

## Virginia Higher Education Performance Funding Model

The Council of Higher Education is tasked under *Section 23-9.9* of the *Code of Virginia* to "develop policies, formulae and guidelines for the fair and equitable distribution and use of public funds among the public institutions of higher education" and to use those policies, formulae and guidelines in making recommendations to the Governor and the General Assembly regarding the "approval or modification of each institution's [budget] request."

At its regularly scheduled meeting of May 18, 1999 the Council adopted the following resolutions:

**BE IT RESOLVED** that the Council of Higher Education adopts the following funding model components:

- 1. Free institutions from unnecessary regulatory constraints, thereby allowing them to pursue their missions with greater efficiency and creativity. Institutions shall remain accountable to the law and, as a minimum requirement of the block grant, shall have to meet internal and external audit standards. The state shall provide general best practice guidelines/principles from which institutions shall establish their own internal policies and procedures. Institutions that fail to manage their human, fiscal, and capital resources appropriately shall fall into receivership, and if corrective action were not taken, shall be closed.**

**Annually adjust the block grant to account for such technical issues as one-time expenditures, annualization of salaries, and Higher Education and Equipment Trust Fund and to exclude equity funding and Unique Military Activities funding.**

- 2. Use a Virginia-specific version of the Higher Education Price Index (HEPI) to calculate inflationary growth in the block grant, the specific version to be approved by the Council.**
- 3. Include maintenance reserve in the block grant and separately calculate future resource needs on the basis of general programmatic criteria.**

**BE IT FURTHER RESOLVED** that the Council of Higher Education directs the staff to 1) propose specific thresholds as "triggers" for base budget adequacy review with respect to significant changes in institutional mission, programs, enrollments, and new construction. 2) to devise procedures and methods to review base budget adequacy for subsequent adoption by Council, and 3) to develop specific performance measures consistent with the general provisions adopted by Council.

## **Overview of the Proposed Funding Model**

Pursuant to Council's earlier decisions and guidance, the key components of the revised funding model are:

- *Initial Assessment of Base Budget Adequacy* --- Staff shall conduct an assessment of base budget adequacy during the summer of 1999 in preparation for the Council's fall 2000-2002 budget recommendations. The purpose of this analysis would be to ensure that proposed block grants did not perpetuate and carry forward any potential funding inadequacies.
- *Block Grant* --- Defined as the prior year's base budget and comprising all Educational and General (E&G) appropriations (general fund and tuition and fee revenue). The block grant entails the deregulation or decentralization of certain provisions identified by the Council, such as removing MEL caps and allowing institutions to earn interest on tuition and fee balances. However, the block grant shall be conditional on institutions meeting certain minimum requirements, such as adherence to management and audit standards.
- *+/- Technical Adjustments* --- These shall include adjustments for such things as one-time-expenditures (e.g. Y2K), removing expenditures funded through other sources such as technology purchases related to the Higher Education Equipment Trust Fund, and annualizing classified and faculty salaries.
- *+ Inflationary Growth Factor* --- Comprised of a composite price index to be developed by staff and approved by Council. In addition, separate analyses shall be made for recommendations regarding Maintenance Reserve and certain special categories of expenditures such as technology purchases related to the Higher Education Equipment Trust Fund.
- *+/- Base Budget Adequacy Adjustment* --- Periodic review of base budget adequacy may be triggered by specific factors identified by the Council, such as significant changes in institutional mission, programs, enrollments, or new construction.
- *+/- Incentive Funding* --- funding tied directly to performance relative to specific outcome measures identified by the Council.

## **Background**

From the early 1970s through the early 1990s, the Council employed a formula funding model, commonly referred to as "Appendix M," to accomplish this task.

Appendix M was an enrollment driven "input" model that used discipline-specific average student/faculty ratios and other mathematical indices to project future resource requirements based on anticipated enrollments. Appendix M was abandoned in the early 1990s when recession-engendered across-the-board funding cuts rendered its formula-driven recommendations of little use.

With the demise of Appendix M, formula funding was replaced with funding policies that have tended to be more incremental and *ad hoc*. In essence, funding has been based on institutions' current operating budgets and *ad hoc* biennial recommendations regarding additional funds for salaries, enrollment growth, operations and maintenance, library materials, technology, capital outlay, and various institution-specific initiatives. Because this process does not provide for the application of consistent, stable, and comprehensive planning guidelines, it has engendered a funding environment that is characterized by uncertainty, fragmentation, and intensified log-rolling.

