

'ZERO-BASED' BUDGETING: WHEN WILL MICHIGAN REVAMP ITS HIGHER EDUCATION FUNDING FORMULA?

It's the latest rage in how Michigan's beleaguered state government should approach its annual job of making ends meet.

It's called "zero-based" budgeting, and, while it may be *au courant*, it's hardly new. In fact, it's been around for decades, at both the federal level and in various state government "laboratories" throughout the country. It was the coin of the realm in Washington, D.C., nearly three decades ago under President **Gerald Ford** and the early years of the **Jimmy Carter** administration.

Zero-based (or "reality") budgeting becomes fashionable whenever governments are cash-strapped, yet politicians don't dare raise taxes. When officeholders realize they must cut government spending, they scramble to 'prioritize,' i.e., make every program justify its existence, beginning with Dollar One.

The current apostles of zero-based budgeting are two pied pipers, **David Osbourne** and **Peter Hutchinson**, who have been down this road before with different *mantras*. Their latest bible is *The Price of Government*, which argues that state government needs to attack any predetermined list of spending 'priorities' by assessing how much each of these priorities costs. Then, making heavy use of 'focus groups' to help it decide what's popular and what isn't, government should fund only the ones it can afford to, starting at the top of the list on down. When the state runs out of money, everything below a certain line gets cut.

This past month, Hutchinson and Osbourne were hired to 'teach' Lansing politicians how best to implement zero-based budgeting in Michigan, even though a good case could be made that voters thought they'd already hired the best candidates available to do exactly that last year in something called a "general election."

After all, isn't zero-based budgeting what should be done every year by all elected officials in order to determine how to get the most value out of taxpayers' money?

Fact is, zero-based budgeting usually survives only until, eventually, a resurgent economy opens the financial spigots, and fresh torrents of revenue once again pour into state coffers. That phenomenon, plus lawmakers' realization that annual justification of spending priorities is an onerous task fraught with pressure, inspires the pols to lapse back into their old "cruise control" *modus operandi*, which means simply tinkering at the margins of various line-items every year without seriously questioning who's spending how much on what.

If Hutchinson and Osbourne are really worth their salt,

they would remind Gov. **Jennifer Granholm** and state legislators that zero-based budgeting should be utilized to force state government to justify its spending not just in broad categories such as "education," "criminal justice," or "health care" but within each of these fields as well.

For example, who can rationalize the way Michigan spends money on Higher Education? Has anybody ever seriously tried to justify it?

Well, maybe one, **Jack McHugh**, a former legislative aide working on a master's degree at Central Michigan University, has written an unpublished treatise entitled "Analysis of Appropriations to Michigan's Public Four-Year Universities, with Recommendations." In his paper, written for a CMU seminar, McHugh argues that:

- The Legislature should shift to a "foundation grant" system of funding undergraduate education, as currently exists for the state's K-12 public schools (now \$6,700 per pupil). This would help eliminate the huge disparities in per-student appropriations for different schools. Universities would be forced to compete on the basis of 'best-value-with-a-comparable-amount-of-state-funding,' not 'best-lobbyists' or 'most-committee-chairmen-in-their-hip-pocket' in Lansing. With a foundation grant (FG) system in place, the rationale for the arbitrary difference between funding for "research institutions" like U-M/A, MSU, and WSU as opposed to the 12 "non-research" campuses would be exposed as largely artificial.

- Higher education funding should "follow the students," just as it does now for Michigan's K-12 public schools. The link between pupil counts and state appropriations should be far more direct than it is today, increasing the incentive for university administrators to "sharpen their pencils" by removing the "cushion" of annual appropriations that are assured regardless of how many students attend.

- "Right-sizing" Michigan's higher education system, including partial privatization and consolidation. Do we really need 15 public universities? Can we afford them? Do three of them need to be located in the Upper Peninsula, which harbors only 3% of the state's population? Exorbitant costs at some institutions, and declining enrollments at others, suggest that Michigan should consider convening a Higher Education version of the federal "Military Base Closing Commission." Economist **Richard Vedder**, in his book *Going Broke by Degree*, contends that three national developments could and should transform the current educational system: **1)** For-profit universities (University of Phoenix); **2)** Distance Learning (UOP-Online); and **3)** Private or non-college certification of skills (Microsoft, Cisco, Oracle and Norvell have already instituted such programs).

