November 18, 2011

Mr. John E. Nixon
State Budget Director
State of Michigan
111 South Capitol
Post Office Box 30026
Lansing, Michigan 48909

Dear Mr. Nixon:

I am responding to your invitation to provide information to the State in support of the fiscal year 2013 budget development process for the University of Michigan – Ann Arbor. In this letter you will find our suggestions on formula funding. As in past years we have also included details of our on-going efforts to contain costs, how these efforts have contributed to the success of the institution, and on our initiatives for regional economic impact.

We will continue to strive for a budget that strongly supports our commitments to academic excellence as well as affordability and to continue our longstanding policy to meet the full demonstrated financial need of all Michigan resident undergraduate students. As careful stewards of public resources we remain focused on and dedicated to prudent and responsible financial planning.

The University of Michigan – Ann Arbor operates in an extremely competitive environment for faculty, students, staff, and research dollars. We recognize the significant efforts the State has made in dealing with uncertain financial circumstances that require hard decisions and thoughtful prioritization of resources. However, the time has come to end the decade-long decline in state support for the University; strategic investment in higher education is essential to the future vitality of the State and its economy.
Funding Formula Suggestions

For the past decade, the public universities in the State of Michigan have seen a significant decline in the level of financial support provided by the State, and today, at the University of Michigan – Ann Arbor, we receive 30% less than we did a decade ago, not even accounting for inflation. We have been seriously challenged in this funding climate, but have worked assiduously to maintain our commitment to access and excellence through relentless implementation of operational efficiencies, as detailed in the next section. The introduction now of an entirely new funding model poses a new array of serious challenges.

Consistent with the comments that we have previously shared with the House and Senate fiscal agencies, the University of Michigan has deep reservations about the adoption of a formula funding model. Formula funding models often favor standardization at the lowest common denominator, ignore economies of scale, and make flawed assumptions about costs being consistent between institutions. They can provide disincentives to excellence and can steer institutions towards uniformity and away from diversity. We believe strongly that the diversity of scope and mission seen among the State’s fifteen public universities is invaluable; it is what enables our universities to meet the State’s critical goals for higher education. A formula that undercuts the important differences amongst the public universities will harm rather than help the State.

If the State institutes formula funding, careful planning will thus be required to minimize the associated risks. Specifically, it is critical that the methodology include comparisons of each university to similar institutions. Using the Carnegie classifications and limiting the comparisons to only public institutions will allow for Michigan public universities to be measured against their peers.

The scope of a research institution like the University of Michigan – Ann Arbor is enormous, with very large educational programs that serve 27,000 undergraduates and 15,000 graduate and professional students and span the arts and sciences, and engineering as well as professional programs such as medicine, public health, social work, dentistry, law, and business. It also includes $1.2 billion in research volume; the facilities, laboratories, museums, and library holdings needed to support these educational and research activities; and an academic medical center. Evaluating it against other “Research universities – very high research activity” institutions will help to put our value to the State into perspective.
The objective of formula funding should be to allocate funding based on the value that each university brings to the State, so that the formula provides financial incentive for each university to maximize that value. A critical task in developing the formula, then, is to make sure it measures value as accurately as possible. Towards that end, the formula must measure performance of the university rather than amount of activity. For example, value to the State is better gauged by graduation rates and degrees granted (measures of performance) rather than by enrollments or student credit hours (measures of activity). Therefore, the kind of performance indicators appropriate to the formula might include:

- Six-year graduation rates
- Freshman to sophomore retention rates
- Total number of undergraduate degrees awarded
- Number of degrees awarded in fields that will fuel economic growth of the State: engineering, mathematics and natural sciences, health professions (nursing, medicine, pharmacy, dentistry)
- Number of advanced degrees, particularly those awarded in fields critical to maintaining and enriching business, legal, civic, and educational endeavors within Michigan (such as JDs, MBAs, PhDs)
- Sponsored research funding
- Technology transfer and economic development indicators, such as the number of patents filed by university faculty or the number of start-up companies spun out of the university

An important design criterion of any performance-based formula funding is how it allocates resources based on absolute performance versus improvement in performance. Both are important and should be considered in determining allocations. By including both types of measures, the State will appropriately incentivize universities at both ends of the performance spectrum. Universities that are performing well have demonstrated that resources invested with them yield high return to the State, and, therefore, continued investment in those institutions is appropriate, as it will accrue continued value to the State. At the same time, the State should also provide an incentive for improvement in performance. Universities should not stay in place, however effective they are; they should always strive to improve. However, it is important that the State not place too great a weight on improvement in performance because high-performing institutions are already at the top of the measures and have less room to do better. Universities that are performing less well on the formula measures have equal opportunity to gain from both the absolute-performance and the improvement-in-performance components of the formula.
While we continue to believe that formula funding models are not in the best interest of the State, we will work proactively with the State to develop a focused set of metrics that are as straightforward and easy to understand as possible, with data extracted from credible and readily available national sources. Funding formulas may appear predictable, transparent, and equitable. But they can also have drawbacks and unintended consequences—and they do not and cannot address the more serious problem: the ongoing decline in State appropriations for higher education.

