Various economic, political, and regulatory developments influence an institution's budget. Most are beyond the control of individual institutions or even the national higher education community. Accordingly, budgeters must anticipate changes in economic and political conditions that may affect the amount of revenues available and, of equal importance, the expenses the institution may have to bear. Unless an institution's budget can withstand the pressures created by external forces, its survival may be in jeopardy.

Beginning in the 1990s, economic changes have significantly affected institutions of higher education. In many respects, a sea change in the nation's support for higher education has accompanied the economic turmoil. Higher education no longer enjoys the high ranking on national, state, and local societal agendas that it once did. Other sectors now capture resources previously directed to higher education, especially by governments. Whether the focus is instead on security, K-12 education, health care, or general social service programs, higher education no longer is viewed as a top priority. Part of this shift stems from a change in perception. Instead of viewing higher education as a public good, many now see it as a private benefit.

In today's environment, higher education must defend itself continuously against criticism from numerous quarters. In years past, it was enough to highlight the economic value of a college education or point to the discoveries growing out of campus-based research. Such arguments no longer sway a nation that no longer focuses on an ability to pay. The issue has shifted to a *willingness* to pay. As college prices have escalated—at rates greater than the Consumer Price Index (CPI) in most years—both the federal government and the general population have questioned whether higher education is being managed effectively.

As of 2012, higher education was coming off the worst economic period since the Depression. Although inflation has been held in check, campuses still are experiencing cost increases in critical areas. At the same time, various revenue sources are depressed, with nothing to suggest that things will turn around in the short run. In fact, even prestigious institutions have suspended programs, eliminated positions, or resorted to other cost-cutting measures that have dramatic effects on program delivery. A climate like this requires careful examination of external factors.

The Political Climate

Higher education leaders have plenty of issues to keep them awake at night, with the U.S. Congress often providing the impetus. In recent years, for example, congressional (or federal agency) initiatives have focused on higher education issues as diverse as college costs and affordability, the size of higher education endowments and annual endowment spending, unfair competition with the private sector by colleges and universities, pollution emissions from boilers powered by certain types of energy, and protection against identify theft.

One large federal initiative related to higher education began early in the Obama administration with a call for the United States to have the highest proportion of students graduating from college in the world by 2020. To support this objective, the Obama administration has proposed new initiatives to raise higher education attainment and student outcomes, as well as encourage colleges and universities to keep tuition affordable. As the country's political winds shift due to party changes in the White House and Congress, different approaches to influencing higher education will likely receive favor while others will fall by the wayside. What is certain, however, is that we have not seen the last of federal government efforts focused on improving higher education's effectiveness or challenging it to become more efficient.

In fact, the Department of Education has continued pressuring institutions to justify tuition increases that exceed what it believes to be reasonable. As reported by The College Board, the fiscal year 2012 average tuition increase for in-state students was 8.3 percent at public four-year institutions and 8.7 percent at in-state public two-year institutions.[1] The comparable numbers for out-of-state students at four-year public institutions was 5.7 percent and 4.5 percent for students at four-year independent institutions.[2] What makes this troubling for those monitoring higher education's performance is the fact that inflation averaged 1.6 percent during 2010, when tuition prices were being set for 2012.[3]

Without question, a reduction in appropriations from the states has contributed to tuition increases at public institutions whose costs continue to increase partially because of increased enrollment. Decreased endowment income, much of it related to the subprime mortgage market meltdown, has placed more pressure on tuition as well. The situation raises a legitimate question: How much endowment is enough? Various stakeholders have asked higher education institutions to increase spending from endowments rather than raise tuition. Some institutions responded with various initiatives aimed at holding tuition increases to a minimum, but endowments still remain an attractive target to various critics of higher education's financial structure. It's highly likely that the pressure will resume when endowments return to previous levels.

Although effective planning and cost management can accommodate steadily increasing prices, most institutional budgets cannot withstand major fluctuations over short periods. Furthermore, exceptional cost increases in any category can wreak havoc on even a well-managed budget. For instance,

colleges and universities continually face the prospect of replacing expensive instructional and research equipment as it becomes obsolete. Unless institutions have funded depreciation and maintained reserves for this purpose (see Appendix), the impact from these purchases will be a significant charge on the current budget and may have significant cash-flow impacts as well. Some exceptional situations may even force a college or university into a serious financial crisis.