While all the above may make perfect sense, two immediate questions come to mind:

■ Why should we care whether the traditional and/or current system of funding Higher Ed is out of whack?

■ Even if it is, any attempt to correct or repair it is fraught with peril. There would be outsized winners and losers, far more so than anything seen in recent appropriations history. Flagship institutions, especially the University of Michigan at Ann Arbor, would fight ferociously to make sure such reform never happens. What politicians, particularly in a term-limited Legislature or in a timorous, unimaginative administration like Granholm's, would have the courage and skill to undertake such an enterprise?

The answer to the second question is easy: they wouldn't, and they don't.

But that doesn't mean we shouldn't try to answer the first question, which McHugh argues deserves attention if we care about productivity and cost.

McHugh contends that, over the past 20 years, Higher Education ranks with health care as the only two sectors of the economy where output-per-worker has declined while prices and costs have risen much more rapidly than the overall rate of inflation.

McHugh observes that both sectors have two things in common: **1)** Heavy government involvement and **2)** Extensive third party payer arrangements. This means that, unlike other areas of the economy, there is a disconnect between these sectors and market processes that increase productivity and restrain prices. McHugh cites Vedder's *Going Broke By Degree*:

"The basic problem is that universities are mostly non-profit organizations, subject to only muted competitive forces, and lacking market-imposed discipline to economize and innovate. University presidents, deans, maintenance supervisors, department chairs, and other administrators do not benefit from reducing costs. Major policy issues are typically decided in committees where advocates of the status quo (often faculty with tenure) usually have the upper hand. With third parties such as government and private donors footing much of the cost, there is little fear that higher prices will trigger a consumer backlash."

McHugh claims that evidence of this decline in productivity can be found in the decreases in number-of-students-per-employee at Michigan universities. Between 1977 and 2002, the three major research campuses saw the ratio of students to each non-faculty employee (administrators, professional and service staff) decline from approximately 9-1 to 7-1. At the other 12 campuses, the ratio fell from about 16-1 to 14-1. In other words, there are more workers per unit of output (educated students) rather than fewer workers as in other sectors of the economy.

In a 2003 report to the House Appropriations Subcommittee on Higher Education ("*The Long View*"), analyst **Hank Prince** notes that this increase in staff per student represents the "development of what is called an administrative 'lattice' . . . Cost efficiencies frequently require revision or dismantling of the 'lattice'" These trends stand in stark contrast to other sectors of the U.S. economy (health care excepted), where output-per-employee (productivity) has increased dramatically over the same period.

Cost Increases in Michigan's University System. Because of this pattern of faster-than-COLA rising costs at the state's four-year universities, not only

tuition paid by students but also state appropriations to universities have exceeded the rate of inflation. Between 1994 and 2002, state aid to Michigan's 15 public universities initially rose by more than \$260 million in real (adjusted for inflation) terms. As a result of lower-than-expected revenues, a February 2003 executive order slashed \$25.5 million from previously adopted 2002-03 Higher Education appropriations, trimming the gains of the previous decade. Even after these cuts, however, the FY 2004-05 budget is still some \$50 million higher than the FY 1994-95 budget in real terms.

In FY 2002-03, \$1.558 billion was appropriated for university "Operations" (see tables below). This includes the executive order budget cut mentioned above; it does *not* include some \$200.9 million appropriated for various scholarship programs, including Merit Awards, need-based scholarships at various state schools, and some \$66 million in tuition grants to Michigan residents who attend independent, non-profit colleges or universities.

