Center for American Progress

Performance-Based Funding of Higher Education

A Detailed Look at Best Practices in 6 States

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Today's fiscal environment has forced states to carefully consider how their limited dollars are spent on higher education. States have commonly allocated funds on the basis of enrollment, a process that reinforces their commitment to college accessibility and ensures a relatively equitable distribution of per-student spending across institutions. Enrollment, however, is a poor predictor of overall institutional performance. Ongoing budget cuts, combined with stagnating graduation rates and a rising national demand for highly educated workers, make it increasingly important for states to invest in completion too.

It's time to rethink the current postsecondary funding model. To ensure that taxpayer investments yield the best possible returns, states must incentivize both college access and college completion.

Performance-based funding is a system based on allocating a portion of a state's higher education budget according to specific performance measures such as course completion, credit attainment, and degree completion, instead of allocating funding based entirely on enrollment. It is a model that provides a fuller picture of how successfully institutions have used their state appropriations to support students throughout their college careers and to promote course and degree completion. Furthermore, this funding structure incorporates both enrollment and performance metrics as incentives for colleges to continue to make progress on these important objectives.

Though many new performance-based funding policies have yet to produce meaningful data, several best practices have emerged in the policy discussion. Many education leaders involved in performance-based funding have made the following recommendations:

- Gain the support and involvement of key stakeholders early on in the process.
- Ensure that enough money is apportioned for performance to create incentives that are sufficiently strong to change institutional behavior.

- Develop different funding formulas for community colleges and universities or use the same formula but weight it differently depending on the type of institution and characteristics of the student population.
- Integrate all metrics and provisions into the state higher-education-funding formula, as this makes it more durable when states are faced with budget cuts.
- Use indicators that measure both progress (course completion, momentum, credit attainment) and completion (degrees conferred, program completion), with an emphasis on progress.
- Incorporate stop-loss provisions that prevent institutions from losing more than a certain level of funding each year.
- Implement a year of learning during the first year that the policy is in effect, a period in which state spending does not change but colleges receive reports detailing how their funding would have been impacted under the new measures; and/or gradually phase in over a multiyear period the percentage of total funding allocated based on performance.
- Subject the system to frequent evaluation and make adjustments where needed.

As higher education spending continues to decline, states face growing pressure to demonstrate that they are fully invested in the long-term success of their students. Going forward, it is imperative that states and the federal government continue to explore performance-based funding options, particularly in the context of a series of outcomes-focused higher education reforms.

The following issue brief will summarize the history of performance-based funding in higher education at the state level, outline in further detail a subset of state experiences, and recommend that states continue to explore performance-based funding options in their higher education systems.

A brief history of performance-based funding

Between 1979 and 2007, 26 states experimented with measures that attempted to incorporate institutional performance as a determinant of higher education funding. During this period 14 states that had enacted performance-based funding programs eventually discontinued them, although two of the discontinuing states later re-established new programs.[1] The states' dissatisfaction stemmed from the fact that these early funding models were plagued by a number of fatal design flaws. In particular, many programs were inflexible to institutional differences, resulting in rigid and seemingly arbitrary requirements that focused too heavily on degree completion and failed to reward intermediate progress. Furthermore, many models failed to allocate enough funding to create genuine incentives for colleges to improve.

After that initial wave of ineffective models, performance-based funding has once again begun to gain popularity. Careful to avoid the mistakes of the past, proponents of "performance-based funding 2.0" tend to emphasize the need to reward progress over completion, to recognize the differences that exist between community colleges and universities, and to partition off larger percentages of base funding in order to incentivize transformative change.

Current state policies

Despite their common goals, states that currently incorporate "performance-based funding 2.0" in their higher education systems differ widely in the structure of these programs. In particular, they vary in the percentage of total funding allocated toward performance-based measures, the types of behaviors that are incentivized, and the funding formula used to measure performance between different types of institutions. Some states have had more success than others; however, most policies are too new to produce significant results at this time.

The diverse nature of current performance-based funding policies provides a useful landscape by which to analyze the effects of a variety of levers. As meaningful data begins to accumulate, policy leaders can identify best practices and develop stronger frameworks for future programs. Let's look at the experiences of several states.