**Specific Project Requests**

You have asked if the University will be seeking funding during the legislative process for a specific initiative or project, separate from the formula or capital outlay process.

The University of Michigan – Ann Arbor would welcome additional support from the State. It has not been our practice to seek earmarked funding, most especially during the last ten years as State resources became more and more constrained. Our foremost priority is to restore stability to State funding for the State’s public universities and to return to a model of higher investments in our universities.

We could most certainly identify a number of initiatives that would benefit from State support, but I would like to make the case that in what is predicated to be a still constrained resource environment, the State should avoid selecting among specific discretionary, one-time funding proposals from the universities. With no identifiable selection criteria, and with limited funding for universities, it is unclear how such a list of initiatives would be evaluated and recommended for support.

**Cost Containment Efforts**

Despite the challenges of the current economy, the University of Michigan – Ann Arbor remains on a stable financial path largely because of our disciplined approach to financial management, which emphasizes multi-year budget planning, on-going cost containment, and continual reallocation of resources toward our highest priorities. For many years, we have incorporated an assumed level of reduction and reallocation (typically 1.5-2 percent of the budget) in each year’s general fund budget proposal.

During recent times, this aggressive approach to containing costs and optimizing the use of limited revenue has been essential in order to innovate, invest in, and advance the excellence of the institution.
More specifically, our cost containment efforts have enabled us to:

- Keep a U-M education affordable by investing heavily in student financial aid
- Recruit and retain top faculty
- Enhance the student learning experience

Improvements in operating efficiency have enabled the University to achieve double-digit percentage increases in the central undergraduate financial aid budget in six of the last seven years, even while support from the State has been deteriorating. These extraordinary amounts of support have reduced the net cost for modest and low income Michigan families to a level that is actually less today than it was in 2004.

When we point to our accomplishments, it is because we are resolute and strategic about protecting and strengthening the academic mission. Our accomplishments have only been possible because our cost containment efforts did not start one or two years ago but have continued unabated since fiscal year 2003. In seeking efficiencies, we have adopted the following principles:

- Protect and invest in our core educational and research missions
- Remain competitive for the best faculty/staff/students
- Leverage our size and scale
- Maintain high quality essential services
- Eliminate duplicate and lower priority activities
- Shift costs from the General Fund to other funding sources, where appropriate
- Avoid short-term reductions that will raise costs or undercut quality in the long-term
- Introduce centralization and greater sharing of resources in cases where this will result in higher quality services and/or more effective use of high quality facilities
- Consider insourcing and outsourcing, when that leads to improvements in service at the same or lower costs
- Take advantage of advanced technologies to achieve efficiency of operations

The chronology below summarizes the strides we have taken since fiscal year 2003 and a path we plan to achieve through 2017.

**Phase I: Fiscal Year 2003 through Fiscal Year 2009**

During this period, we successfully reduced recurring general fund expenditures by about $135 million, reallocating some savings to our highest priorities.
Cost containment efforts during this period of time were focused on seven areas:

- Purchasing
- Energy Efficiency
- Health Benefit Strategies
- Leveraging Information Technology
- Other Revenue Sources
- Greater Productivity of Staff
- More Efficient Utilization of Space and Facilities

More details about these efforts can be found at
http://www.vpcomm.umich.edu/pa/key/budget/.

**Phase II: Fiscal Year 2010 through Fiscal Year 2012**

Several years ago, we announced a goal of achieving an additional $100 million (recurring) in general fund reductions and reallocations by the end of fiscal year 2012. This equates to an average of over $33 million per year in each of the three years, significantly more than the prior six years, but we felt that this level of reduction was essential to maintaining our commitment to excellence and access for students. Through disciplined management and effort across the campus by faculty, staff and administrators at all levels, we will meet that challenge and achieve this three-year goal by the end of the current fiscal year.