Tracking Cost Increases

Costs incurred in higher education do not mirror costs used to track inflation in the general economy. That's why many in higher education rely on the Higher Education Price Index (HEPI) as an alternative to the more popular Consumer Price Index (CPI). The CPI is deemed too general and not representative of the types of purchases made by higher education institutions; the HEPI cost components include faculty salaries, administrative salaries, clerical salaries, service employee salaries, fringe benefits, miscellaneous services, supplies and materials, and utilities.[4]

The HEPI has attracted critics, however, and it may no longer represent the accepted standard for higher education price changes. One reason HEPI has not enjoyed universal acceptance stems from the fact that it was developed in the private sector. Also, questions have arisen about the validity of the method used to calculate the index.

Another commonly used index is the CPI-U—a variation of the CPI based on goods and services purchased by the typical urban consumer. Some argue that, because HEPI and the CPI-U have not differed dramatically for some brief periods, the CPI-U is a reasonable choice. Others contend that significant variances can occur over time. As a result, efforts continue to identify a reliable index for use by higher education.

The State Higher Education Executive Officers (SHEEO) organization has attempted to bridge the gap between the HEPI and the CPI-U by offering the Higher Education Cost Adjustment (HECA). The HECA is developed by weighting and combining two federally developed and maintained indexes—the Employment Cost Index (75 percent) and the Gross Domestic Product Implicit Price Deflator (25 percent).[5]

Impact of Federal Regulation and Social Programs*

A portion of the cost of doing business in any industry can be attributed to informal social pressures and government mandates in a number of areas: personal security and safety, participation and due process, public information,

* This section is based largely on Howard Bowen, *The Costs of Higher Education: How Much Do Colleges and Universities Spend per Student and How Much Should They Spend?* (San Francisco: Jossey-Bass, 1980).

and environmental projection, to name a few. In addition to these universal pressures, colleges and universities experience costs unique to their operations, such as protection of students' privacy and federal financial aid programs.

Overall, commercial entities have an advantage in dealing with socially imposed costs. First, many regulations do not apply to commercial entities because they do not typically receive federal funding. In addition, when they are subject to external mandates that increase operating costs, commercial entities can pass these costs along to their custovmers. While independent institutions have control of their tuition, this is not always the case for public institutions. Frequently, a state agency or the legislature has the authority to set tuition at public institutions. When institutions are unable to raise tuition to offset the costs of mandated programs, the only option is to cut back in other areas—either in the primary programs of instruction, research, and public service or in a support activity.

At What Cost?

Federal regulations and mandated social programs touch all aspects of institutional operations, from athletics to the care of laboratory animals. It has proven difficult, if not impossible, to isolate the true cost of externally imposed regulations and guidelines. A primary reason is that compliance with the mandates often cannot be separated from the routine operations of the institution. Another reason is that colleges and universities frequently support the objectives of imposed regulations and programs, and would initiate similar actions on their own even without the requirements.

Consider the following factors when assessing the impact of federal regulation and social pressures:

- The adoption of programs can increase or decrease costs. For example, a mandated staff training program may lead to greater employee morale and improved productivity, thereby reducing operating costs.
- Socially imposed programs have two types of costs: the cost of program operations and the cost associated with compliance (for example, reporting). In many cases, the concern about program cost is focused on the compliance aspects rather than the substance of the program.
- How costs are counted and when they must be incurred introduce another set of issues. The overall cost of a program may not be significant when measured over time. Too often, however, the mandate requires significant up-front investments that become a burden on a single year's budget.
- The implementation of some programs may not increase aggregate expenses but may force a shift in priorities. For instance, resources once earmarked for library acquisitions may be diverted to cover safety and security mandates.

To illustrate the range of issues campuses must address, here are some of the mandates and requirements applicable to higher education:

Personal security and safety. Occupational Safety and Health Act of 1970 (OSHA) establishes employee safety and working condition standards. Other federal laws provide legislation on radiation safety and the protection of human and animal subjects used in research and teaching. The Campus Security Act of 1990, including the Campus Sexual Assault Victims Bill of Rights and the Campus Sex Crimes Prevention Act, and 1999 Department of Education regulations mandating the reporting of campus crime statistics.

