Performance Funding: From Idea to Action

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COMPLETE COLLEGE AMERICA

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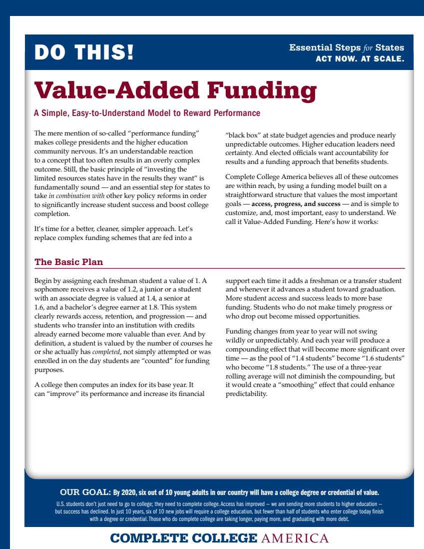
Established in 2009, Complete College America is a national nonprofit with a single mission: to work with states to significantly increase the number of Americans with quality career certificates or college degrees and to close attainment gaps for traditionally underrepresented populations.

NCHEMS

Dennis Jones is President of the National Center for Higher Education Management Systems (NCHEMS), a nonprofit research and development center founded to improve strategic decisionmaking in institutions and agencies of higher education.

Now What?

This THINK THIS. brief makes the case for why colleges and universities should shift to a system of performance funding, one of our six essential steps for states. The accompanying DO THIS! brief provides specific advice for implementing such a system.


DO THIS!

Essential Steps *for* States
ACT NOW. AT SCALE.

Value-Added Funding

A Simple, Easy-to-Understand Model to Reward Performance

The mere mention of so-called "performance funding" makes college presidents and the higher education community nervous. It's an understandable reaction to a concept that too often results in an overly complex outcome. Still, the basic principle of "investing the limited resources states have in the results they want" is fundamentally sound — and an essential step for states to take *in combination with* other key policy reforms in order to significantly increase student success and boost college completion.

It's time for a better, cleaner, simpler approach. Let's replace complex funding schemes that are fed into a "black box" at state budget agencies and produce nearly unpredictable outcomes. Higher education leaders need certainty. And elected officials want accountability for results and a funding approach that benefits students.

Complete College America believes all of these outcomes are within reach, by using a funding model built on a straightforward structure that values the most important goals — **access, progress, and success** — and is simple to customize, and, most important, easy to understand. We call it Value-Added Funding. Here's how it works:

The Basic Plan

Begin by assigning each freshman student a value of 1. A sophomore receives a value of 1.2, a junior or a student with an associate degree is valued at 1.4, a senior at 1.6, and a bachelor's degree earner at 1.8. This system clearly rewards access, retention, and progression — and students who transfer into an institution with credits already earned become more valuable than ever. And by definition, a student is valued by the number of courses he or she actually has *completed*, not simply attempted or was enrolled in on the day students are "counted" for funding purposes.

A college then computes an index for its base year. It can "improve" its performance and increase its financial support each time it adds a freshman or a transfer student and whenever it advances a student toward graduation. More student access and success leads to more base funding. Students who do not make timely progress or who drop out become missed opportunities.

Funding changes from year to year will not swing wildly or unpredictably. And each year will produce a compounding effect that will become more significant over time — as the pool of "1.4 students" become "1.6 students" who become "1.8 students." The use of a three-year rolling average will not diminish the compounding, but it would create a "smoothing" effect that could enhance predictability.

OUR GOAL: By 2020, six out of 10 young adults in our country will have a college degree or credential of value.

U.S. students don't just need to go to college; they need to complete college. Access has improved — we are sending more students to higher education — but success has declined. In just 10 years, six of 10 new jobs will require a college education, but fewer than half of students who enter college today finish with a degree or credential. Those who do complete college are taking longer, paying more, and graduating with more debt.

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PERFORMANCE FUNDING

From Idea to Action

Performance funding — the linking of allocation of resources to accomplishment of certain desired outcomes — is an idea that is once again finding favor with policymakers. It has intuitive appeal; what's not to like about paying for results? While it is a notion that makes common sense to most decisionmakers, it is an idea with a very checkered past — it has been tried, found wanting, and with few exceptions abandoned. A review of past experiments suggests that it's not the idea that failed, but the design and implementation of the strategies that derived from the idea. This brief paper presents a set of first principles for putting in place an approach to performance funding that will help policymakers avoid many of the pitfalls that plagued prior efforts in this arena. The principles presented fall into two categories — those dealing with design of the system, and a separate set dealing with implementation.