In particular, our fiscal year 2012 budget included aggressive cost-cutting measures amounting to nearly $44 million in recurring (annual) expenses. Examples of fiscal year 2012 specific actions taken or in process, along with approximate annual general fund savings, include:

University-wide strategic cost containment efforts ($10.5M recurring):
- Greater sharing of health benefits costs with employees ($1.4M)
- Implementation of a waiting period for our retirement savings plan ($3.5M)
- Expanded energy conservation efforts ($1.7M)
- Strategic procurement initiatives including computers and office supplies ($3.9M)

Reduction in support for academic program initiatives ($3.5 million recurring)

Administrative restructuring/reorganization ($2.8 million recurring)
- Operational reorganizations in facilities maintenance and building services ($2.1M)
- Cost reduction in academic administrative units ($0.3M)
In-sourcing of Student Payment Plan ($0.3M)
- University Human Resources restructuring ($0.1M)

Centers and Institutes closings and streamlining ($1.8 million recurring)

Other campus activities ($25.2 million recurring)
- Staff reductions through attrition
- Offering lower enrollment courses less frequently
- Deferring planned curricular investments
- Shift of expenditures to other revenue sources
- Reduced travel budgets

Again, details of our cost containment activities can be found at http://www.vpcomm.umich.edu/pa/key/budget/

Phase III: Fiscal Year 2013 through Fiscal Year 2017

We are in the process of planning longer-term efforts to achieve additional operational efficiencies and enhance revenue beyond fiscal year 2012. Work to lay the foundations for these continued operational efficiencies began in 2009, with an internal panel that was convened by the Provost’s Office, and that led to a set of suggestions for cost containment and/or revenue enhancement. These suggestions were then further developed by a set of task forces, and the work of the task forces has led to specific efforts that are underway.

For example, one of the task forces explored creative staffing and shared services opportunities and there are now multiple efforts underway at the University of Michigan to put in place such staffing arrangements. Central administration has created a shared staffing services organization that includes human resources, finance, and basic clerical services. Similar shared staffing is being developed in other units including the College of Literature, Science, and the Arts and the School of Dentistry.

On a large scale, we are implementing a major IT rationalization project across the Ann Arbor campus. Once implementation is complete, savings should total $25-30 million per year, of which 60-70% will be in our General Funds accounts. An administrative service benchmarking study that was completed in late 2009 is also helping us to identify additional areas in our human resources, procurement, and financial operations that have the potential for increased efficiency and cost savings, and we are actively investigating the potential for shared services in these areas.
We are implementing a strategic sourcing program that we anticipate will result in an additional $5-10 million in general funds savings annually, and our retiree health benefits program will yield another $2-3 million.

We are also working diligently to identify additional cost-containment opportunities and fully expect to expand on efforts currently underway.

Working to achieve this level of cost containment has been both difficult and disruptive, but necessary. We are committed to continue to find ways to be more efficient in order to manage fixed cost increases and enable investments in financial aid, faculty recruitment and retention, and academic programs. But, there is a risk that consistently cutting and reallocating at a level higher than our rate of new investment will have a negative impact on the quality of the institution. With continued reduction in the level of State support, it will become extraordinarily difficult to continue to provide the same level of financial aid to our students, to keep world-class faculty on the Ann Arbor campus, and to provide the range of innovative educational programs we do today.

Although we are buoyed by our progress, we recognize that the fiscal environment remains challenging. While these disciplined and strategic efforts around cost containment and revenue enhancement have been key to our success during this difficult financial period and will help to position us for a stable future, a renewed effort to improve support from the State of Michigan has never been more important for a sustainable future.

**Growth and Regional Economic Impact**

The University of Michigan is committed to catalyzing the economic transformation of the State and the nation. The University has developed programs and partnerships among academia, industry, and government that foster an environment of creative innovation. Economic development is a high priority within the University’s public mission, and sustaining these efforts is an important outcome of maintaining a high quality academic enterprise. Through business engagement, technology transfer, industry partnerships, student internships, entrepreneurship, and community assistance, the University is continuing to put resources toward addressing our region’s economic challenges. “Great ideas change everything” is the theme of the University of Michigan’s Innovation website, www.innovate.umich.edu, where these efforts are featured.
During the last year, the University activities have created opportunities for economic growth for businesses new and old. The University’s Business Engagement Center (BEC) focuses on advancing partnerships between the University and industry through connections for sponsored research, student hiring, technology licensing, usage of equipment or facilities, executive education, and engagement on University committees and boards. It manages relationships with more than 1,200 companies, large and small.

The University also fosters opportunities to create high-growth jobs and improve the quality of life for the residents of Michigan through commercialization of University research. In Michigan and across the globe last year, more University of Michigan technologies were licensed to companies than ever before. U-M Tech Transfer recorded 101 licenses and options in fiscal year 2011. Researchers reported 322 inventions and filed for 122 patents. And in these challenging economic times, the University helped launch 11 companies with technologies developed in campus labs. Eight of these companies have opened operations in Michigan. In January 2011, U-M Tech Transfer opened its Venture Accelerator at the North Campus Research Complex to provide lab and office space and other resources for U-M start-up companies. So far, ten companies have located there and the space is filling up faster than Tech Transfer officials expected. Last year, the university recorded $16 million in tech transfer revenues, which include royalties and equity returns. U-M has recently announced a new program, Michigan Investment in New Start-Ups—U-M will invest directly in select, promising spinoffs.

