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Stronger Fiscal Incentives Can Improve High School and Postsecondary Outcomes

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Summary

Never before in U.S. history has the quality of human resources—the skills and education of its people—been so important to the economic prospects of states and their residents. Within the next 20 years, the nation will lack 14 million people with postsecondary education unless states realize significant improvements in high school and postsecondary performance. High school and postsecondary completion rates **and** college readiness need to improve, particularly among disadvantaged populations.

Governors and state legislators can influence *how* high schools and colleges spend their resources through *fiscal incentives* that encourage schools to improve students' outcomes, chiefly college readiness and high school and postsecondary completion rates. Several finance policies can lead to higher student achievement.

- *Give principals greater autonomy to spend instructional resources.* Principals need discretion to direct resources in ways that match curriculum, instruction, and support services with students' identified needs. Research on high-performing, high-poverty schools suggests that decentralized budget authority is a contributing factor to school effectiveness.
- *Provide support to high-quality education options.* Competition in education is one promising way for states to improve the effectiveness and efficiency of their public school systems. Along the continuum of public school choice, three types of education options show the most promise for helping to improve high schools and the students they serve: charter schools; small high schools (either freestanding schools or campuses of autonomous public schools located within larger facilities); and early and middle college high schools. Current state finance policies impede the supply of education options by providing less money for these options and by limiting the flexibility K–12 and postsecondary educators need.
- *Reward public colleges and universities that achieve postsecondary degree completion goals.* Only six out of every ten freshmen enrolled at four-year colleges complete a bachelor's degree within six years. The United States is no longer first in the world in college attainment, measured by the percentage of 26-34 year-olds with a four-year college degree. Historically, state higher education finance policy has focused almost exclusively on enrollment growth and inflationary increases. Performance funding in higher education can influence higher education outcomes, but the emphasis on degree completion needs to be strengthened. Governors and state legislators should consider providing greater general fund support to colleges and universities that achieve or exceed an institution-specific benchmark for postsecondary completion. This benchmark should fit into the statewide goal for completion and be based on the academic records of the students admitted.

The Need to Improve Secondary and Postsecondary Completion Rates

The economy has changed significantly. “Good jobs”—jobs that are growing quickly and pay enough to support a family of four—require postsecondary education or training. More than two-thirds of workers in occupations and industries that are growing have at least some postsecondary education, compared with one-third of workers in occupations and industries that are declining. Moreover, 67 percent of new jobs created by 2010 will demand skills that require at least some college education. This rapid increase in the demand for postsecondary education will be accompanied by baby-boom retirements, resulting in a predicted shortage of as many as 14 million workers with at least some college education by 2020.¹

While the economy has changed, postsecondary degree completion in the United States has not changed significantly in two decades. Stagnant attainment rates are reflected in high college dropout rates. One of every four students enrolled at a four-year college and nearly half of all community college students fail to return after their first year.² On average, about 20 percent of all courses in which students enroll are never completed. The United States has one of the highest postsecondary enrollment rates in the world, but its rates of degree completion rank average to below average among developed nations.³

Postsecondary degree completion, signified by earning a certificate, credential, or degree, affords the individual and the state significantly higher economic returns. Workers who receive some postsecondary education but do not receive a degree earn, on average, 14 percent more than adults with only a high school diploma. Earning an associate’s degree, a bachelor’s degree, or a graduate degree results in 30 percent, 73 percent, and 120 percent higher earnings, respectively.⁴ For states with large-growing populations of blacks, Hispanics, and other nonwhite groups, persistent gaps in postsecondary degree attainment rates have significant economic and social implications. Texas, for instance, has estimated that unless education levels increase, the average Texan household in 2040 would have an average income \$6,500 less than the average Texan household in 2000, the percentage of families in poverty would increase by 3 percent, and per-household state tax revenues would be nearly \$500 less in 2040 than in 2000.⁵

Increasing postsecondary completion rates begins with increasing high school success rates. First, graduation rates must increase. In some of the largest urban school districts, as many as 60 percent of students who begin the ninth grade drop out before earning a diploma.⁶ Nationwide, only 70 percent of all students in public high schools graduate, and only 32 percent of all students leave high school qualified to attend four-year colleges. Furthermore, only 51 percent of black students and 52 percent of Hispanic students graduate, and only 20 percent of black students and 16 percent of Hispanic students leave high school college-ready.⁷ Second, increasing high school success rates means that high school graduates must leave high school with the knowledge and skills to participate in postsecondary education or high-skills work.

