Historic Dynamics Shaping the Higher Education Budget in California

Background white paper, prepared by Jane Wellman for discussion with the College Futures Foundation Forum on Finance, September 2016

The California state budget for higher education has gone through a number of iterations over the years, from the early days when both university systems were funded almost entirely from state general funds to the current day. The behavioral and fiscal attributes of the current process bear many traces of this history. This brief and the histograms that follow describe some of that history, focused on the strands we believe are most helpful to understanding current dynamics:

- Changes in the allocation criteria for the two university systems (including changes in funding formulae and performance criteria over the years)

- Changes at the state level both in the sources of general fund revenues and in patterns of state spending by functional areas; and

- Changes in understanding the underpinnings of quality in higher education, and the relationship between spending and performance.

Together these elements shape not just the funding levels or the composition of revenues within institutions, but also the decision-making dynamics between the state and the systems, and between systems and individual campuses. Some of the pieces of that history that we think are most important to current dynamics include:

1) The behavioral residue around what is counted in the budget, and the treatment of budgetary savings and reserves, is still a powerful driver of behavior. In the days when both UC and CSU were funded as state agencies, the state provided 100% of the funding for the institutions. Any funds that were not spent were to be returned to the state. This incentivized institutions to spend every cent they could or, if they could not spend the funds, to encumber them or to spend them into a reserve that could not be reappropriated to the state. People within the institutions—particularly faculty who had access to extramural funds—were socialized to keep what they conceived of as "their" funding separate from institutional funds.

   The state also maintained position control for both systems, which technically meant that no one could be hired on "hard" (general fund) budgets unless the position was authorized in the state budget. When positions were vacated, through retirement or resignation, both the position and the dollars associated with it had to be returned to the state if they were kept vacant for any period of time. The policies have changed, and general funds that are not spent can be carried over to subsequent years without forcing a budget reduction or without being returned to the state. Position control has also long since been abandoned, although the Department of Finances still published a list of authorized positions as part of the state budget. But the habits of work around budgetary savings and turnover management have not completely changed as a result.

2) The mode and level funding formula that used to provide more funds to high cost disciplines and to graduate education were abandoned by the mid-1980s, although they lived on for many years beyond that in the CSU "Orange Book" of budget formulae. The systems have both been funded on a block budget basis for over twenty years. Still, the expenditure patterns of the past, and the cross-subsidies required to pay for higher cost programs, live on because they are baked into workload policies and expectations about class size. The accounting systems necessary to document costs and subsidies have not matured, so campus leaders who might want to do cost-based allocations, or to know what the margins and cross-subsidies are, cannot find the data with existing information.

3) Changes over time in the composition of the general fund, and in the ability of the state and the state legislature to approach the budget holistically. The state budget has changed enormously since the 1960s when the Master Plan was put in place, through changes in both the composition of the general fund and in the weakening of both executive and legislative control over decisions in the budget. Until the passage of Proposition 13 in 1978, the California state budget was shaped by constitutional dictates about the shape of the budget bill that were put in place in the late 1800s by Governor Hiram Johnson, one of the early "good government" reform-minded governors. Johnson pushed budget rules that created a comprehensive budget bill including appropriations from all funds for all public functions. The reforms were both statutory and constitutional. They were designed in large part to wrest control away from the legislature which in those days was perceived to be controlled by a handful of special interests. In addition to the comprehensive budget bill, the reforms gave birth to easy access by the citizens to the initiative and referendum processes.

   Proposition 13 fundamentally changed the rules of the budget, by limiting growth in local property taxes and as a result by pushing the state into assuming funding responsibility for what had historically been local responsibilities. Proposition 13 also gave birth to an increased use of the initiative and referendum process to decide fiscal issues, Proposition 98 being the most prominent. The accumulated effect of these measures has been to reduce legislative control over the shape of appropriations. Proposition 98 now controls more than 40% of the state general fund budget. Another 62% of the general funds outside of Proposition 98 go to health and human services. Mark Hill, author of a commissioned paper on general fund trends estimates that the discretionary share of state spending will continue to decline, from 7.3% of spending in 2015 to under 4% by 2019. Advocates for higher education often point to the declining share of state spending on higher education as evidence of the depth of the state fiscal abandonment of the sector, including estimates of the "missing share" of the budget that would have gone to higher education without these controls. While higher education advocates are certainly correct about the decline in state shares for higher education, we believe that particular statistic is a poor measure of state fiscal commitment, since appropriations can increase on a per capita basis even if shares of spending decline. Nonetheless, the changes in state funding have given rise to a belief among many in higher education that the only cure for the fiscal changes affecting higher education will be through an initiative process that guarantees revenues for higher education the way they are guaranteed for K-12 education.

4) Conflicting notions of quality and the relationship between funding and quality. When the funding systems were first established, there was an implicit understanding in California and elsewhere in the country that quality in higher education, while hard to define, was a function of admissions selectivity, faculty credentials, the presence (or absence) of graduate education and research, and funding levels. Institutions who wanted to advance their reputation did so by raising money, recruiting superstar faculty, and setting incoming admissions standards to weed out the majority of students. Prominent economists—William Baumol and William Bowen, most notably—further theorized about the higher education '"cost disease," that costs in higher education inevitably increased as labor costs increased, because productivity gains were not possible without compromising quality. The cost disease theory, along with notions about quality, meant that many in higher education believe that productivity and cost effectiveness inevitably come at the expense of quality.

   Institutional ratings and other consumer tools designed to inform student enrollment behavior came into vogue in the early 1990s and are still in vogue today. These measure quality via standard measures of admission selectivity and resources. Many economists have now come to believe that competition in higher education contributes to the higher education cost problem, in part because the ratings recognize spending and admissions selectivity as indicators of quality. The tensions between regulation and market, always a source of friction in higher education, have never been stronger than they are today.

Source Documents:

Baumol, William J., and William G. Bowen, "On the Performing Arts: The Anatomy of Their Economic Problems," *The American Economic Review* 55, no. 1/2, (1965): 495–502.

Winston, Gordon C. "Economic Stratification and Hierarchy in U.S. Colleges and Universities," Williams Project on the Economics of Higher Education, 2000.

Winston, Gordon C., "Toward a Theory of Tuition: Prices, Peer Wages, and Competition in Higher Education," Williams Project on the Economics of Higher Education, 2003.

Winston, Gordon C., and David J. Zimmerman, "Peer Effects in Higher Education," Williams Project on the Economics of Higher Education, 2000.

Winston, Gordon C., and David J. Zimmerman, "Where Is Aggressive Price Competition Taking Higher Education?" Williams College Project on the Economics of Higher Education, 2000.

Zemsky, Robert, Greg Wegner, and William Massy, *Remaking the American University: Market-Smart and Mission-Centered*. New Brunswick, NJ: Rutgers University Press, 2005.