Retirement. The Social Security Act of 1935 as amended, addresses retirement, pensions, survivors benefits, disability insurance, unemployment compensation, and health insurance. The Employment Retirement Income Security Act of 1974 (ERISA) provides safeguards for employees participating in pensions offered by independent institutions.

Labor relations. Major laws include the National Labor Relations Act of 1935, establishing the rules applicable to collective bargaining and employee organizing; the Fair Labor Standards Act of 1938, establishing minimum wage levels, maximum work hours, and overtime compensation rules; and the Equal Pay Act of 1963, mandating that employees doing similar tasks must receive equal pay regardless of sex.

Personal opportunity. Although various courts have reduced protections in some areas related to affirmative action, guidelines remain in force through federal regulations and laws. These include Executive Order 11246 of 1965, as amended in 1967, prohibiting discrimination on the basis of sex; the Employment Act of 1967, prohibiting discrimination on the basis of age; Title VII of the Civil Rights Act of 1964, as amended by the Equal Employment Opportunity Act of 1972, prohibiting discrimination on the basis of sex, race, creed, or national origin; Title IX of the Educational Amendments of 1972, prohibiting discrimination on the basis of sex in educational policies, facilities, programs, and employment practices; student financial aid programs rules, which impose significant administrative burdens and may require institutional contributions; and Internal Revenue Service regulations concerning discrimination in favor of highly compensated individuals and in student admissions.

Participation, openness, due process, and privacy. The guiding legislation includes the First Amendment to the Constitution; the National Labor Relations Act of 1935; and the Family Educational Rights and Privacy Act of 1974 (FERPA, or the Buckley Amendment), dealing with the management of records and the release of information. The Gramm-Leach-Bliley Act, aimed at financial institutions, imposes requirements to protect the privacy of consumers engaging in financial transactions. Regulations commonly known as the Red Flags Rule require institutions to have a protection program designed to detect warning signs (or "red flags") of identify theft in their daily operations. Terrorist actions and threats have somewhat clouded privacy issues, with campuses frequently caught in the middle in terms of complying with FERPA while responding to requests for information from federal agencies.

Public information. Requests for information primarily relate to consumer protection, fund-raising, enforcement of government programs, general statistical needs of society, national security, and the general public's demands for accountability. For example, the Office of Management and Budget (OMB) must clear all surveys funded under federal grants; OMB Circular A-21 dictates procedures for calculating indirect or facilities and administrative (F&A) cost rates applicable to sponsored activities; federally funded student financial aid participation requires verification and audit reports; and the Department of Education's National Center for Education Statistics Integrated Postsecondary Education Data System (IPEDS) collects data from institutions annually. The Student and Exchange Visitor Information System (SEVIS), which grew out of the events of September 11, 2001, requires all colleges and universities to provide information on international students, scholars, and other visitors.

Environmental protection. Increasingly, pollution control requirements, restrictions on research involving hazardous materials and recombinant DNA, and vandalism and the problems of neighborhood deterioration call for action by colleges and universities. The Environmental Protection Agency (EPA), for instance, assesses fines under the Resource Conservation and Recovery Act, which also mandates specific safety steps related to the treatment of hazardous waste; the Toxic Substances Control Act mandates storage and usage procedures for industrial chemicals.

Disabilities. The Americans with Disabilities Act (ADA) of 1990 specifies how to make programs and facilities accessible to people with disabilities and requires employers to make those accommodations in the areas of employment, education, and commercial activities. This alone has had staggering implications for campuses, which have invested in technology and facilities for students and employees with special needs. As an example, supporting just one hearing-impaired, full-time student can equal the cost of a full-time employee.

Shared costs in federal grants and contracts. Institutions are expected to absorb some costs associated with conducting research sponsored through federal grants and contracts. Cost sharing may involve matching on individual grants and contracts. Especially frustrating to campuses is

the federal government's complex approach to the reimbursement of F&A costs related to sponsored programs, as outlined in OMB Circular A-21. In theory, the calculation mandated under A-21 should support a negotiation designed to ensure the government and the institution pay their respective fair shares of the direct and indirect costs of sponsored projects. The federal government, however, has unilaterally disallowed some cost categories and imposed seemingly arbitrary caps on others. These actions force campuses to bear an increasingly larger share of the F&A costs of conducting research.