Different finance policies can influence *how* high schools and colleges spend their resources through *fiscal incentives* that encourage schools to improve students’ outcomes, chiefly college readiness and high school and postsecondary completion rates. The level of budget flexibility and the strength of incentives in secondary and postsecondary finance policies vary. Many high school principals lack the budget autonomy they need to develop and support high-performing schools. High school finance policies at the state and district levels typically decide how 80 percent of resources will be spent, leaving little discretion for principals to manage instructional resources. Moreover, there is a shortage of high-quality school environments that can motivate low-achieving high school-age students to take responsibility for their learning and academic success. Many high school and postsecondary finance policies do not encourage diverse learning options, including public charter schools, alternative schools, and schools that blend high school and college coursework. Finally, enrollment and inflationary increases drive postsecondary finance policies, rather than completion rates.

Finance Policies for Improving High Schools

For the last century, finance policy for high schools—and all public K–12 education—has focused on reducing local wealth disparities among school districts. The landmark plaintiff victory in Kentucky’s *Rose vs. Council for Better Education* in 1989 marks a shift in emphasis to the adequacy of school finance systems and the funds they provide to schools and districts. The adequacy arguments focus on whether the system provides enough money for students to meet basic educational goals. The “adequate” amount of money can vary substantially based on individual student needs. Since 1989 plaintiffs have won about two-thirds of the decisions, a fact that is largely attributed to the shift to adequacy arguments.

Many of the court rulings specify remedies the state should implement. For example, the New Jersey Supreme Court’s *Abbott v. Burke* ruling requires the 30 lowest wealth school districts to implement “whole school reform” measures, including full-day kindergarten for all five-year-olds and half-day preschool programs for all three- and four-year olds. The 1989 Kentucky decision specified that an adequate system would develop the capacities of students in seven areas: communication skills, economic and political knowledge, mental and physical wellness, knowledge of the arts, and academic and vocational training sufficient to compete with peers in surrounding states.

Courts in several states, including Arizona, Arkansas, New York, and Wyoming, also have included in their decision orders for studies to determine the cost of an adequate education. Those court orders have started a trend. During the past six years, over half the states have hired consultants to conduct such studies. In some cases the courts have ordered the studies, while in other cases litigants have commissioned the studies before filing their lawsuits. Policymakers are requesting the studies in still other cases.

Both the studies’ findings and the courts’ rulings call for significant increases (approximately 20-40 percent) in education spending, amounts that states cannot appropriate in one or even two years. In 2002 the Maryland legislature agreed to raise spending by \$1.3 billion over six years. Education funding advocates in New York have suggested that the state needs to increase school spending by \$2 billion in fiscal 2005 to comply with a 2003 court order to remedy the state’s funding of the New York City schools, and want over \$10 billion in the coming years. The state board of regents has proposed a \$500-million increase, which is a fraction of what might be required, but even this amount is unlikely given the current budget climate.

The current focus on adequate school funding and the significant proposed increases draw attention away from finance policies that can improve the cost-effective use of resources. Experts agree that states’ K–12 and postsecondary education finance policies do not go as far as they should to provide incentives for higher performance.⁸ With different finance policies, governors and state legislators can influence *how* high schools and colleges spend their resources and *what incentives can work* to improve students’ college readiness as well as high school and postsecondary completion rates.

Principals Need Greater Budgetary Autonomy

Principals are seldom given control over a substantial portion of their school’s budget. Most funding for high schools is controlled by the school district, not the individual school. The school district is then often responsible for personnel decisions, with corresponding costs that can account for up to 80 percent of all K–12 education costs. Many school administrators, school board members, and state policymakers see this lack of budgetary control and flexibility at the school-site level as the most significant obstacle to high school reform or redesign efforts.⁹

Research on high-performing, high-poverty schools suggests that how schools spend resources matters and that principals need the discretion to direct resources in ways that match instruction, curriculum, and support services with students’ identified needs. A rare, natural experiment in Austin, **Texas**, during the late 1980s shows that how money is spent explains increases in student

achievement more than additional resources alone. In 1989, as part of a plan to resolve a desegregation court case, 16 elementary schools serving minority, high-poverty populations were each given \$300,000 per year for five years. The payments were additions to normal school spending amounts. Five years later, student attendance and achievement remained very low in 14 of the 16 schools. In the other two schools, Zavala Elementary School and Ortega Elementary School, student attendance rates were among Austin's highest, and scores on state-mandated achievement tests had risen to the city's average. In most of the schools, the new money was used to hire extra teachers to reduce class size, but little was spent to change what happened inside the classrooms. In the higher-performing Zavala and Ortega schools, principals changed how money was spent. They provided teachers with incentives and opportunities to improve their teaching.¹⁰

