Pumping the Money Lever

Why state approaches to higher education finance need an overhaul

DENNIS JONES

Finance policy is the most powerful tool available to state governments seeking to influence performance of the state's postsecondary education system. This is true whether the objective is greater contributions to solutions of key problems or simply greater productivity — an unspecified bigger bang for the buck. To be sure, there are other arrows in the state policy quiver including governance changes such as reorganizing system structures or appointing university trustees with particular philosophies, regulatory devices and accountability mandates. But money is the big lever, and not necessarily the final amount, so much as the rules by which it is meted out by the state and "earned" by the institutions and students who are recipients of taxpayer dollars.

The rules governing resource allocations to higher education were developed years ago to meet the very different needs of those times. Those needs could be characterized as promoting access for a larger and more diverse student population and creating the institutional capacity necessary to meet the needs of these enrollees. A related objective for a successful funding model was affordability: keeping the cost of attendance low enough that all state residents could afford college and enrich their lives. Federal policy has historically borne the brunt of this obligation through an evolving set of student financial aid programs, though several states with large independent college sectors have created major aid programs to allow students choice as well as access. In most states, the policy response to the affordability criterion was low tuition (and therefore high state subsidies) for students attending public colleges and universities.

The states' obligations have been conceived predominantly as those to ensure the presence of institutions of sufficient size and diversity of mission to meet the needs of the state and its residents. The criteria for financing models in this domain have traditionally been adequacy (do they yield funding at levels that allow institutions to fulfill their assigned mission?) and equity (given their different missions and needs, are institutions treated fairly?). Funds for creating and maintaining the necessary institutional capacity have traditionally been derived from state and local taxes along with student tuition and fees.

Different states use varied approaches to institutional funding, but there are two variations on a basic model, both driven by costs associated with undertaking certain activities. One is a base-plus model where determination of next year's funding starts with this year's number and adjusts it (usually upward, but sometimes downward) to reflect changes in activity levels (e.g., enrollments) and prices of production factors. The second is an approach that applies negotiated factors such as dollars per full-time equivalent (FTE) student or dollars per square foot of facilities to a variety of cost drivers (enrollments, physical plant size) to calculate a measure of institutional financial need.

These approaches have certain characteristics in common:

1. They are essentially cost-reimbursement models. They start from a set of assumptions about education production and carry these assumptions forward in developing requests for funding in future years.

2. They are activity-based. The major cost drivers are factors such as students to be served, credit hours taught (often distinguishing those at different levels in different fields), size of the plant to be maintained, and size of the budget or workforce to be managed.

3. They typically contain a mechanism for changes in levels of activity (the numbers of each of the cost drivers to be accommodated) and in costs of units of production (an inflation adjustment).

All approaches to resource allocation contain incentives for institutional and student behavior, intended or not. In pursuit of the adequacy and equity goals in institutional funding, states created incentives for institutions to:

- Enroll students but not get them to the point of graduation.
- Expand their mission to attract more students and to build a program portfolio with higher revenue potential.
- Acquire more resources (faculty, buildings) rather than make more efficient use of the assets already in hand.

To rein in the behaviors encouraged by these financing models, states have created regulatory constraints, regarding mission, role, scope review and approval processes, course and program approval procedures, position control, facilities approval processes and directives on use of resources, such as maximum share of resources devoted to administration. College administrators find some of these constraints intrusive. Some states have attempted to overcome the inherent incentives in current funding models by adding a performance-based component to their funding models. These have generally been considered failures, largely because the funding dependent on performance, for example, pegged to increasing numbers of degrees produced, has not been large enough to offset the pressures in the core funding model that push institutions toward traditional ways of doing business.

Current funding mechanisms are recipes for maintaining the status quo. But policymakers and educators have come to understand that the status quo is not serving well either the polity or its citizens. A focus on access with an accompanying indifference about success is passé. Whereas the loss associated

with failure to complete some level of postsecondary education once fell squarely on the individual, now that loss is much more widely shared by the larger society. As awareness of the country's (and states') declining competitiveness spreads, the importance of a "public agenda" for higher education in the state gains traction. Policymakers now almost uniformly recognize that the states' colleges and universities are their best hope for addressing the critical issues facing the state — such as an underperforming K-12 system, the development of a workforce big and skilled enough to compete globally and the need for innovations that can help diversify and expand the economy.

This increasing dependence on higher education is coming at a time of constrained resources. Even if the economy hadn't gone into a tailspin, demands from other quarters (Medicaid, corrections, K-12) would have made it impossible for states to pay for the levels of activity at the rates they've been paying. Shifting the burden to students threatens to become a self-defeating strategy. The economics have to work for the students as well as institutions and the state; affordability has to be maintained at a level that ensures a sufficient flow of students into — and all the way through — the education system so that societal needs will be met and individual prosperity and quality of life sustained.

Clearly, the funding models currently in play misalign incentives with priorities. The reality that productivity enhancements must be achieved is at odds with mechanisms that coddle inefficiencies, and the failure to factor incentives for student behavior into the models in an explicit way, are all shortcomings of the prevalent approaches to higher education funding employed by the states.

A New Model

A more ideal funding model would incorporate institution- and state-focused elements in a way that they are aligned with the state priorities — *the public agenda* — and with one another.

