the academic units and the administrative units. On average, the academic units experience a moderate increase in their General Fund budgets most of which results from increased numbers of students and increased volume of indirect cost recovery from sponsored research. For the most part, the administrative units have very slight increases in budget for FY2006 as compared to FY2005. The administrative area which does show budget growth is the EVPCFO area. However, the operating costs of newly constructed academic spaces are budgeted to units reporting to the EVPCFO. With increases to operate new space removed from its budget, the EVPCFO area receives a much more modest increase in its FY2006 budget.

As usual, there is considerable variation in the rates of growth of the General Fund budgets of the academic units. In cases where an academic unit has experienced a significant change in general fund budget, that change reflects a change in instructional or research activity. Units with significant changes in instructional activity (numbers of students) include the Taubman College of Architecture and Urban Planning, the School of Art and Design, the School of Education, the Division of Kinesiology and the Law School. The School of Public Health and the School of Social Work have each seen significant increases in sponsored research. In two cases, the College of Engineering and the Medical School, rather modest changes in general fund budgets are a result of increased space costs for new buildings (BSRB in the Medical School and the Biomedical Engineering and Computer Science Buildings in the College of Engineering).

There is very significant growth in the University Items category. The drivers of this increase are financial aid, which increases faster than the rate of tuition growth (consistent with our long-standing policy that it grow at least as rapidly as tuition), and utilities. The double-digit increase in utilities costs is due to an increase in natural gas prices of 28% together with incremental utilities costs for new space. This is an unavoidable increase of expenditures on the general fund.

This budget is built on the assumption that the State appropriation will be $314M as recommended by the Governor. We note that the current proposals by the House and Senate provide UM with slightly larger appropriations. But we also note that the State has enacted mid-year cuts in each of the last several years. Given the State’s fiscal situation, we believe that the Governor’s recommendation is the most likely to be enacted. Should the enacted budget amount differ from what we are predicting, we will seek a revision from the Board at the appropriate time.

Conclusion

The University of Michigan remains a strong, vibrant institution that is moving forward despite a period of daunting budgetary challenges. We have maintained our focus and priority on our core missions of teaching and learning and our core values of excellence, diversity and access. We are continuing to innovate and to build the foundation that will allow the University of Michigan continued, long-term success.

The last several years have been difficult for public universities across the nation - support for higher education has waned as almost every state has endured difficult financial circumstances. Whereas matters have improved in many states, the State of Michigan faces continued economic and fiscal difficulties. President Coleman has challenged the University of Michigan to define the great public research university of the future. Such a university must give back to the students and public who support it through a commitment to its educational mission, by adding through its research to our understanding of an increasingly complex world and by spurring economic growth and development through new ideas and by providing a highly skilled workforce. The budget we propose here allows the University to continue its success in meeting the President’s challenge.

Figure 1

The University of Michigan - Ann Arbor

Annual Percentage Change in General Fund Revenues from State Appropriations and Tuition