Fiscal autonomy for principals is a common finding in more recent studies of high-performing, high-poverty schools. Principal autonomy to spend money was the first of seven common traits shared by 21 effective schools.¹¹ In a more narrow review of high-performing high schools, another study observed the positive effects of principals' freedom to hire and fire staff, shape budgets, and set instructional strategies.¹²

Significant budgetary authority has been given to two urban districts that have clear performance goals, and students in these districts have made positive gains on statewide assessments. In **Houston, Texas**—a school district recognized nationally for the gains its disadvantaged students have made, including performance on the Texas Assessment of Knowledge and Skills—site-based budgeting has been in place since 1992–93.¹³ The Texas Education Agency gives the district superintendent and school principals clear roles and responsibilities for implementing site-based budgeting. For instance, the district assumed responsibility for curricula in four basic subjects that align with state standards and assessments. In addition, district administrators give schools data on staffing guidelines, enrollment projections, and standard per-pupil resource allocations. The district office often supplies technical assistance to principals in purchasing, budget amendments, and grant fund use. The principal is responsible for working with campus resource planning groups (or their equivalents), department heads, and campus improvement teams to determine campus resource allocation and develop nonallocated requests.

In **Seattle, Washington**, where fourth-, seventh-, and tenth-grade test scores have risen steadily, principals and the school community are responsible for managing the resources to provide the educational program. Since 1997–98 Seattle's schools have been funded based on a weighted pupil formula, with each student receiving a weight based on his or her characteristics; for example, high school students receiving a free or reduced-price lunch receive a higher weight than half-day, low-income kindergarteners. The city's finance strategy is based on three principles: resources follow the student; resources are denominated in dollars, not full-time equivalent (FTE) staff; and the allocation of resources varies by the individual characteristics of each child. For 2002–03, 58 percent of the district's budget was distributed directly to the schools through the formula, while the remaining funds were controlled centrally. The district has an extensive system of school choice, supported in part through an excellent public transportation program that enables students to commute throughout the district, so schools compete for students. Schools with enrollments falling below the minimum are eventually scheduled for closure.¹⁴

What Governors and Legislators Can Do to Promote Principals' Budgetary Autonomy

To improve high school effectiveness, governors and legislators can provide principals with greater budgetary authority through a variety of actions.

- ***Reduce categorical education funding that limits school discretion.*** Specific education objectives are commonly funded through categorical programs that specify how schools can spend resources. As programs proliferate, principals' discretion to target resources on instructional priorities and respond to the changing needs of different student populations diminishes. With existing state laws and the more recent federal *No Child Left Behind* (NCLB) legislation, states must now have accountability systems that set standards for

learning and publicly report individual student progress toward those standards. Governors and legislators are encouraged to rely on these accountability systems in exchange for greater principal discretion over all school resources.

NCLB provides an example of how a state can allow schools to consolidate large pools of funding to be used at their discretion. All states and districts can now transfer up to 50 percent of the funds they receive from several programs. These funds may be transferred to the federal Title I program serving disadvantaged students, but they may not be transferred out of the program. Some states and districts have even more flexibility. Up to seven states can be granted State-Flex authority (**Florida** now operates with this authority), and up to 80 districts can be granted Local-Flex authority (the **Seattle, Washington**, school district now operates with this authority). This broad spending authority is granted, however, only if states and districts continue to meet established performance goals. State-Flex or Local-Flex authority will end if a state or district fails to meet performance goals for two consecutive years.