At the same time, the government has imposed additional requirements that increase the amount of unreimbursed costs by incorporating provisions of the Cost Accounting Standards Board (CASB) in A-21. Many of the CASB standards, initially designed to address issues in the for-profit defense contracting industry, do not recognize the nonprofit approach taken by colleges and universities. One particularly burdensome requirement applies to institutions that receive the largest amount of federally sponsored support. These institutions must make a comprehensive filing with the federal government—the DS-2 Disclosure Statement—describing their accounting practices in significant detail. If they subsequently change anything addressed in the disclosure statement, they must justify the change to the government.

Although accountability for the use of taxpayer funds is appropriate and necessary, some requirements are excessive and impose significant additional costs on institutions. For instance, the receipt of grant and contract funds comes with strict accounting requirements, which affect both direct project expenses and the institution's method for claiming project-related indirect costs. Cumbersome processes, referred to as effort reporting, require faculty, staff, and graduate students to document the time they spend on sponsored projects. The institution must have a methodology to ensure each project is charged only the appropriate salary for the amount of time spent by those working on the project.

Equally daunting are regulations related to federal financial aid programs that provide grant, loan, or work-study funds to students. The rules specify how and when funds may be disbursed, the methodology for providing refunds to the federal programs when students withdraw before the end of a term, and the collection procedures that must be used to recover amounts loaned. These complex regulations change regularly, making it difficult to remain in compliance. As is the case with sponsored programs funding, however, the benefits of federal financial aid funds far outweigh the costs of compliance and the negative impact on institutional flexibility. In fact, few institutions could survive if their students did not participate in the federal student aid programs.

Audit standards and mandated management practices. Institutions receiving federal support in the form of student financial aid or sponsored grants and contracts are subject to rules promulgated by the sponsoring federal agencies as well as OMB. OMB Circular A-110 specifies uniform administrative requirements applicable to all federal programs. OMB Circular A-133, the single-audit standard, specifies the requirements for audits of federally funded programs and activities.

In theory, colleges and universities should undergo only one annual federal financial audit. All federal agencies are supposed to rely on that audit to ensure proper management of their resources. In practice, however, many federal agencies go beyond the requirements of A-133 and conduct their own audits.

Special costs of teaching hospitals and clinics. Although primarily targeted to hospitals and physicians serving the general public, the Health Insurance Portability and Accountability Act (HIPAA) imposes significant burdens on higher education student health and counseling clinics, which must ensure the privacy and security of patient information. In addition, institutions with teaching hospitals and clinics are subject to restrictions and guidelines governing patient care review, patient privacy, accreditation and licensure, accounting procedures, control and care of drugs and blood, use of radiation, and use of human and animal subjects for research purposes.

Higher education is unlikely to receive relief from all of these regulatory mandates anytime soon. As the federal government continues investing significant amounts in postsecondary education, it also will seek assurances about the effectiveness of institutional operations.

Issues Unique to Public Institutions

In addition to the federal regulations affecting all higher education institutions, public institutions must comply with regulations imposed by state agencies and departments. Here are a few of the regulations that typically affect only public colleges and universities:

Formula allocation procedures. In general, budget formulas guide institutions in developing their funding requests. Formulas are intended to simplify what otherwise would be a complex process for determining the level of support required to operate an institution. The formulas, however, do not represent how campuses actually operate. In fact, they are nothing more than a shorthand to ease the difficult process of allocating scarce resources. It is highly unlikely that the formula would be used to make allocation decisions within the institution.

The restrictiveness of formula allocation procedures stems not from their use as a means to generate budget requests but from the perception of formulas as an implicit or explicit commitment of how funds will be used. The more that state-level decision makers perceive the formula as an instrument of

accountability—as opposed to a tool for allocating resources—the more complex it becomes to respond to the variety of activities taking place on campus. In this way, formulas can lead to a more restrictive budgetary environment.

Enrollment ceilings. To control institutional demands for financial support, some states have imposed enrollment ceilings on colleges and universities. The state usually agrees to support instructional and other costs up to the level required to serve the target enrollment. That leaves institutions to absorb the excess costs of educating students at levels beyond the target—or simply decide not to admit those students. A backlash to this approach has led many states to replace enrollment ceilings with appropriation formulas, which are adjusted to manage the state's financial commitment. The burden still falls on the campus to find resources to finance its operations, but the state does not become the target of an unhappy population.