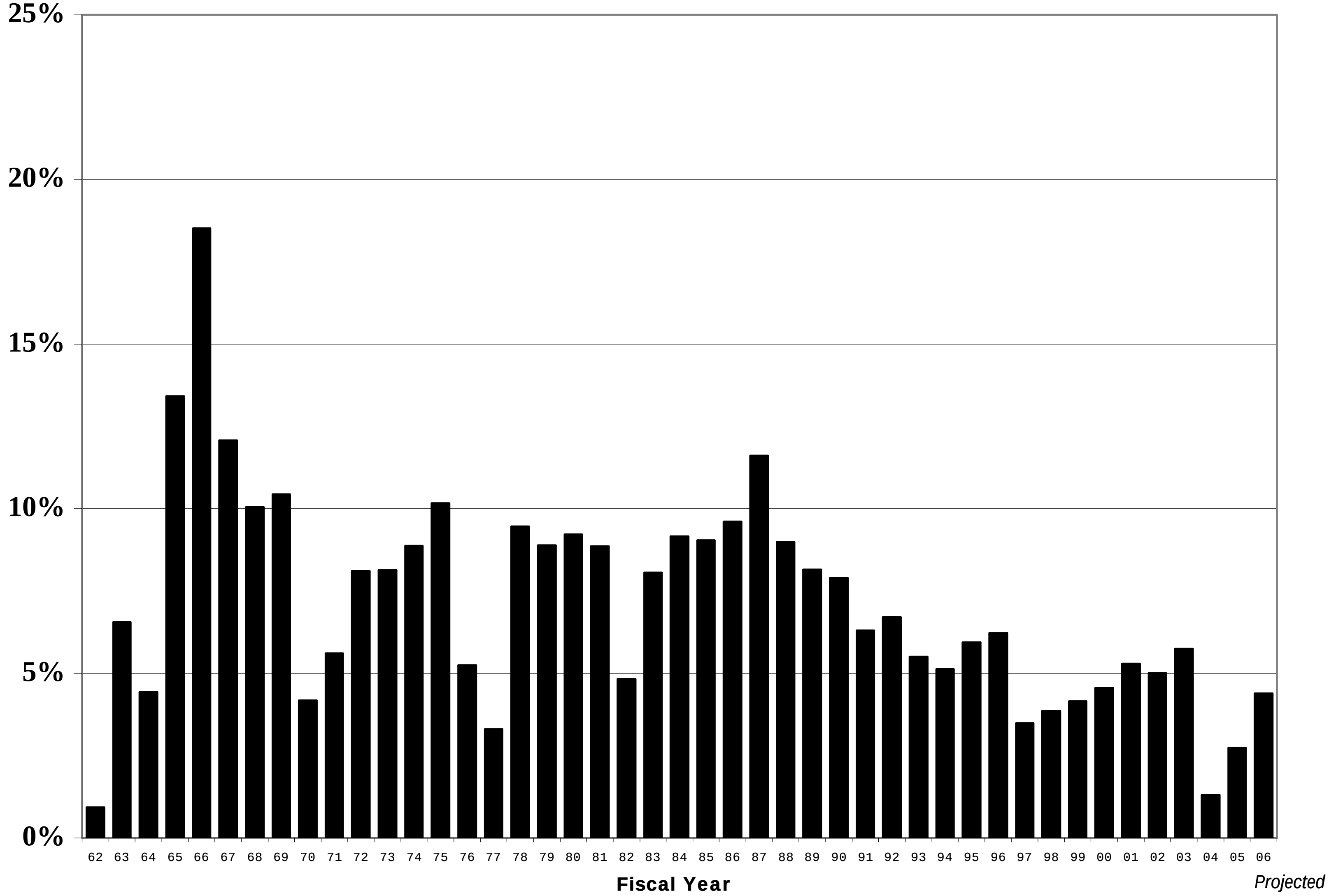


Figure 2

The University of Michigan - Ann Arbor

Annual Percentage Change in General Fund Revenues from State Appropriations and Tuition Adjusted for Inflation Using the Consumer Price Index (CPI)