- ***Make increased principal autonomy an explicit goal.*** With proper training, school districts and high schools can be given site-based budgeting authority contingent on their fulfilling certain responsibilities.
 - *Identify new district roles and responsibilities in a decentralized system.* Given high student mobility and wide variation in teaching quality, districts may want to assume an expanded role in curriculum development. The Committee for Economic Development's report, *Investing in Learning: School Funding Policies to Foster High Performance*, also recommends decentralized spending authority with the caveat that "giving schools control over the bulk of their budgets does not mean replacing district influence over instructional programs. Every school doing its own thing can be disastrous in large urban districts where large numbers of students frequently change schools and where academic performance levels are persistently low."¹⁵ In its decentralized system, the Houston Independent School District asserted a new role for curriculum when it replaced five different reading programs with a unified reading approach.
 - *Specify the core district functions* (e.g., building construction, accountability system, and technology infrastructure) and their budget levels and call the remaining funds the "potential school budget."
 - *Determine the proportion* of the potential high school budget that will be provided to schools/sites in a lump sum and how that percentage will increase over time.
 - *Structure the formula* each district must use to calculate the actual high school budget for each school site.
 - *Describe the general type of program budget* each high school site will be required to develop with its lump-sum budget allocation.

Increase the Supply of Education Options

Competition in education is one promising way for states to improve the effectiveness and efficiency of their school systems. Borrowing from the lessons of business and industry, education reformers believe that a stronger supply of education options will generate more substantial innovations than can be expected from existing providers, who are apt to make incremental, rather than "disruptive," changes.¹⁶ Along the continuum of public school choice, three types of education options show the most promise for helping improve high schools and the students they serve: charter schools; small high schools (either freestanding schools or campuses of autonomous public schools located within larger facilities); and early and middle college high schools. Although each option is grounded in

effective practice, the supply of high-quality options is significantly limited by existing finance policies.

Charter schools, operating in 41 states and serving more than 500,000 students, are nonsectarian public schools of choice that operate with freedom from many of the regulations that apply to traditional public schools. The “charter” establishing each such school is a performance contract detailing the school’s mission, program, goals, students served, methods of assessment, and ways to measure success. The National Working Commission on Choice in K–12 Education’s 2004 meta-analysis of school choice literature, including research on charter schools, finds that charter schools are about as effective as district-run schools serving similar students and are more efficient because they operate with less money.¹⁷

As a high school improvement strategy, charter schools are promising. A Massachusetts study of higher-performing urban high schools found that one-half of the effective high schools were charter or charter-like (i.e., “pilot”) schools.¹⁸ Charter schools can also influence the behavior of existing public schools by stimulating competition. Studies of schools in Arizona, Michigan, Minnesota, and North Carolina found that student achievement increased in public schools located near charter schools, but the amount of difference varies.¹⁹ Findings from a study of 60,000 Arizona students indicate that charter school students, on average, began with lower test scores than their traditional public school counterparts, and they showed overall annual achievement growth roughly three points higher than their peers in noncharter schools. Charter school students who completed the twelfth grade surpassed traditional public school students on SAT-9 reading tests.²⁰

States also are experimenting with an education option that entails creating new public high schools—typically small schools serving not more than 400 students—within existing, comprehensive high schools. These smaller, semi-autonomous schools offer the focus, personalization, and academic rigor that are typically missing in large high schools. Evidence from the efforts of large urban school districts in Baltimore, Boston, New York City, and San Diego suggests the promise of this strategy to address chronically low-performing high schools. Small high schools in these districts generally have higher achievement levels, higher graduation rates, and lower dropout rates, and they tend to be safer than larger high schools.²¹

A third promising education option for high school students connects low-achieving and low-income students with higher-quality, college-level learning programs. This model, known as early college high schools, builds on the highly successfully middle college high school model pioneered at New York’s La Guardia Community College in 1973. The La Guardia Middle College offers at-risk students a high school education while they are enrolled physically on a college campus. The typical La Guardia Middle College entrant has a history of absenteeism and has failed three or more core subjects in the year prior to entrance; two of every three entrants have reading and math skills that are two years below grade level. Despite the at-risk nature of the student body, 80 percent of the students who enter La Guardia Middle College graduate, and 75 percent of each graduating class enrolls in college. Consistently since 1979, students at La Guardia Middle College outperform or score near the New York City citywide average on the New York Regents reading and mathematics tests.²²

Bard College in New York expanded on the middle college high school model in 2001 with the early college high school, which enables highly motivated students to move in four or five years from ninth grade through the first two years of college, earning an associate of arts (A.A.) degree as well as a high school diploma. The early college high school is a structured form of dual enrollment, which more than 30 states support. Dual enrollment, including the early college high school, can save states money (e.g., financial aid and enrollment-based institutional appropriations), because students’ time-to-degree is accelerated. Washington, for instance, estimates its statewide dual enrollment program saved more than \$34 million in public higher education expenditures in 2001–02.²³ Partnerships in California, New York, North Carolina, Ohio, Texas, Utah, and Washington are committed to introducing 150 early college high schools during the next five years.