But it is "Operations" funding that constitutes the lion's share of state appropriations to Michigan's public universities, and that is *not* distributed on the basis of enrollment at each institution. Rather, each school receives a lump sum varying widely from campus to campus. For example, in FY 2002-2003, per-student Operations funding for the 15 state campuses ranged from a low of \$3,473 per student at Grand Valley State to a high of \$15,369 at U-M in Ann Arbor.

Why such a wide disparity? First and foremost, because of what might be called Michigan's public university "caste system":

● There's a distinction made that favors the state's three "research institutions," i.e. U-M/A², MSU and WSU, because they have large graduate and professional programs, including medical schools. It is argued that these three institutions generate large amounts of federal and private research grants which benefit the state directly and indirectly. On this basis, these three institutions have successfully made the case that legislators should grant them substantially higher appropriations, resulting in higher per-student appropriation amounts.

● The other dozen institutions are considered "non-research" campuses and so they are often compared with each other in terms of funding while the three "research universities" are considered separately. Five of these so-called "non-research" schools — Western, Central, and Eastern Michigan Universities, in addition to Oakland and Northern Michigan Universities — offer some graduate programs, but are primarily undergraduate schools. Michigan Tech focuses primarily on engineering, while Ferris State specializes in vocational and technical programs. The remaining five campuses — Grand Valley State, Saginaw Valley State, Lake Superior State, and U-M's two "sub-universities" in Flint and Dearborn — offer primarily undergraduate liberal arts programs.

But why, other than the distinction between "research" and "non-research" universities, is there such wide variation in funding — even between the various non-research institutions — in operational funding amounts for each school?

Because, charges McHugh, who gets how much is little more than the fossilized expression of past and present legislative "mud-wrestling." For example:

■ It's no coincidence that **1)** For a record two decades state Rep. **Dominic Jacobetti** (D-Negaunee) dominated the pre-term limits appropriations process in

the House, and **2)** Northern Michigan University, lying in the heart of Jacobetti's district (Marquette), receives from 22% to 106% more than every other "non-research" university except Michigan Tech.

■ Similarly, while state Senator **John J.H. "Joe" Schwarz** (R-Battle Creek) chaired the Senate Higher Education Appropriations subcommittee for a dozen years, his alma mater (U-M/A²) — he's now president-elect of its alumni association — did very well in garnering an outsized proportion of the budget. In fact, Schwarz's influence led to a vitriolic floor speech by then-House Speaker **Chuck Perricone** (R-Kalamazoo) on June 20, 2000, in which Perricone accused Schwarz of lying in order to hold up final passage of the Higher Ed budget bill so as to gain additional funds for U-M.

■ Finally, it should not be forgotten that Wayne State University saw its funding boosted for years while state Rep. **Morris Hood** (D-Detroit) chaired the House's Higher Ed appropriations subcommittee — even though Detroit's influence dwindled in 1998 with Hood's death concomitantly with the institution of term-limits.

Wait! — there's more. In annual budget bills of the past, various special programs were frequently authorized for specific schools, and the amounts for those programs then became part of the "base" on which the colleges' budgets were built. While this process has ceased and Detroit's clout has declined — and 'Jake' is 10 years in the grave — legislative inertia still maintains WSU's and Northern's appropriations at high levels. In addition, because legislative appropriations are not based on the number of students at each school, and at these two schools the number of students has declined relative to the total number of students attending all state universities, their relative appropriations have increased disproportionately.

Finally some institutions, such as GVSU, receive lower levels of funding because they are considered to be better able to attract "private" funding from "philanthropic" individuals and organizations in their service area (read: DeVos and Van Andel).

Note that there appears to be little relationship between a school's tuition and the level of its per-student appropriation. Many schools that receive more than the median per-student appropriation do NOT charge less in tuition, and vice-versa. This is the case even when the three "research" universities are taken out of the equation. Here is how tuition and per-student spending at the 12 non-research institutions compare with the median "non-research" appropriations:

- Six schools receive BELOW median appropriations and charge BELOW median tuition.
- Five schools receive ABOVE median appropriations, yet charge ABOVE median tuition.
- Two schools receive BELOW median appropriations and charge ABOVE median tuition (this makes sense).
- Two schools receive ABOVE median appropriations and charge BELOW median tuition (this also makes sense).