Design a Smart System

1. **Recognize that all funding models are performance based; this is not a new idea.** Institutions have consistently received appropriations from the state for achieving certain objectives. Most often the objective has been providing greater access and growing enrollments. In other cases, the incentives have been for maintaining the status quo. In the current incarnation, it's not the idea that's new — it's the objectives for which incentives are being provided that are new. Access is no longer the dominant goal. It has been replaced by an emphasis on completion of academic programs. Numbers of students enrolled are becoming less the coin of the realm; production of degrees and high value certificates is becoming the new currency. Over the years, decisionmakers and analysts have become very good at devising ways to appropriately reward improvements in student access. The task now is to become equally adept at rewarding a different set of goals.

2. **Get agreement on goals before putting performance funding in place.** Resource allocation models are the means to an end, not ends unto themselves. If there is not a clear statement of goals that has broad bipartisan acceptance, then there is almost no chance of creating a performance funding model that can last. It is well worth the time and effort to get broad consensus around a "public agenda" for the state before embarking on design of a performance-based funding model. The public agenda should state a limited set of goals that:

   - Are tailored to the needs of the state, not borrowed from elsewhere
   - Focus on the needs of the state and its citizens, not the institutions of higher education

   The absence of such a public agenda undercuts the efficacy of many prior efforts to build performance funding systems. Goals need to be the driving force for performance funding, not a rhetorical afterthought.

TEXAS provides a good illustration. Its goal of "Closing the Gaps" preceded by several years its initiation of a performance funding component to its allocation model that rewards institutions for increasing the numbers of degrees awarded. Indiana and Ohio also illustrate this principle.

3. **Construct performance metrics more broadly.** The current focus nationally is on education attainment of the population and the associated encouragement for institutions to increase the numbers of degrees and employer-recognized certificates produced. In most states, this is a necessary and important goal but is likely not the only one of importance to the state. Others frequently found include:

   - Innovations that expand and broaden the state's economy
   - Production of graduate and professional degrees in selected fields such as STEM or health care
   - Development of a workforce for high-need occupations

   It is important that all institutions have an opportunity (not a guarantee) to benefit by excelling at their different missions. It is important to reinforce the point that institutions should be able to "win" by contributing to state goals, not doing well at their own. Failure to abide by this principle can easily lead to:

ILLINOIS is a good example of a state whose public agenda is both well-focused on the needs of the state while simultaneously calling on the different capacities of different kinds of institutions to achieve that agenda. (See http://www.ibhe.state.il.us/masterPlanning/materials/070109_PublicAgenda.pdf)

- Encouragement of unwanted behavior by institutions — mission creep by some institutions, and research institutions enrolling more students than deemed desirable by policymakers and increasing competition for students even more in the process.
- Legislative opposition from supporters of institutions that can't benefit from staying within their mission and doing that mission well.

4. **Design the funding model to promote mission differentiation, not mission creep.** This can be accomplished in at least two distinct ways:

   - Use different metrics/drivers for different kinds of institutions. Tennessee's model is particularly good on this dimension, rewarding
     - The research universities for producing doctoral and professional degrees and successfully competing for more research funding
     - The comprehensive institutions for producing master's and baccalaureate degrees
     - The community college for producing associate degrees and certificates, transferring students and reaching specified "momentum points" (remedial success, dual enrollment, and job placement, for example.)
   - Create different pools of resources for different kinds of institutions — and make sure that each institution can compete for resources in only one pool. Ohio uses this strategy and makes distinctions among
     - Main campuses
     - Regional campuses
     - Community colleges

   The fundamental principle is to reward institutions for fulfilling their missions and not encourage/allow them to benefit by altering their mission. The largest bone of contention almost always arises when teaching institutions are discouraged from benefitting from engaging in research.

5. **Include provisions that reward success with underserved populations.** One of the major concerns voiced about performance-based funding, especially when the goal is to produce more graduates, is that institutions will seek to enroll only those students most likely to succeed and ignore students who are at risk academically, economically, or otherwise. To counter this possibility, most states that have instituted performance funding give extra weight for graduating students from at-risk populations. The weights vary from 40 percent (in Tennessee) to 100 percent (in Texas). The definitions of "at-risk" differ considerably from state to state.

   The beauty of the formulation that gives added weight to graduates with specified characteristics is its flexibility; flexible in the weights attached and in the characteristics of students identified as priorities for extra attention.