Finance Policies Limit the Supply of Education Options

The supply of education options, the kind of instruction these schools can provide, and how long they survive all depend on supportive finance policies. With current finance policies, the growth of charter schools—a common type of education option—has leveled off after expanding rapidly in the 1990s.²⁴ Most charter schools are already operating at or close to capacity. Waiting lists alone indicate that there is demand for 900 more charter schools.²⁵

State finance policies can limit the supply of education options in several ways. For example, states can provide less per-pupil funding for these options and can provide no or limited support for capital costs. Moreover, states can limit the flexibility K–12 and postsecondary educators need to offer college-level learning opportunities in high school.

In most states, per-pupil funding for charter schools is substantially less than the average district per-pupil expenditure. Just eight of the 41 states with charter legislation send 100 percent of district and state operating expenditures to charter schools.²⁶ A study of school finance in Dayton, Ohio, indicates that charter schools received 44 percent less funding than the Dayton Public School District's other schools. The study estimates that if the city's charter schools would receive the same per-pupil revenue as the district's public schools, charter school funding would have risen by more than \$9 million, or more than \$900,000 per school.²⁷ Per-pupil funding for charter schools can also be lower in states where charter schools negotiate their funding with the chartering agency, which is apt to continue to favor funding for traditional public schools. In New York City, for instance, charter schools receive 36 percent less in per-pupil funding than the city's other public schools.²⁸ In addition, charter schools are often ineligible for state resources allocated through categorical education programs.

Finance policies for capital construction and maintenance also limit the supply of education options. Charter schools, for example, are required to rent their own facilities, and they rarely receive adequate funding for facilities. As a result, these schools have to pay facility costs out of an already-slim budget. One analysis estimates that charter schools may pay up to 20 percent or more of their operating funds for their facilities.²⁹ Charter schools that seek to float bonds to pay for capital construction find that they carry lower bond ratings than traditional public schools, and therefore they are subject to higher interest rates.

The growth of early college high schools and other forms of dual enrollment is hindered by finance policies that treat secondary and postsecondary education as discrete functions, rather than as connected parts of an education pipeline. Most states fund concurrent enrollment in high school and postsecondary education by allowing the high school per-pupil funding—calculated at a rate of average daily attendance—to pay tuition. This provides incentives for students, but high schools can be disinclined to encourage broad student participation because funding is lost. Washington's *Running Start* program provides useful lessons. Student participation in this dual enrollment program has increased 160 percent since its inception 10 years ago. In recent years, however, growth has leveled off, due in part to the way the program is funded. At a 2003 forum hosted by the American Association of State Colleges and Universities and Jobs for the Future, Linda Whitehead, superintendent of the Marysville, Washington, school district, reported that in many communities, little FTE-generated funding remains after paying a *Running Start* student's tuition. "Thus, high schools are legally mandated to inform students about dual enrollment options but in practice are conflicted about doing so."³⁰

Finance policies present some unique obstacles for expanding early college high schools. For instance, some states do not permit their secondary dollars to pay for postsecondary faculty. Moreover, states can prohibit high school dollars from paying for students' postsecondary credits. States can also limit partnership-related activities through its strict separation of secondary and postsecondary funding. These activities may include joint curriculum development or additional academic counseling to support students expected to earn their high school diploma and two years of postsecondary credits in four years. In many states, public four-year colleges are discouraged from

partnering to offer early colleges, because full-time equivalent dollars are not generated for the enrollment of high school students.

What Governors and Legislators Can Do to Improve the Supply of Education Options

Governors and legislators can use school finance policies to encourage an increased supply of education options.

- ***Permit 100 percent of state and local education operating funds, including categorical funds, to flow to approved public charter and choice providers of public education.*** Several states, including **Colorado, Delaware, Florida, Massachusetts, Michigan, Missouri, New Jersey, and North Carolina**, allow 100 percent of state and local funds to flow to providers of education options.³¹
- ***Support the use of student-based school budgets and actual expenses, rather than district-based budgets that rely on salary averages.*** Whether supporting entirely new schools or restructured “high schools-within-a-school,” governors and state legislators can equalize funding by encouraging their state’s school districts to develop student-based budgets, rather than district-level, staff-based budgets. Most school districts typically allocate resources to schools through formulas that allot each school a certain number of staff positions; these formulas rarely consider the educational needs of students enrolled at different schools. The practice of using salary and benefit averages hurts high-poverty schools, which tend to employ younger professionals who make less money. When actual salary and benefit rates are calculated, school budgets differ significantly from the budgets the district publishes.³² District-based budgeting perpetuates inequity in funding and provides weak incentives for providers of education options to serve at-risk students.