In other words, says McHugh, just because a particular school receives more from the state, it does not necessarily charge less in tuition. And just because a school receives less from the state, it does not necessarily charge more in tuition.

Huge Variations in Total Cost May Indicate Muted Competitive Forces. A look at the "Total Cost," or combined tuition and state appropriations (current spending per student from both sources), for the 15 schools reveals that the range is stunning, i.e. from a low

of \$8,268 at SVSU to a high of \$23,329 at U-M's Ann Arbor campus. Even among the "non-research" schools there is tremendous range from \$8,268 at SVSU to \$17,500 at Michigan Tech, located in Houghton in the U.P.

Everyone knows that heating bills and snow removal costs are higher in the U.P. than in Saginaw, to be sure, and it may cost somewhat more to train engineers than to turn out liberal arts graduates. But it strains credulity to believe that such expenses could account for a \$9,292 per student cost differential.

Above Median Total Cost May Indicate Trouble. If a Foundation Grant system were to be substituted for the current funding system, several schools would require large tuition increases in order to maintain their current level of spending. This may be a sign of trouble at these institutions.

But what about the "caste system?" Isn't it imperative that it be maintained? Probably not, but for those who can't bear to part with it, McHugh offers a "Table 2" that excludes the "research institutions" and their higher funding from all calculations. Instead, he produces a FG of \$4,671 per student in the dozen "non-research" schools, rather than \$6,300 per student when all 15 colleges are included in the FG calculation (see Table 1).

Segregated from the "Big 3" and given a \$4,671 per-pupil FG, half of these dozen schools would need to raise tuition to maintain their Total Cost (current level of spending): Ferris State, LSSU, Michigan Tech, NMU, U-M/Flint, and Western.

All but one of these schools are at or above the median Total Cost for non-research institutions; U-M/Flint comes in below it by just \$113, or 1.1%. At four of these schools, the 2004 fall term enrollment shows a decline from the previous year, according to a report by *The Detroit News* (11/15/04). At the other two, enrollment is essentially flat. Only one university would have lower tuition under a Foundation Grant system saw its enrollment fall — Eastern.

Two of the schools in this declining or stagnant enrollment category — NMU and Michigan Tech — feature Total Costs that are in the stratosphere compared with the "non-research" median of \$9,585. Northern's Total Cost is \$2,360 above the median, and Tech's is \$7,975 above the median. NMU added just 24 students in its 2004 enrollment (up .26 percent), while Michigan Tech lost 29 (down .44%). Northern would need to raise its tuition by \$2,494 if it received a "non-research" institution median FG of \$4,671 per student, and Michigan Tech would need to hike tuition by \$6,298.

Ferris State is a third school whose current cost of \$11,307 is substantially above the non-research median of \$9,585; Western is also above the median with a Total Cost of \$10,477. Both of these universities experienced enrollment declines in the fall of 2004.

The link between above-median Total Cost and stagnant or falling enrollment may be a coincidence. In the private sector, however, a combination of above-average costs and flat or declining customer base means something, and is a loud and clear signal to management that changes are needed.

Lack of Transparency and Consistency in University Accounting Raises Questions About Some Comparisons. McHugh says that it is beyond the scope of his treatise to parse out what portion of each university's budget is actually spent on educating students. In any case, an attempt to do so may not yield meaningful answers because of a lack of transparency

and uniform accounting practices at public universities. This was noted in a 2002 report by the "University Investment Commission," chaired by former House Speaker **Paul Hillegonds** (R-Holland), which stated: "The public and political leaders deserve transparency of information, especially with regard to tuition and state appropriations." Hillegonds was a member of the Wayne State University Board of Governors at the time his panel authored the report; he's been president of Detroit Renaissance since 1997.