Student interest in entrepreneurship is enormous, and we have been expanding our efforts to develop the next generation of entrepreneurs for the State of Michigan. We have invested in the Center for Entrepreneurship at the College of Engineering and continue to provide numerous educational opportunities for student-entrepreneurs. A unique professional master’s degree in entrepreneurship has been developed by the College of Engineering and the Stephen M. Ross School of Business as a joint program that will educate students on forming and managing high-growth potential, scalable businesses. A new Law and Entrepreneurship program will provide much needed legal help for student entrepreneurs. TechArb, a student business accelerator provides free space, internet access, and mentoring. Many of the eight first generation ventures have enjoyed success. June Energy, a clean energy venture that is designing a portable solar powered light and energy source for developing countries, recently secured more than $500,000 in venture funding and shipped its first 40 domestic orders. The TechArb expects to have 25 companies for the next six-month session beginning in November 2011.
Support for research that yields innovation leading to economic development is also prominent on campus. Indeed, innovation is fueled by U-M’s $1.4 billion in research expenditures. For example, the Center for Wireless Integrated MicroSystems (WIMS) has developed leading-edge research in vital sectors such as health, national security, and environmental monitoring. Established in 2000 by a 10-year grant from the National Science Foundation (NSF), the Center has had an estimated $400 million economic impact on the State of Michigan. Technology developed through WIMS has spawned 11 start-up companies that have created 130 jobs.

And enhancing products at established firms has led to an additional 1,500 jobs, according to the Center’s final report to NSF. In addition, the Robert H. Lurie Nanofabrication Facility has contributed an estimated $500 million to the State’s economy.

Partnering with other universities, industries, governments, and foundations is another way that U-M is leveraging its efforts in economic development. The University of Michigan leads three initiatives recently awarded more than $6 million by the Michigan Strategic Fund and the Michigan Economic Development Corporation (MEDC).

- An award of $1.8 million is being used to develop a Corporate Relations Network for Michigan’s research universities. Expanding on the work that the University of Michigan BEC has successfully undertaken for the last five years, this effort will partner six public universities and the University Research Corridor. The network will support university projects that, with companies, provide university interns, develop a database of faculty expertise, provide university library resources to small companies, and convene innovation sessions where university experts meet with companies to solve company problems. The network connects business relationship offices at Michigan Technological University, the University of Michigan, UM-Dearborn, Western Michigan University, Michigan State University, and Wayne State University.

- A Tech Transfer Talent Network is being launched with a $2.43 million award. The University of Michigan, Michigan State University, Wayne State University, Michigan Tech University, Western Michigan University, Grand Valley State University, and Automation Alley will accelerate the transfer of technology through programs that focus on enhancing talent and strengthening relationships with the private sector.
Incorporating many ideas that have worked well at U-M, the plan includes developing: a database of experts who can assist with tech transfer projects, a Mentor-in-Residence program that embeds experienced entrepreneurs in tech transfer operations to help assess new opportunities, a Tech Transfer Fellows program where graduate student fellows assist in technology assessment and market analysis of tech transfer opportunities, a Post-Doc Fellowship program where post docs and graduate students work on research projects that are on the start-up or licensing path, and activities to help recruit and engage new talent to these opportunities.

- The Michigan Initiative for Innovation and Entrepreneurship (MIIE), a state-wide consortium of public universities that promotes regional economic development and entrepreneurship, began with a $2 million planning grant from the Mott Foundation and continued with grants of $1.5 million from the New Economy Initiative and a $1 million from the Dow Foundation. The University also administers MIIE’s predecessor program MUCI (Michigan Universities Commercialization Initiative), which continues with limited funds realized from returns on previous investments. MUCI has distributed a total of $8.1 million in grants for technology commercialization projects. These programs were recently awarded $2.4 million from the MEDC.

Conclusion

To achieve our mission and to advance the excellence of the institution, we must maintain a focus on the future. Despite funding challenges, we must continually innovate so that the topics we study, and the methods we use to create knowledge, remain at the cutting edge.

Over the past several years, we have relied heavily on internal reallocation and cost containment to mitigate the effects of rising costs and simultaneous reductions in state support. We must continue these efforts -- but there are risks to the institution if even modest relief does not materialize. Our costs continue to rise, the faculty environment remains fiercely competitive, the needs of our student body continue to grow, and we must continue to ensure that qualified students of all economic backgrounds are able to attend the University.

For our state to be prosperous and successful, higher education must flourish. As one of the world’s leading educational and research institutions, the University of Michigan is a key resource that can help stabilize and revitalize the Michigan economy.
We are managing our resources strategically so that we can maintain the ability of the University to contribute to the vitality of our region, and the nation. The state’s continued and expanded investment in our success is central to our collective future.

Sincerely,

[Signature]

Mary Sue Coleman
President

MSC/RPF/dan

Attachments