Toward the end of developing a more systematic funding approach for higher education, the Council directed staff in late 1998 to assemble options for revising Virginia's higher education funding policies. As part of this effort SCHEV staff made a presentation to the Resources Committee at its November 1998 meeting on the current process and timelines adhered to by staff in making budget recommendations. This was followed in December with a presentation on the history of higher education funding policies in Virginia.

In January the Resources Committee held a retreat to discuss options for revising the current funding policies. At that retreat a Council consensus favored adopting a block grant approach. This approach would decentralize the front end of the funding process, thereby maximizing the ability of Virginia's public colleges and universities to allocate resources creatively and efficiently in pursuit of their institutional missions. At the same time, however, institutions shall be held accountable for the responsible use of their resources, through a combination of (1) routine reviews of the outcomes of their expected performance and (2) additional incentives to innovation through funding. These discussions were subsequently reported to the full Council at its regularly scheduled January meeting.

Based on input received at the January retreat and a February 1999 meeting of the Finance Advisory Committee in which workgroups were established to provide input on issues pertaining to base budgets, incentive funding, and decentralization, staff further refined the funding policy proposal and identified options regarding key parameters. These options were distilled into a

"decision tree" that was presented at Council's February meeting. At that meeting the Council:

- adopted a funding policy work plan that calls for extensive interaction during the period between February and May among SCHEV staff and FAC, IPAC, and GPAC regarding the revised funding guidelines, adoption of a preliminary model and draft policy document at Council's April and subsequent meetings;
- stipulated that the revised guidelines will reflect a decentralized or "block grant" approach;
- agreed that the block grant will be comprised of all Educational and General expenditures (E&G), and, in addition, maintenance reserve funding;
- instructed staff to conduct an analysis of current base funding adequacy;
- stipulated that the method used for making biennial recommendations regarding base budgets will entail technical adjustments (e.g., adjustments for one-time items and annualization of salaries) and an inflationary growth factor;
- decided that enrollment growth funding will not be provided *per se* as part of the block grant, however, funding for marginal enrollment growth may be accommodated through incentive funding recurring in the base and periodic re-evaluation of base budget adequacy; and
- agreed that the revised guidelines will include a performance funding component.

Based on this guidance, and taking into account input received at a March 9 joint FAC/IPAC meeting to address performance measures and a March 31 FAC meeting to address issues pertaining to decentralization, staff further developed the revised funding policy proposal. The further developed model was then presented to the Resources Committee at its April meeting. At that meeting Resources Committee members directed staff to develop scenarios regarding implementation of the block grant and performance funding proposals. In addition, Resources Committee members voted to approve the funding proposal as amended and forward it to full Council for consideration at the May Council meeting.

The remainder of this document details key features agreed to by Council members at the February and April Council and eventuating in the provisions adopted in the May meeting.

## Deregulation/Decentralization and the Block Grant

### The Challenge

The challenge for state governments has been to provide higher education the tools necessary to manage their affairs while at the same ensuring that institutions are accountable to the state for the efficient use of the resources they receive. Dr. Kenneth Shaw, Chancellor of Syracuse University, in a 1996 article entitled *Helping Public Institutions Act Like Private Ones*, challenges states to volunteer to be the first to attempt true regulatory reform. Virginia is in a position to take such a challenge.

Virginia has been discussing deregulation/decentralization, since the early 1980's. During the 1990's, under the leadership of the Secretaries of Finance and Education, much has been accomplished in providing opportunities for decentralization in areas of financial management. However, much of the conversation thus far has, for the most part, centered around benefits to the institutions with little focus on benefits to the state. The proposal now before the Council provides a new paradigm. Not only will deregulation/decentralization be discussed in the context of benefits to the institution, but also with it come benefits to the state.

As in private business, in order for organizations effectively to manage resources, they must be in control to do so. That means that they not be so over-regulated that they cannot quickly make decisions about people to hire and the amounts to compensate them or what to buy and from whom to buy it. If every resource, whether physical, human, or fiscal is controlled by central processes, institutions cannot be fully accountable for their actions or failure to act. This is the premise behind deregulation and decentralization. In order to hold institutions fully accountable for results and outcomes, the institutions must first be in full control of their resources. Through day to day management, working toward stated goals, institution management and faculty can be held accountable for what is achieved and what is not. However, this will not work if deregulation leaves the state with more problems or less success than it had previously. Therefore, a system of accountability, whereby the state has key indicators by which it measures institutional success, and an effective audit process, are integral to this model.