The interaction of McHugh's recommendations — conditioning the receipt of state money on attracting students, and equalizing the per-student appropriations at each university — could trigger an immense change in the

incentives that drive college administrators and boards. Universities would be free to raise or lower their tuition to a level that both covers costs and allows them to compete in the marketplace. If a school's tuition is too high to attract enough students to cover costs, then it would have a strong incentive to cut its spending. Alternatively, it could seek ways to add value so that students would be willing to pay higher tuition.

In both tables below, parentheses around figures in the far right-hand column indicate how much *less* in annual tuition per student that institution would have to charge under McHugh's system. No parentheses around a dollar figure shows how much *more* the school would have to charge. A "resident" student hails from in-state:

**Table 1: All Universities
FY 2002-03 Figures (UG = undergraduate)**

	'Operations' Grant	Approps Per UG Resident	Resident UG Tuition	Total Resident UG Cost	#Resident UG Students	Tuition +/- Change if FG
CMU	\$86,853,522	\$4,247	\$4,747	\$8,994	17,415	\$(2,053)
EMU	84,569,756	4,535	5,027	9,562	15,521	(1,765)
Ferris	53,577,031	5,890	5,417	11,307	8,372	(410)
GVSU	57,992,024	3,473	5,148	8,621	14,438	(2,826)
LSSU	13,769,310	4,850	4,758	9,608	2,834	(1,450)
MSU	314,572,583	8,377	6,412	14,789	30,128	2,078
MTU	53,308,105	10,969	6,591	17,560	4,695	4,669
NMU	50,192,383	7,165	4,780	11,945	6,522	865
OU	50,551,147	3,951	5,031	8,982	10,623	(2,348)
SVSU	26,434,503	3,887	4,381	8,268	5,953	(2,412)
U-M/A ²	350,837,633	15,369	7,960	23,329	15,674	9,070
U-M/D	27,013,503	4,511	5,520	10,031	4,974	(1,789)
U-M/F	23,225,711	4,686	4,786	9,472	4,593	(1,613)
WSU	244,766,818	11,454	5,104	16,558	13,497	5,154
WMU	121,278,313	5,322	5,155	10,477	19,886	(978)
Total	\$1,558,942,342				175,125	

Equalized Resident Undergraduate Foundation Grant: \$6,300
 Median Resident Undergraduate Tuition: \$5,104
 Median Per Resident Undergraduate Appropriation: \$4,850
 Median Total Cost: \$10,031

"Operations Grant" figures derive from the House Fiscal Agency, and represent the actual appropriations or grant for all undergraduate and graduate education for each university in the FY 2002-03 budget, less the amount this appropriation was reduced, by "Executive Order 2003 3" issued, in February, 2003.

**Table 2: Non-Research Universities Only
FY 2002-03 Figures (UG = undergraduate)**

	'Operations' Grant*	Approps Per UG Resident	Resident UG Tuition	Total Resident UG Cost	#Resident UG Students	Tuition +/- Change if FG
CMU	\$86,853,522	\$4,247	\$4,747	\$8,994	17,415	\$(424)
EMU	84,569,756	4,535	5,027	9,562	15,521	(136)
Ferris	53,577,031	5,890	5,417	11,307	8,372	1,219
GVSU	57,992,024	3,473	5,148	8,621	14,438	(1,198)
LSSU	13,769,310	4,850	4,758	9,608	2,834	\$179
MTU	53,308,105	10,969	6,591	17,560	4,695	6,298
NMU	50,192,383	7,165	4,780	11,945	6,522	2,494
OU	50,551,147	3,951	5,031	8,982	10,623	(720)
SVSU	26,434,503	3,887	4,381	8,268	5,953	(784)
U-M/D	27,013,503	4,511	5,520	10,031	4,974	(161)
U-M/F	23,225,711	4,686	4,786	9,472	4,593	15
WMU	121,278,313	5,322	5,155	10,477	19,886	711
Total	\$648,765,308				115,826	

Equalized Resident Undergraduate Foundation Grant: \$4,671
 Median Resident Undergraduate Tuition: \$5,029
 Median Per Undergraduate Resident Appropriation: \$4,611
 Median Total Cost: \$9,585

*Same explanation as in Table 1 above.