Student-based budgets, in contrast, allocate dollars to schools based on the number of students enrolled and are weighted to take into account the special educational needs of poor, disabled, and English-language learner students. School districts in Cincinnati and Houston use student-based budgets to increase interschool equity. Prior to this change in finance policy, a \$6,000 gap in funding existed between the least-funded and highest-funded schools in Cincinnati; similar patterns with less variance existed in Houston.³³

- ***Support the cost of developing and maintaining facilities.*** State policymakers can make charter schools more attractive to borrowers by guaranteeing their loans. For example, the NCB Development Corporation, a national organization that supports communities’ business and operating environments, has a Charter School Capital Access Program. This program holds \$6.4 million in reserve in case payments fall through on a \$45-million loan pool that NCB and the Reinvestment Fund raised from large financial institutions. Similarly, Chicago Public Schools have guaranteed \$4.5 million of a \$5.5-million letter of credit for a charter school serving low-income students in grades six through twelve. State policymakers can also allow bond authorities to issue tax-exempt bonds on behalf of charter schools. **Colorado** and **Michigan** give bond authorities this allowance. In addition, governors and legislators can create revolving pools of loan capital. New providers of education need to establish credit track records to access affordable long-term debt. Revolving pools of capital, such as the **Illinois** Facilities Fund, make low-cost loans to charter schools with accelerated payment schedules. Finally, policymakers can provide financial assistance for lease payments. Even after low-cost credit is made available to providers of education options, payments can comprise 20 percent of a school’s operating budget.³⁴ To help alternative providers focus their dollars on instruction, **California, Florida, and Minnesota** allocate some financial assistance for charter school’s lease payments.³⁵
- ***Combine K–12 and postsecondary per-pupil reimbursements into a K–16 Innovation Fund.*** Governors and legislators may want to support blended education options by redirecting

some state support for high schools and postsecondary enrollment—or appropriating new funds—into a pooled K–16 Innovation Fund. This fund would combine high school per-pupil allocations, postsecondary per-credit allocations, and state financial aid or performance funding dollars for students enrolled in an early college high school. Philanthropic and corporate dollars could also be deposited in this pooled fund. This fund could prevent the competition that occurs between high schools and colleges to retain full funding for students who are concurrently enrolled. A K–16 decisionmaking body could facilitate joint decisions on the use of funds.

North Carolina's Innovative Education Initiatives Act of 2003 provides much of the flexibility needed to improve the supply of innovative high school programs. The Act pools public, private, and corporate funds. It also authorizes boards of trustees of community colleges and local boards of education to use state, federal, and local funds allocated to either high schools or community colleges for accelerated secondary and postsecondary models. The program is exempt from all laws and applicable rules, except the number of instruction days and laws related to the instruction of students with disabilities. The law also requires participating schools and partners to report to the state board of education on state policies that need to be strengthened, adopted, or eliminated to support the supply of high-quality education options.

New Institutional Incentives for Degree Completion

State responses to increased demand for postsecondary skills must also address institutional incentives for degree completion. States have relied too much on access as a goal for postsecondary finance policies. As a result, enrollment rates have increased for all population groups during the past 25 years, but college dropout rates are high. Institutional graduation rates vary significantly, even among institutions with similar students.³⁶ Further, one-quarter of American colleges have graduation rate gaps between white and African American students and between white and Latino students of 20 percentage points or more.³⁷ Performance funding is a promising way to increase incentives for degree completion. States can reward institutions on such completion measures as course completion; credit-to-the-degree, and the number of postsecondary credentials conferred.