Some states employ enrollment thresholds when making their appropriations. The state establishes a bandwidth for enrollment projections of, for example, plus or minus two percent of a specified target. If actual enrollments fall within the four percent range, the appropriation remains unchanged. If enrollments exceed the projection by more than two percent, the state provides funds for the additional enrollment. Similarly, if enrollment is lower than the floor of the bandwidth, the institution receives less funding. In this example, the institution would cover any funding deficiency caused by enrollments exceeding the projection by less than two percent and retain the full appropriation if enrollments are less than two percent below the projection.

Appropriations bill language. The contents of the state appropriations bill may restrict an institution's flexibility. Some states include all institutional resources in the appropriation—even resources that do not come from taxpayers. Other states appropriate only the resources provided directly by the state. In general, the fewer items addressed in the appropriations bill, the more control the institution has over its resources.

Many states use the appropriations bill to regulate activity within colleges and universities. This approach can be troublesome because, unlike the more typical process for establishing state regulations—which usually involves department and agency staff, appropriation bills tend to be developed by legislators and their staff. Without the expertise of staff from departments and agencies, it is possible, if not probable, that the bill will have impacts beyond what the legislature anticipated. Items that might be addressed in this manner include faculty productivity, student-faculty ratios, travel, intercollegiate athletics, campus security, technology standards, and distance education. Serious problems may arise with this oversight mechanism, because states usually don't have provisions to waive legislation.

State agency staff. Many state agencies and departments directly influence daily operations on public college and university campuses. State agencies, for example, often draft statewide plans for higher education, review new and existing academic programs, look over budget requests, and have a say on capital projects. In addition, staff members in various state legislative and executive offices influence the development of policies affecting campuses and, in some states, wield tremendous power over financial matters affecting higher education.

Position control. States commonly control the number of authorized employee positions at public institutions. Some grant campuses a great deal of latitude to determine the mix of employees, setting an overall position maximum and leaving the detailed decision making to the institutions. Provided they don't exceed the maximum at any point during the year, the institutions can hire as needed. Other states attempt to control only full-time employment and leave institutions with the flexibility to rely on part-time employees or independent contractors for some services.

Still other states prescribe the number and types of employees a campus may employ in a given period. This approach limits the way in which salaries and wages are spent and may prevent the institution from optimally deploying staff and faculty resources.

Year-end balances. It is not unusual for colleges and universities to spend a disproportionate amount of their annual budgets in the latter part of the fiscal year. In many states, this flurry of activity is driven by a requirement to revert unexpended funds to the state treasury at year-end. Unfortunately, such "budget balance sweeping activity" may lead to purchasing unneeded materials and supplies to avoid returning funds. It's usually based on the thinking that unexpended funds may lead to future budget reductions, because legislators will believe the budget was too generous.

The overall goal should be to expend resources for what is necessary, when it is needed. A more rational policy allows unspent funds to be carried forward from one fiscal year to the next; this policy reflects the reality that the timing of an expenditure may be as critical as the expense itself. When carryover is allowed, institutions and their departments no longer feel obliged to spend every dollar just to avoid the appearance of having more resources than needed.

Some institutions operating in states that allow carryforward of funds don't extend the same flexibility to their own units. In doing this, the institution essentially encourages units to spend unwisely, to avoid losing funds in future budgets. Admittedly, managing the budgets to allow carryforward is difficult and time-consuming, but it usually leads to improved effectiveness. Institutions that invest the effort to manage the carryforward process will achieve better operating results and more effective resource utilization.

In general, states rely on controls rather than incentives to ensure that funds are expended appropriately. A common method for distributing appropriated resources is the allotment process. Essentially, this rationing process makes appropriated funds available to institutions on an established schedule, such as monthly or quarterly. The more frequent the allotments, the greater flexibility institutions enjoy. Because purchasing commitments usually require having the funds on hand, receiving less frequent allotments may force a campus to postpone some purchases.

Salary savings targets. A few states rely on a management device intended to force the early return of a portion of an institution's appropriation. Such programs are known by various names, including salary savings, budgetary savings, turnover savings, vacancy savings, and forced savings. State agencies, including public colleges and universities, are expected to return a specified portion of their total appropriations, usually expressed as a percentage of salaries and wages. The practice is most prevalent in states that do not allow carryover of unspent funds as well as in states that budget personnel costs using a line-item approach.