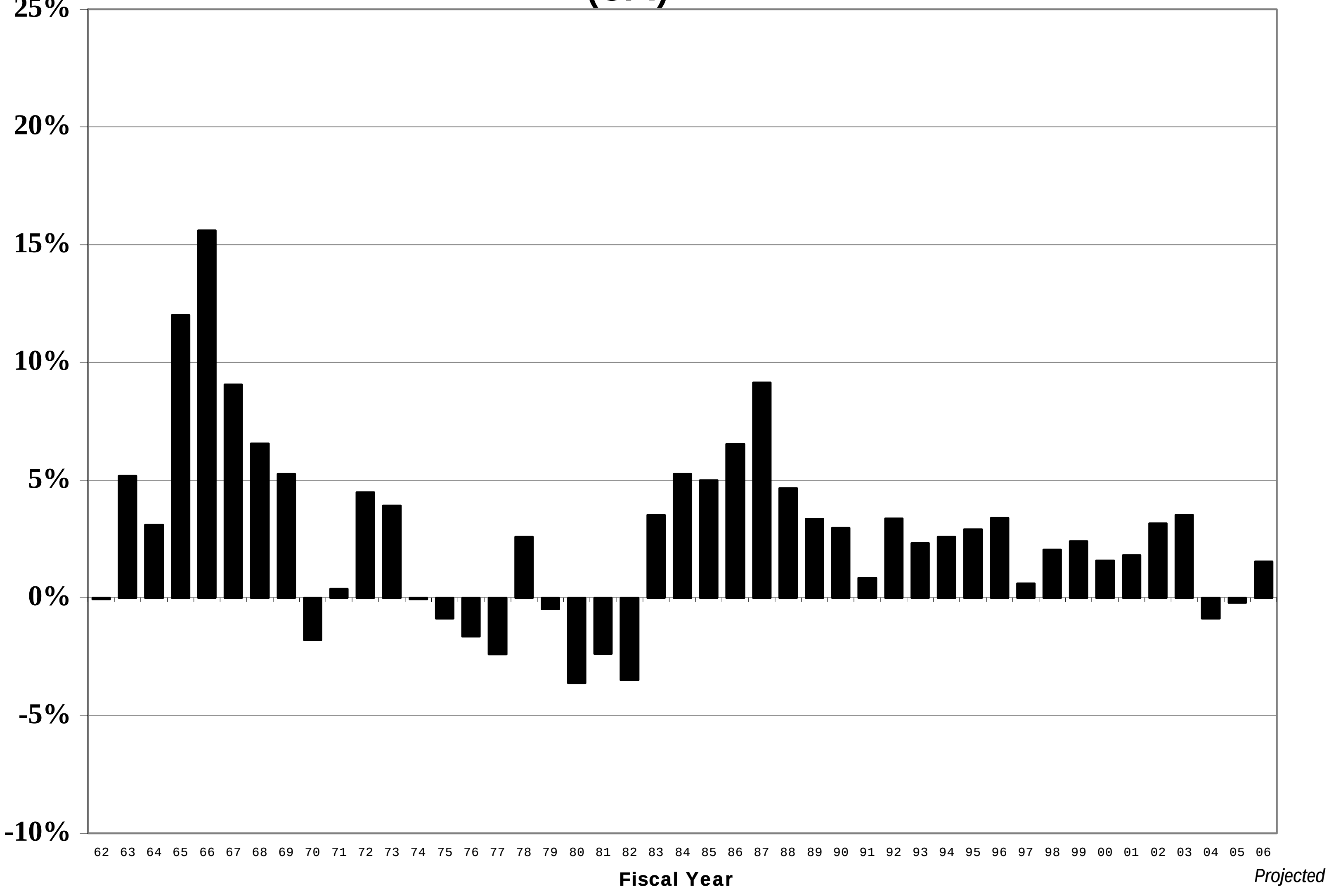
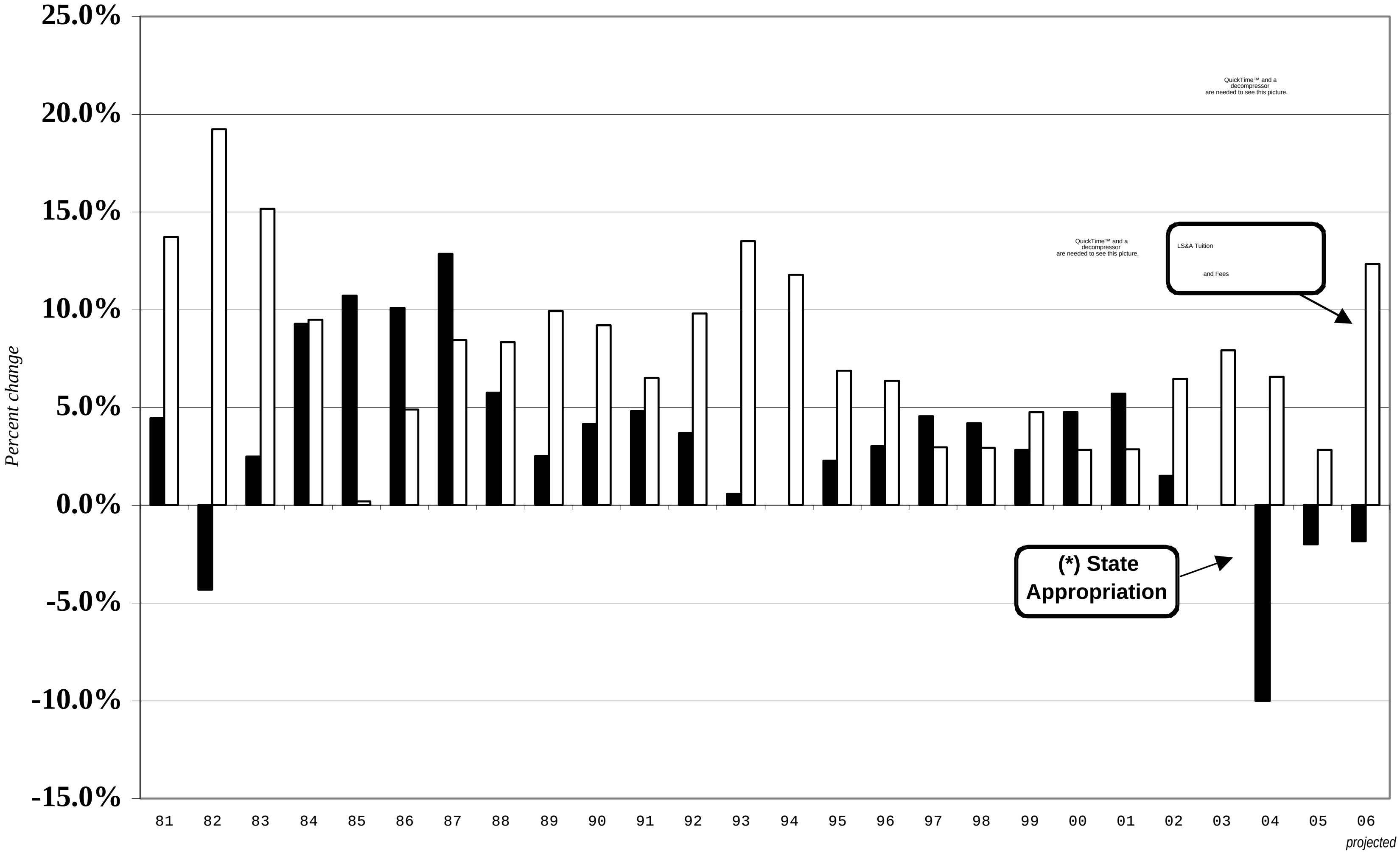