Ohio

Prior to 2010 Ohio's higher education funding system relied on challenge grants, which rewarded institutions with additional funding if they met various enrollment and completion objectives. The state began to realize, however, that this system failed to properly incentivize colleges for three reasons:

- The funding came from additional sources rather than from the base allocation.
- The amount of performance-based funding that colleges could receive was too low in proportion to enrollment-based funding.
- Every school received some sort of benefit.[2]

Ohio's new performance-based funding model takes significant steps to address these and other issues. The state has allocated 5 percent of its total higher education funding for performance in 2012, an amount that is expected to rise to 30 percent by 2015.[3] To recognize institutional differences in mission, student body composition, and goals, Ohio developed three unique funding formulas for its universities, regional university campuses, and community colleges. While the universities are primarily funded based on course completion and, over time, degree completion, the formula for community colleges is more nuanced. It includes indicators such as the completion of developmental education courses, the transition between developmental and college-level courses, the completion of 15 credit-hours and 30 credit-hours of college-level coursework, the number of associate's degrees awarded, and the transfer rates into a four-year college or university. Furthermore, all of Ohio's funding formulas reward the achievements of "at-risk" students, as defined by economic, demographic, and college-preparedness data collected by the state. Doing so encourages rather than penalizes colleges for enrolling these students by recognizing that they often face greater barriers to completion.[4]

The new model also includes several provisions that address many colleges' concerns that their funding would be dramatically impacted. It contains a stop-loss provision that caps the amount of money an institution can lose in the first year at 1 percent. Furthermore, the model incorporated a learning year during which funding was not impacted but all institutions received detailed reports on what the financial impact would have been under the new policy. The state has also taken steps to make all performance results publicly available to ensure heightened accountability.[5]

Pennsylvania

Pennsylvania is an example of a state that has successfully incorporated performance-based funding into its higher education system. The Pennsylvania State System of Higher Education achieved these results by setting aside 8 percent of its state appropriation, equivalent to about $36 million, to reward schools for meeting or exceeding certain targets. The Pennsylvania State System of Higher Education developed eight performance measures that encompass a variety of key areas such as degree completion, retention, and faculty productivity. All of these targets had to be met in order for colleges to receive a share of these funds, and those schools that exceeded performance requirements received a larger portion. Since the approach was adopted in 2000, Pennsylvania's public colleges have experienced a 10 percent increase in overall graduation rates and a 15 percent increase in retention rates for Hispanic students. Many college officials have also noted a positive change in institutional culture—one that is more clearly focused on solving issues and increasing efficiency.[6]

In 2011 the Pennsylvania State System of Higher Education made several improvements to its performance-based funding model to better incorporate specific institutional goals. Beginning in 2012 colleges are measured against 10 separate performance indicators, half of which are unique to the institution. The five metrics that remain across all institutions are the number of degrees awarded, graduation rates, reduction in achievement gaps, diversity of the faculty, and private donations. Colleges are also measured against national performance standards where appropriate.[7]

The improved model also reduces competition over performance funds by eliminating additional funding for colleges that exceed performance measures. Of course, progress is still accounted for—particularly through the institution-specific metrics, which are based on the strategic goals of the institution and encourage improvement. The Pennsylvania State System of Higher Education also adjusted their funding formula so that the percentage of funding allocated toward performance is now calculated from the total education and general budget, instead of the smaller appropriations pot. This allows total funding to remain more stable in the face of declining state appropriations. Under the improved formula, overall funding based on performance remains unchanged at approximately $36 million annually.[8]

Indiana

Indiana's Reaching Higher initiative allocates 5 percent of its total higher education budget for 2011–2013 performance-based funding. Unlike Ohio, the state's performance-based funding system does not distinguish between different types of institutions; rather, it uses the same benchmarks across the board. Indiana assesses college completion based on several performance indicators, including the number of degrees conferred, degree completion of low-income students, and the number of community college transfers.[9] Institutions receive $5,000 and $3,500 for each additional bachelor's and associate's degree produced the previous year, respectively.[10]

Indiana has also taken an important step toward restructuring how the enrollment portion of higher education funding is measured: The state determines enrollment levels at the end of the semester, rather than at the beginning, to emphasize the importance of course completion.[11] Doing so incorporates a stronger element of accountability into enrollment-based funding. As a result, Indiana essentially allocates a much larger portion of funding based on performance than it would appear.

Tennessee

Tennessee has implemented the most aggressive performance-based funding model—over several years 80 percent of total state higher education funding is expected to be allocated on the basis of performance. The Complete College Tennessee Act of 2010 introduced performance-based funding as one item in a package of reforms centered on college completion.[12] Performance is measured on the basis of student retention, degree attainment, and completion of remedial courses. The state also incorporates a 40 percent premium in its funding formula for adults and students receiving Pell Grants. To address institutional differences between community colleges and four-year universities, funding formulas are adjusted to weigh various factors—such as retention, research, or job placement—more heavily depending on the institution's focus.[13] Tennessee's formula is output based and sets no specific targets.[14]

Washington state

Washington initially implemented a performance-based funding program in 1997 for all of its higher education institutions, but the program was discontinued just two years later in 1999 due to a lack of popular support. College leaders and the higher education boards were frustrated that they had little voice in the legislative discussion, which left them unable to propose institution-specific metrics or have time to prepare for the impacts of the policy once it was implemented. Furthermore, as a simple budget provision, performance-based funding could be easily eliminated.[15]