Examples include:

- Low income — usually measured as Pell or state grant eligible (TENNESSEE, OHIO, TEXAS)
- Adult (TENNESSEE, WEST VIRGINIA, TEXAS)
- Academically at-risk — below national average on ACT/SAT and those with GED (TEXAS)

6. **Include provisions that reward progress as well as ultimate success (degree completion).** This is especially important in the early implementation stages of performance funding. Degree production is difficult to increase in a single year; a mechanism that rewards improvement in the shorter term is a useful and appropriate tool. It helps institutions, but more importantly, it helps students succeed by rewarding institutions who help students make step-by-step progress.

   It is possible to make this an inclusive provision, but it is also possible to confine this provision to at-risk students.

7. **Limit the categories of outcomes to be rewarded.** A frequent urge is to create an ever-expanding list of variables that can serve as drivers of the performance funding model; all institutions will press for inclusion of a factor that will benefit them. It must be remembered that performance funding should reward contributions to attainment of state, not institutional, goals, and state policymakers are counseled to keep the variables attached to each type of institution to no more than four or five. One of the primary purposes of outcomes-based funding is to focus institutional attention on key state priorities. If state policymakers can't limit the number of priorities, then they are providing insufficient leadership and the message sent to institutions will be garbled at best. Success will be achieved only if the message is clear.

8. **Use metrics that are unambiguous and difficult to game.** *Numbers* of graduates is an unambiguous measure; students either graduated or they didn't. *Graduation rates*, on the other hand, are fraught with ambiguities. There are all kinds of definitional problems associated with determining rates. Furthermore, institutions can "game" improvements in graduation rates; rates can be improved by graduating fewer, better-prepared students. This doesn't serve the overall goal — raising education attainment by graduating more students.

   Regardless of the goal being pursued, it is always useful to test the metrics that will serve as drivers of the calculation by asking two questions:

   - If an institution sought to maximize its benefit on each metric what would it do? What is the easiest way to "win"?
   - Is the behavior elicited the intended behavior?

   If the answer to the second question is "no," go back to the drawing board; the chosen metrics are constructed incorrectly.

9. **Reward continuous improvement, not attainment of a fixed goal.** Creating conditions under which institutions can be rewarded only if they reach a predetermined level of performance is generally a bad idea. Either the goal will be set too low in an effort to ensure success by at least a few institutions, or the goal will be viewed as unattainable and institutions will give up before they make a concerted effort to succeed. Better each institution's current performance be established as the baseline and funds allocated on the basis of year-over-year improvements from that baseline.

States that have implemented performance funding have pointed the way to different approaches to accomplishing this objective. They include:

- Providing rewards to institutions on the basis of the number of students who complete 24 credits, 48 credits, 72 credits (TENNESSEE).
- Valuing completed credits at the upper-division level at a higher rate than at the lower-division level (OHIO).
- Rewarding institutions for students achieving certain momentum points — completing developmental education and succeeding in the first college-level courses, completing 15 credits, 30 credits, etc. (WASHINGTON community colleges).

10. Make the performance funding pool large enough to command attention.
Controversy almost always surrounds the determination of the proportion of the state appropriation to be allocated on the basis of performance. Institutions typically argue for a small percentage; there is comfort in business as usual. Policymakers take the opposite position; more is better. There is no proven right answer and different states have reached different conclusions in this regard. Tennessee for years allocated 5.4 percent of the state appropriation on the basis of performance. Under the new model, nearly all of the allocation is outcome based.

Legislation in both COLORADO and LOUISIANA sets the amount at 25 percent. INDIANA now has one of the lower amounts at 6.5 percent. A minimum of 10 percent is probably a reasonable target.

11. Ensure that the incentives in all parts of the funding model align with state goals.
In most states, the performance funding component of the allocation model is constructed on top of a base funding component that can be characterized as either enrollment driven or base-plus. The former rewards access rather than success. The second is a recipe for maintaining the status quo. The orientation-to-enrollment increases as the primary driver is reinforced by the growing importance of tuition as a revenue source. Regardless of state goals, institutions have an ever-growing incentive to increase enrollments. Both approaches to base funding work at cross-purposes to the intentions of performance funding.

Faced with these realities, it is important that steps be taken to ensure that the performance funding component doesn't get negated by the (often countervailing) incentives inherent in the base allocation. Some suggestions:

- In enrollment-driven base models, base the calculations on completed credits, not enrolled credits. This is based on the fact that programs won't be completed if courses that constitute those programs aren't completed.
- In base-plus arrangements, freeze the base at current levels and devote all *new* funds to the performance pool.
- Make the performance pool an increasingly large part of the state allocation. In states where tuition makes up half of institutional revenues, allocation of half the state appropriation to performance equates to 25 percent of institutional revenues — a level still overshadowed by enrollment-driven considerations.