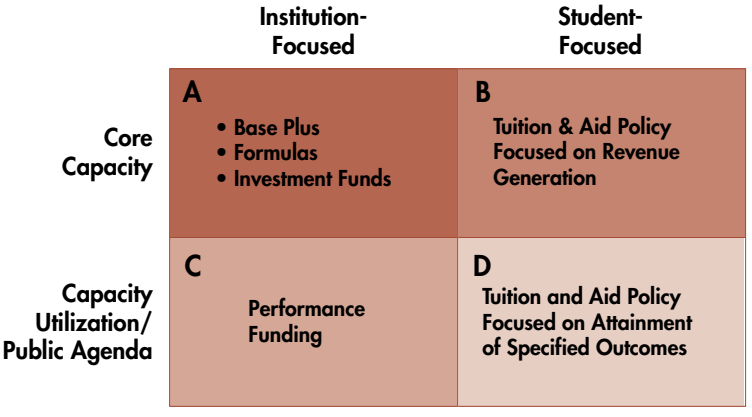
Component A is the institutional funding designed to create and maintain the core capacity of the enterprise needed to enroll and graduate students in the numbers and with the characteristics needed by society. It should be the centerpiece of any funding model. The key change needed here is to create a culture that rewards student success rather than mere enrollment. The obvious step would be to shift funding from a system based on credit hours or FTE base to one that pays for the numbers of degrees produced, with variations in allocation based on types of degree and centrality to state priority. But institutional leaders would be loath to embrace a financing model that depends on student behaviors outside their control and postpones payment until long after the costs associated with producing the desired results have been incurred.

The fallback position is to fund on the basis of credit hours completed rather than credit hours enrolled — to utilize cost drivers counted at the end of the term rather than at an early-term census date. This strategy, pursued by a handful of states, is based on the conclusion that students will not complete a degree program if they fail to complete the program's constituent courses. This shift is being contemplated by several other states, and early indications are that this modification to state policy can affect institutional behavior in desirable ways.

Component B reflects the basic tuition and financial aid factors designed to yield a revenue stream to support capacity maintenance. As the basic funding from state government becomes more problematic, tuition and financial aid become more important. In most instances, the policy focus has been on setting tuition rates at levels required to fill gaps in revenue streams and on need-based aid programs intended to ensure continued affordability. Such aid programs have been more oriented to access than to ultimate program completion. There are ways, however, that basic need-based programs can be modified to reflect the success agenda. The point of intervention is at preparation for college — ensuring that students take a rigorous high school curriculum. One approach is to make access to means-tested aid conditional on taking a prescribed high school curriculum such as Indiana's 21st Century Scholars does. An alternative is to provide a bonus to the means-tested amounts for students taking

Funding models built on the priorities of student access and institutional growth will no longer suffice. Those based on student success and productivity increases consistent with getting more entering students through the pipeline will become ascendant.

Figure 1: Financing Model



a college-prep curriculum, as Tennessee's Lottery Scholarship program does.

The Shared Responsibility models of Minnesota and Oregon establish a fixed cost of attendance for each type of institution; indicate the amount expected from the student through work, merit aid or loans; maximize the use of federal grant programs; factor in expected family contributions; and make the state funding the "last dollar in."

The structure of these programs sends the signal that funds for college will be there, that the amount of student earnings required would be limited, and that good performance in high school will make it possible to work and borrow less.

Component C represents the element that can tie funding directly to accomplishment of state priorities. Performance funding is being implemented in numerous states, most frequently to reward institutions that increase the number of students graduated from the institution. Variations emphasize graduating students in high-need areas (STEM, nursing, etc.) or graduating students who enter the institution as "at risk" students. Performance funding will have greater leverage if:

- Core funding (category A) is outcome-oriented and performance funding can reinforce it or add specificity to the basic model.
- The size of the performance funding pool is large enough that it can't be ignored — under 2% won't get the job done.
- Each institution gets access to only performance pools that expressly reinforce its mission (research universities get rewarded for increasing numbers of graduate — but not undergraduate — degrees, while teaching institutions are precluded from benefiting from pools designed to enhance research competitiveness).
- There is no ambiguity in measures of success.

Component D, incentive funding directed at students, is largely uncharted territory. But as society's stake in student success goes up, attention to this component will increase as well. Historically, the only initiatives in this category have been loan-forgiveness programs, in which some part of a student's loans are paid back by the state, if the student earns a degree in a particular field and stays employed in the state for a specified period of time. Some states are now talking about bolder initiatives, such as direct payments to students who complete their programs on time, or complete a degree while taking fewer credits than the catalogue-specified number at the college.

There Will Be Change

The demands of society and constraints on resources will require change in the financing models states use to fund their higher education enterprises. Models built on the priorities of student access and institutional growth will no longer suffice. Those based on student success and productivity increases consistent with getting more entering students through the pipeline will become ascendant. Models based on preserving the status quo will have to give way to those that foster purposive change. They will have to be more explicitly a tool of public policy rather than a device for institutional funding.

To be effective, financing models need to comprise all four components identified above, coordinated in ways that make them mutually reinforcing. To this end, state policymaking will also have to change. First, states must become more explicit about statewide goals, and expectations for performance of the higher education enterprise will have to be stated and pursued over an extended period. In addition, finance models consistent with the expectation will have to be fashioned. In all likelihood these models will have to be more comprehensive and more sophisticated than those currently in vogue. Failure to make these changes will yield the same old inadequate results.

Dennis Jones *is president of the National Center for Higher Education Management Systems, based in Boulder, Colo. Email: dennis@nchems.org.*