The Washington State Board for Community and Technical Colleges made a second attempt at performance-based funding in 2007 and adopted a new model as part of its Student Achievement Initiative for community and technical colleges. After a learning year in 2008, the board began to implement these measures in 2009.[16]

The Student Achievement Initiative was developed by a task force of higher education board members and institutional leaders. Under this model, colleges receive money for each so-called achievement point attained. This money is allocated through supplemental funds, leaving base funding untouched. Achievement points are accrued based on the number of students who:

- Improve their scores on basic skill tests
- Make progress in remedial courses
- Complete a college-level math course
- Earn 15 college credits and 30 college credits
- Receive a degree or certificate
- Complete an apprenticeship training program[17]

Washington's model—elements of which have been adopted in Ohio, as well—attempts to recognize the challenges associated with educating at-risk populations by rewarding incremental gains such as the attainment of pre-college skills.[18]

From 2007 to 2011 the Student Achievement Initiative has delivered relatively strong results. During that period, colleges increased their achievement point total by an average of 31 percent and experienced moderate gains in momentum. At the same time, however, only about 50 percent of students contribute any points.[19]

Louisiana

In 2010 Louisiana implemented a controversial performance agreement system called the GRAD Act that allows institutions to increase their tuition by 10 percent each year if they meet certain goals for performance.[20] These targets encompass a variety of objectives relating to student performance, articulation and transfer, workforce development, and efficiency and accountability. The GRAD Act is expected to eventually comprise 25 percent of an institution's total budget.[21]

Developing a system

As evidenced by the range of state policies in existence today, there are a variety of factors that influence the structure of a performance-based funding system. Some of these design considerations include:

- **Who is implementing the system?** Given the political and fiscal climate of individual states, it may be better that performance-based funding is legislated by the state, as was the case in Tennessee. At the same time, education boards such as the Pennsylvania State System of Higher Education might find it more appropriate to voluntarily implement a policy, either as a pre-emptive measure to future legislation or to encourage institutions to assume greater accountability for performance.

- **Who are the key stakeholders that should be involved in the discussion?** Many leaders of performance-based funding stress the necessity of attaining widespread support prior to implementation. Though they vary between states, many of these key stakeholders include board members, legislative offices, institutional leaders, faculty members, businesses, and education organizations. These individuals and groups should be actively included in the system design process.

- **What state- and institution-specific performance goals should be incorporated in funding?** When developing performance metrics, policymakers should consider both overarching state and national goals for higher education performance and the goals of individual colleges. Consideration must also be given to how an institution's unique mission and student population affect performance, as these factors are critical to setting reasonable targets and performance indicators. State goals and institutional characteristics should also determine how much more emphasis is placed on progress than completion.

- **How can states allocate funding toward performance most effectively?** The majority of performance-based funding models have provided a financial incentive for improved performance in the form of state appropriations to institutions that meet certain goals. Other models incentivize performance by rewarding greater institutional autonomy such as a heightened authority to adjust tuition prices. There are three basic types of performance-based funding models:

  - **Output-based funding formulas** such as the one used in Tennessee incorporate performance metrics into the state funding formula. Rather than set specific targets, these models create a financial incentive for institutions to generate positive outcomes in certain areas such as increasing the number of students who attain credit and degree completion milestones. Institutions can boost their total funding by improving their results on these metrics. Output-based formulas are often weighted to recognize differences in institutional mission and student population.

- **Performance set-asides** allocate a percentage of the higher education state appropriation for performance-based funding. Money may be drawn from either the base funding or from additional sources. Institutions compete for shares of the performance fund by producing results that meet or exceed certain targets. This model is in use by Pennsylvania's colleges.

- **Performance contracts** are personalized agreements between states and individual institutions in which a certain level of funding is guaranteed if the institution meets specific goals. Louisiana's GRAD Act, for example, establishes a performance contract between the state and its public colleges.[22]

• **What additional funding provisions are necessary to remain sensitive to the needs of individual colleges?** Policymakers should take careful steps to ensure that the funding formula incorporates provisions that recognize and address potential institutional concerns. One commonly expressed fear is that performance-based funding undermines an institution's autonomy. Many states with successful policies have dispelled these concerns by working closely with institutional leaders and the community during the design and implementation period.