The process by which the model is designed is critically important to long-term success. It's not just adherence to sound principles, but it is also the environment in which they're deployed that matters. Institutions are understandably interested in the means by which state funds are distributed. For both technical and political reasons, it is important to have institutional representatives at the table at every step. Most have knowledge and experience that will improve the final product. Equally important, their involvement improves the chances of achieving a model that has broad support.

Implement Wisely

Even a well-designed performance funding scheme will likely come up short if not thoughtfully implemented. Some basic implementation principles are:

- **Don't wait for new money.** Given the economic outlook for most states, funding the performance component of the allocation model only with new resources is a recipe for indefinite postponement. Because pursuit of state goals is such an imperative, delay in attaching performance requirements to some part of the allocation sends entirely the wrong message.

- **Include a phase-in provision.** Don't try to do it all at once. If the ultimate size of the performance fund is intended to be 25 percent, consider phasing it in at the rate of 5 percent over five years — 5 percent in year one, 10 percent at year two, etc. The objective should be to get to the target level as fast as possible without making the changes so large that institutions can't adjust.

- **Employ stop-loss, not hold-harmless, provisions.** Institutions should not be held harmless from cuts to their allocations if they are not contributing to state goals. At the same time, cuts should not be so large as to jeopardize the stability of the institution. One way to accomplish this objective is through a "stop-loss" provision that establishes a maximum cut that can be imposed in any one year — e.g., 2 percent the first year, another 2 percent the second, etc. At some point — four or five years from the point of implementation — the stop-loss provision should be sunsetted and the performance funding model should function without artificial constraint.

- **Continue performance funding in both good times and bad.** If pay for performance is intended to reward institutions for addressing the most critical issues facing the state, then it is hard to see how postponing its implementation could be a good idea. Funds that address the issues identified as being most important should be the last dollars cut, not the first. If the overall state appropriation is reduced, then the strategy should be to allocate performance dollars first and then make cuts. The net effect will be to cut the high performers less than those making a lesser contribution to state goals.

Overcome Potential Roadblocks

Those not fully sold on performance funding will raise predictable counter arguments. Among them:

- **Performance funding has been tried before with limited, if any, success. Why should this incarnation of an old idea be any more successful than previous cycles?** There are several critical differences this time around. First, if done right, it is now being driven by a public agenda; it is seen as a tool to achieve key goals, not as a device for talking the legislature into providing marginal new dollars. Second, it derives its power from a consensus about priorities, not from promotion by a single persuasive leader or a group of self-interested proponents. Third, data systems are now much improved; it is possible to calculate metrics for important outcomes directly without relying on proxy measures. Finally, legislatures are raising the stakes; it's no longer 2–5 percent, but 25 percent. It is much harder to ignore such programs than it was in times past.

- **Quality will suffer — institutions can easily graduate more students if their standards are lowered.** There are several potential responses to this concern.
  - Faculty are the guardians of institutional quality; we have every faith that they will continue to be diligent in fulfilling this responsibility.
  - We will put in place a rigorous (outcomes-based) approach to assessing quality and will monitor results on an ongoing basis to ensure that quality is not slipping.

- **What is the evidence that it has made a difference?** It's too early to judge in several cases, but there are some states in which implementation has resulted in higher performance.
  - In Texas, institutions increased degree production by 9.3 percent over baseline levels. The number of "at-risk" students graduated increased by 17.6 percent.
  - Similarly, Washington Community Colleges increased the number of momentum points achieved by 12 percent after initiation of a modest performance funding program.

- **You have to restore the base before setting aside funds for performance.** This is perhaps the most common argument put forward by opponents of performance funding. The reality is that institutions are producing their current (baseline) level of outcomes with whatever resources they currently have at their disposal. It should be expected that any new resources lead to higher levels of performance, not the same level of performance at a higher cost.

Conclusion

Performance funding is moving into the mainstream of state-level higher education financing policy. Several states have thoughtfully fashioned approaches to allocation of resources in ways that link funding to achievement of state goals. As a result, there is a growing body of information about good practices regarding design and implementation of such financing models. This brief paper is an attempt to succinctly describe those practices. The field has advanced to the point that the knowledge base regarding *how* to develop such systems is now in place. The issue now is one of political will, not technical know-how.

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