Historical Policies for Funding Postsecondary Institutions

State higher education finance policy, though it varies significantly among states, typically aims to increase student demand or “access.” States have tried to stimulate student demand by increasing public institutions’ capacity to serve students. Finance policies focus on funding institutions for enrollment growth, inflationary increases, and special initiatives. States also stimulate student demand by making college more affordable through student financial aid programs. After World War II, states began to use funding formulas based on the number of full-time equivalent students enrolled at each institution, with the cost per student varying according to institutional mission. During the recent state fiscal crisis, many states abandoned their funding formulas in favor of across-the-board increases or decreases for public institutions. These decisions reinforce historical patterns of funding institutions and provide weak incentives for institutional performance, particularly for degree completion. One scholar notes, “State budgeting for public higher education resembles a family’s attic. Everything is added but nothing is thrown away.”³⁸ Funding should continue to support increasing student access, but states are encouraged to establish stronger financial incentives for degree completion.

Since the mid-1990s, 44 states have tried to provide fiscal incentives to increase degree completion through performance-based reporting, budgeting, and/or funding. Each of these strategies helps satisfy the growing need for public data on institutional and statewide higher education performance. Each uses market forces of information and competition to improve effectiveness and efficiency. Market forces are more prevalent in postsecondary education than in K–12 education because of the diversity of providers, diffuse governance, and declining state support as a percentage of total revenue. Of the three performance-based strategies, performance funding is regarded as the most effective, according to an analysis of 11 states, an opinion survey of state and campus policymakers in nine states, and a study of performance indicators in eight states.³⁹

Performance Funding

Performance funding ties specified state funding directly and tightly to the performance of public institutions on individual indicators. Fifteen states currently have adopted some variant of performance funding. If an institution achieves a set target on an indicator, it receives a specific amount of performance money for that measure. Experts assert that institutions need greater financial incentives for increased performance, but they argue that current performance funding programs have several limitations.

- There are too many indicators without statewide performance goals, and the emphasis on completion is not strong enough. Graduation rate is one of a dozen or more indicators with equal weight in states with performance funding.
- Performance targets can be set too low to be meaningful.
- State funding for performance has been reduced or eliminated when overall funding for colleges is not increasing. As discretionary incentive funds have declined in the past few years, state higher education finance officers concurrently report a drop in the impact of performance funding on institutional improvement.⁴⁰
- Political will to reallocate resources from institutions that fail to perform can be weak.⁴¹

What Governors and Legislators Can Do to Strengthen Performance Funding for Degree Completion
Governors and state legislators can emphasize degree completion as an educational outcome through several actions.

- ***Establish a statewide performance benchmark for postsecondary attainment.*** This benchmark should promote completion of postsecondary courses and credentials. It should emanate from a statewide planning process that has established the groundwork for a reasonable level of consensus about priorities. When performance-based reporting and funding systems are implemented before statewide planning has occurred, or when there is a lack of consensus about the priorities or goals from state plans, the systems often lead to volumes of data that policymakers cannot use.⁴²

State policymakers could use the National Center for Public Policy and Higher Education's measurement of "top performers" to help quantify how many additional students a state needs to graduate with some postsecondary education between now and 2015 to match the top performer nationally.⁴³ Governors in **Iowa** and **Michigan** have adopted ambitious goals for postsecondary attainment, and state governing and coordinating boards in **Kentucky**, **Oklahoma**, and **Texas** have used their statewide goals to set institutional benchmarks for college completion. Since Kentucky set a statewide postsecondary performance benchmark and reformed postsecondary education in 1998, college participation has increased 24 percent and six-year graduation rates have improved at every public four-year institution.

- ***Emphasize degree completion rates and credentials, certificates, and degrees conferred above all other performance indicators.*** Stronger emphasis on degree completion can be influenced by simplifying the number of indicators and weights used in performance funding systems. Governors and legislators are encouraged to award performance funding to institutions with completion rates that meet or exceed a predicted target rate, based on the academic records of enrolled students and the institution's completion rate from a previous year (or average of years). Institution-specific benchmarks can prevent invidious comparisons among institutions with different missions and student populations while enabling policymakers to compare institutional performance against a statewide goal for postsecondary attainment.

Florida implemented performance funding for community colleges in 1996. Through the community college budget process, institutions are awarded just below 1 percent of the

system's budget based on three performance measures: number of A.A. degree, A.S. degree, and certificate completers; number of these completers who were economically disadvantaged, disabled, or English-language learners or who were placed in jobs in targeted fields; and number of A.A. completers who graduated with fewer than 72 total attempted credit hours. Another initiative, Workforce Development Education Fund (WDEF) focuses incentives on completion and job placements. WDEF, established in 1997 by the state legislature, was to allocate community colleges (and district-operated technical centers) 85 percent of their prior-year appropriation upfront. The remaining 15 percent is to be distributed based on completion points and placements in high-wage, high-demand fields. The formula also rewards institutions for the completions of economically disadvantaged populations.