Another frequent worry is that performance-based funding creates uncertainty for colleges during the fiscal planning process. To address this concern, some states, including Ohio and Washington, have incorporated a learning-year into the process and have provided detailed reports in order to familiarize colleges with the expected funding impacts of the policy. Many states have gradually increased the amount of funding allocated based on performance to provide colleges with more time to adjust their behavior. Many policies also include stop-loss provisions that prevent dramatic fluctuations in funding. Other funding formulas calculate allocation based on multi-year averages rather than just on the previous year.[23]

Another complaint is that it is unfair to hold colleges to certain performance standards because their differing student populations and missions affect completion rates and other measures of performance. There have been a variety of different approaches to ensuring that the performance-evaluation process is a fair representation of this diversity in mission and student body. States such as Ohio use different funding formulas for community colleges and universities. Others, including Pennsylvania and Tennessee, adjust their metrics based on institutional differences or weigh certain factors differently. Many policies also include additional incentives and premiums for reducing achievement gaps or demonstrating progress in low-income or minority student persistence and completion.[24]

Best practices

The multitude of state experiences with performance-based funding reveals a number of best practices in the system design-and-implementation process. The following lessons should help guide states that are looking for ways to hold higher education institutions accountable for success.

- **Actively involve key stakeholders in the funding model's design.** Much of the success of Ohio's, Pennsylvania's, and Washington's newer programs can be attributed to the widespread support those states received from institutional leaders and the important contributions they made to ensuring the metrics were a fair representation of performance.

- **Ensure that enough money is apportioned for performance to create strong incentives.** Enough of an institution's funding should be determined by performance to compel actions that would significantly change institutional behavior. Models that allocate performance money from the base budget, as opposed to creating supplemental funding, are more likely to result in stronger incentives.

- **Recognize institutional differences with separate funding formulas or differently weighed metrics.** Community colleges and universities are each unique in their student population, mission, and goals. They therefore require separate funding formulas or should be evaluated against metrics that are weighed differently, depending on their specific characteristics.

- **Integrate all metrics and provisions into the state formula.** Incorporating performance funding into the state's higher education funding formula, rather than as a set of add-on provisions, makes the overall system more durable when states are faced with budget cuts.

- **Use indicators that emphasize progress.** Early performance-based funding models placed too much emphasis on completion rather than progress, creating unfair and inflexible targets for colleges that serve large at-risk student populations. Newer models stress the importance of progress indicators such as course completion, momentum, and credit attainment, which allow institutions to exhibit performance through incremental measures of individual student progress. Indicators of completion such as degrees conferred and program completion should also be used in a progress context by allowing institutions to demonstrate their improvement over time.

- **Incorporate stop-loss provisions that prevent institutions from losing more than a certain level of funding each year.** A stop-loss provision can help to assuage a major concern by colleges that the new system will create dramatic fluctuations in funding. It also provides institutions with greater leeway to adjust to the new policy.

- **Gradually phase in new measures.** During the implementation phase, states must take care to reduce fiscal uncertainty for colleges. Many models incorporate a learning year before the policy goes into effect, and states such as Ohio also worked closely with colleges to help them understand the impacts of the new funding model. As colleges begin to adjust to new measures of performance, states can also gradually increase the percentage of total funding allocated based on performance.

- **Subject the system to frequent evaluation.** After the new policy goes into effect, colleges may encounter unexpected difficulties with achieving certain performance targets. Institutions producing results that already meet or exceed national standards may also find it difficult to achieve continued progress over extended periods of time. As a result, performance-based metrics and the overall higher education funding model should be subject to frequent review and adjustments should be made where necessary. Doing so provides institutions with more reasonable challenges and greater flexibility over time.

Going forward, a careful analysis of the impacts of "performance-based funding 2.0" measures should help revise and expand on these best practices.

Recommendation

The ongoing policy debate on higher education budget cuts has compelled an increasing number of states to adopt performance-based funding models. Although it is short-sighted to reduce state budgets for higher education, the shift toward experimentation with performance-based funding is a welcome result and should be encouraged.

The U.S. Department of Education should direct a research study that more closely examines the costs and benefits of "performance-based funding 2.0" programs and identifies best practices. The department might also use the experimental site authority granted to it by the Higher Education Opportunity Act of 2008 to develop pilot projects in states that lack performance-based funding measures. Doing so would help policy-makers understand if a need for a federal role exists and, if it does, how to move forward with policies that encourage states to embrace performance-based funding. Linking performance to funding in the higher education realm may also have analogies to other sectors and are worth exploring at the federal level.

Conclusion

The recent wave of "performance-based funding 2.0" measures signals a change in the way states are prioritizing goals in higher education. Institutions must go beyond simply raising enrollment; they must also ensure that students complete their degrees and graduate with the skills to be successful in an evolving economy. As the national conversation on higher education shifts toward completion, it must be accompanied by equally significant changes in institutional behavior. Performance-based funding is a necessary step toward aligning the objectives of state and institutional leaders, while ensuring that states are investing their limited funds wisely and productively.

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Endnotes

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