Figure 3
State Appropriation and Tuition History



(*) 2006 figure based on Governor's recommendation

Table 1
The University of Michigan-Ann Arbor
Proposed General Fund Budget, Fiscal Year 2005-06 (in thousands)

	FY2005 Adjusted Budget	Recommended Change	Proposed FY 2006 Budget	% change GF Budget
Revenues				
State appropriation	320,662	(5,929)	314,733	-1.85%
Tuition and Fees	675,392	49,716	725,108	7.36%
Indirect Cost Recovery	156,458	8,926	165,384	5.71%
Other Revenue	10,870	4,390	15,260	40.39%
Total Revenues	1,163,382	57,104	1,220,485	4.91%
Expenditures				
A. Alfred Taubman College of Architecture & Urban Planning	9,063	1,087	10,150	11.99%
School of Art & Design	7,060	(537)	6,523	-7.60%
Stephen M. Ross School of Business	53,319	2,905	56,224	5.45%
School of Dentistry	24,386	1,100	25,487	4.51%
School of Education	13,379	1,090	14,469	8.15%
College of Engineering	106,859	975	107,834	0.91%
School of Information	8,673	232	8,906	2.68%
Division of Kinesiology	5,695	1,710	7,405	30.02%
Law School	30,089	3,181	33,270	10.57%
College of Literature, Science and the Arts	234,564	11,055	245,619	4.71%
Medical School	82,197	(613)	81,584	-0.75%
School of Music	21,481	1,543	23,024	7.18%
School of Natural Resources & Environment	5,409	146	5,555	2.70%
School of Nursing	10,763	685	11,448	6.37%
College of Pharmacy	7,956	484	8,441	6.09%
School of Public Health	24,048	4,048	28,097	16.83%
Gerald R. Ford School of Public Policy	6,714	183	6,898	2.73%
School of Social Work	15,346	1,320	16,667	8.60%
Horace H. Rackham School of Graduate Studies	7,232	795	8,027	10.99%
University Academic Units	45,233	980	46,213	2.17%
Research Units	4,251	(60)	4,191	-1.42%
Academic Program Support	35,050	(1,433)	33,617	-4.09%
TOTAL ACADEMIC	758,769	30,878	789,647	4.07%
President	1,775	13	1,789	0.76%
Provost & Executive Vice President for Academic Affairs	42,182	615	42,798	1.46%
Executive Vice President & Chief Financial Officer	131,695	5,160	136,855	3.92%
Vice President for Communications	4,619	88	4,707	1.91%
Vice President for Development	8,059	63	8,121	0.78%
Vice President & General Counsel	2,668	54	2,722	2.02%
Vice President for Government Relations	1,628	18	1,646	1.11%
Vice President for Research- Support Units	15,514	(166)	15,349	-1.07%
Vice President & Secretary of the University	618	(40)	578	-6.55%
Vice President for Student Affairs	10,183	234	10,417	2.30%
TOTAL EXECUTIVE OFFICER AND SERVICE UNITS	218,942	6,039	224,981	2.76%
General University Support	38,693	1,812	40,506	4.68%
Centrally Awarded Financial Aid	78,099	6,660	84,759	8.53%
Utilities	62,879	11,713	74,593	18.63%
Departmental Income	6,000	0	6,000	0.00%
UNIVERSITY ITEMS	185,671	20,186	205,857	10.87%
Total Expenditures	1,163,382	57,104	1,220,485	4.91%

* Detail may not sum to totals because of rounding

** Transfers between units are incorporated in the FY2005 Adjusted Budget