Since the programs began, community college completion rates have increased, even while the funding associated with those indicators has decreased. Since 1996–97 the number of A.A. degree completers has increased 8.4 percent. Further, A.A. degree graduates with fewer than 13 “excess hours” accounted for 34.7 percent of all A.A. graduates in 2000–01, up slightly from the 33.3 percent they represented in 1996–97.⁴⁴ As a result of WDEF, administrators report that they find the focused measures are a useful tool to eliminate poorly performing programs in terms of enrollment and other criteria; they report that more than 90 percent of their programs are now on the state's high-skills/high-wage list.⁴⁵ Florida's K–20 accountability legislation will require, beginning in 2005–06, the legislature to allocate 10 percent of each school district's and postsecondary institution's based on performance indicators including learning gains, graduation and completion rates, and employment/earnings rates.

States are encouraged to think about ways this increased emphasis on completion does not harm institutions that enroll and graduate disadvantaged students. **England**, for instance, provides most of its institutional support based on the number of students who complete a year of study. To counter a tendency to enroll better-prepared students so completion rates will be higher, England provides a 5-percent bonus to institutions that enroll students living in postal codes with the lowest incomes.⁴⁶ Since the 1990s the percentage of the English adult population enrolled in postsecondary education has increased, even though funding has decreased. **Ohio** provides a good example of balancing the focus on completion with service to at-risk populations. Success Challenge is one of four performance funding programs in Ohio, and it is narrowly focused on raising graduation rates at four-year campuses. Two-thirds of the allocation for this program is awarded to institutions that devote more attention to strategies to improve the graduation rate of low-income students, such as changing program requirements, expanding course offerings, and providing additional counseling for undergraduates.

- ***Dedicate more funds for completion.*** Performance funding should continue in good and bad fiscal times. It is unreasonable to expect that higher education institutions will pay significantly more attention to completion when, on average, 2 percent of any campus' budget from the state is based on performance and when incentives exist only when state budgets for higher education are growing. **Ohio, Florida, and Tennessee** have specific performance funding legislation that enables them to appropriate funds every year to institutions that meet their performance objectives. These states also have gradually appropriated a larger percentage of total support for higher education for demonstrated performance. For example, the funds Ohio University earned for completion in 2000–01 represented a larger increase than it received from the enrollment-based instruction subsidy.

Tennessee has the nation's longest-standing performance funding program with clear and consistent fiscal consequences. Its program grew out of a desire for more higher education accountability and recognition of the limitations of the state's enrollment-driven funding formula. The program provides institutions with an opportunity to earn a budget supplement

to the instructional components of their educational and general funding budget. As total state support for institutions' budgets has declined during the past few years, the performance funding program has become increasingly essential to maintaining the base operations of many institutions. Funds for performance have gradually increased from 2 percent to 5.4 percent of the total budget campuses receive from the state. Tennessee's institutions have responded to the clear, meaningful incentives, with most institutions performing at higher levels on the 10 performance indicators and some achieving 100 percent of their performance goals. Persistence-to-graduation, however, is just one of 10 performance indicators used, and it is weighted less than other indicators such as testing of general education outcomes or major field testing. The number of certificates or degrees conferred is not now a performance indicator in Tennessee.⁴⁷

Colorado's recently passed College Opportunity Fund has the potential to be the nation's most aggressive performance funding. Beginning in 2005, Colorado will transfer institutions' operating funds into this pool of portable student stipends, each of which is worth an estimated \$2,400. Institutions (public and private) that want to enroll students with this stipend have to agree to meet certain goals, including improving graduation and retention rates.

Conclusion

Governors and state legislators have a powerful tool, state finance policy, to influence high school and postsecondary outcomes. Instead of looking exclusively at levels of resources as a means to improve secondary and postsecondary effectiveness, state policymakers are encouraged to address *how* high schools and colleges spend their resources and *what incentives they have* to improve the number of high school students who graduate high school ready for college and complete a postsecondary credential. High school principals need greater flexibility to spend resources on the specific needs facing their student population. Innovative education leaders at the high school and postsecondary levels need flexibility and incentives to expand education options that have proven effective in improving student progression to a postsecondary credential. Finally, postsecondary institutions need clearer signals from the state that degree completion is as important as enrollment.

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