States created these programs when they began focusing on unspent amounts at year-end related to position vacancies at agencies and institutions. This approach can be problematic for colleges and universities, because it often takes a long time to recruit faculty, especially at senior levels. By specifying savings targets and requiring the return of the funds throughout the year rather than at year-end, some states can increase appropriations in a given year and accelerate the distribution of those funds. In other cases, however, states use such programs to reduce the level of support provided to higher education.

Salary savings programs do not generate new resources but shift existing resources. They merely recognize that not all compensation can be spent in a given period. Rather than allow state agencies and institutions to make judgments about how to use the savings, the states capture the savings and then use them to fund specific initiatives or increase contingency reserves.

In most cases, an institution of higher education achieves the specified target by either holding back enough resources from the appropriation or passing the savings target on, pro rata, to all campus units receiving state funding. The first approach ensures the institution will meet its savings target, but it shields the units most likely to generate salary savings through turnover. It also enables units to retain the savings from position vacancies and use them for internal activities that may reflect the highest institutional priorities. The second approach ensures that individual units do not benefit from savings at the expense of other institutional priorities. On the other hand, distributing the target among all units can place a large burden on the smaller ones, which may not experience the turnover needed to generate the required savings.

A third approach combines the first two. Rather than meet the target completely from central resources or distribute it to all units pro rata, the administration assigns the majority of the target to the major budget units and allows them to determine how their departments will meet the target. Some administrators assign variable targets to their departments, thereby shielding the highest-priority areas, while others distribute the target pro rata to all departments within the major budget unit. Shortfalls arising when departments are unable to meet the target due to a lack of turnover are addressed on a case-by-case basis.

Topics of Discussion

Issues of greatest importance will vary by institution and by state. Here's just a sample of what state-level officials and campus representatives might discuss during their interactions:

- Funding formulas
- Budget review practices
- State appropriations—both operating and capital
- Tuition and fee policies
- Auxiliary enterprise policies, especially as they relate to competition with the private sector
- Continuing education, evening programs, and summer programs
- Distance education
- Acceptance by public four-year institutions of credits for courses taken at public two-year institutions
- Time to degree
- Research policies and funding
- Technology transfer
- Economic development
- Relative importance of athletics and whether it can be subsidized with educational and general revenues
- Faculty workload standards
- Enrollment ceilings and thresholds
- New facilities needs
- Deferred maintenance
- Debt policies
- Investment policies
- Procurement policies
- Travel policies

Relationship between state policy makers and higher education institutions.

The operating environment in public higher education varies tremendously from state to state. Some states rely on a central system office to oversee all public institutions. In other states, individual campuses are freestanding entities not included in a state system. Still others use a combination: Some campuses are part of a system, while others operate as freestanding entities with their own governing boards. As another option, states may rely on the use of a coordinating body in place of a central system office; the coordinating agency serves as an interface between the executive and legislative branches and the individual campuses.

Regardless of the organizational model, public institutions must ensure that key decision makers in their state have an in-depth understanding of the issues colleges and universities confront. Even when a state system or coordinating agency advocates on their behalf, campus officials must leverage opportunities to interact directly with state executive and legislative staff as well as with staff from state agencies that influence higher education.

Formal opportunities for interaction occur on a semi-regular basis, for example, at legislative budget hearings or capital project review hearings. Although important, such formal interactions may carry less overall significance than the informal contact that occurs from time to time—for example, at college athletic events. The informal exchanges between campus representatives and state-level decision makers at sporting events provide the opportunity to share information and advocate for specific decisions that will provide the maximum benefit to the institution.

Key Points

- Higher education institutions are subject to many external mandates that affect how they conduct their operating and capital activities. The Obama college-completion initiative is just one example; it's having a tremendous impact on higher education, particularly community colleges.
- The extensive range of issues emanating from the federal government addresses topics as diverse as unfair competition between institutions and the private sector, protection against identity theft, and whether higher education endowments should be subject to taxation.
- In addition to the above issues affecting all colleges and universities, institutions receiving state support are affected by an additional set of laws, regulations, and policies. They vary from state to state but address issues as diverse as enrollment ceilings, staffing levels, and the reversion or carryforward of year-end budget balances.