### Decentralization/Deregulation

Along with a base budget, provided in the form of a block grant, institutions should be deregulated from unnecessary central processes. Such deregulation in Virginia shall come not in the form of exemptions from law but in the form of freedom from regulations promulgated in administering the law. The state would provide general best practice guidelines/principles, from which

institutions would establish their own internal policies and procedures. Audit review, both internal and external from such bodies as the Auditor of Public Accounts, would assess institution compliance with law and with institutional policies and procedures. All audit reports shall be reported to Boards of Visitors, who, via their governing responsibilities, shall be held accountable for requiring corrective action if deemed necessary.

The following specific proposed deregulatory initiatives would allow institutions fully to control their own resources and allow the state to hold institutions fully accountable for the outcomes obtained with those resources.

### *Procurement*

The Procurement Act is law. Institutions, under this proposal shall still be subject to the state procurement law, but would not be required to follow state regulations as promulgated by such central agencies as the Department of General Services, Department of Information Technology, and/or other bodies. The following policies and procedures adversely affect procurement practices: Virginia Correctional Enterprise Furniture Release Request, Minority Purchases Report, Off-state Contract Report, Sole Source Report, CIMM IT purchases over \$50 report, CP-15 Form for Vehicle Purchase, mandatory State Contracts by the Department of Purchase and Supply and Department of Information Technology, Bid Bonds for Projects over \$100,000, VPO Advertising requirement, and Virginia Industry for the Blind Purchases.

To promote effective procurement by the institutions, they should be allowed to purchase furniture without external approval, be relieved of onerous reporting requirements, and released from mandatory contracts. What should occur instead, is that the state should set guidelines for best practices in the context of procurement activities (e.g. to keep costs low and ensure that the state receives the best prices) and leave it up to the institutions to set policies and procedures to achieve those goals. The internal audit activities of the institution will determine whether those internal policies and procedures have been met and the external audit activities of the state, via the Auditor of Public Accounts (APA), will determine if the institution is in compliance with state Procurement law and if its operations are consistent with best practices.

### *Personnel*

In order to deregulate personnel, institutions need to be freed from the classified system. This would allow institutions maximum flexibility in reacting and adapting quickly to human resource needs of the institutions. It would free them from a very rigid and confining system in controlling one of their largest resources – people. For two reasons, this may require special sensitivity: 1) the long history of the classified system and traditions associated with it and 2) the Governor has established a Commission on Reform of Classified Compensation

Plan, which may provide greater flexibility in the classified system structure. That said, optimal control would be full freedom from existing regulations.

There is some precedent for removing employees from the classified system. Effective the year 2000, the Medical College of Virginia Hospitals' employees will no longer be classified employees as a result of the establishment of the Hospital as a public authority in 1996. Decision-makers recognized certain responsibilities to existing classified employees and grand-fathered them until 2000. After 2000, employees will be subject to policies and procedures of the Authority and not the state system. The rationale for creation of a public authority was to free MCV from state rule and to eliminate the obstacles that inhibited MCV's ability to compete in a very competitive environment. In order for MCV to compete with other area hospitals, it had to be freed from state regulations such as those described herein. In addition, the University of Virginia Medical Center is also provided relief from the Virginia Personnel Act in order to provide maximum flexibility for health care professionals. Health care professionals have actually been exempted from the Virginia Personnel Act since the early 1980s to allow for effective recruitment and retention of specialized personnel.

Instead of the current personnel system, the state should set guidelines for best practices in the context of personnel activities (e.g. ensuring fair and equitable treatment of personnel) consistent with law and leave it up to the institutions to set policies and procedures to achieve those goals. The internal audit activities of the institution will determine if those internal policies and procedures have been met and the external audit activities of the state via the Auditor of Public Accounts (APA) will determine if the institution is in compliance with applicable state law and if its operations are consistent with best practices.

### *Real Property Management*

Currently institutions must follow the regulations of the Department of General Services when seeking to enter into lease agreements, in dealing with easements, acquisition, and disposition of property. Many times, these processes can add weeks, months, and more to the institutions' plans of action. In some cases, the time consuming nature of these activities can be costly. Consistent with the issues of personnel and procurement, guidelines for appropriate management of real property consistent with state law should be established. These guidelines shall reflect best practices in the area of property management. Institutions shall then be required to establish policies and procedures for effective management of real property. Institutional actions shall be subject to audit activities, both internal and external.

## *Management of Tuition and Fee Revenue*

Currently tuition and fee revenue, although non-general fund revenue, is defined as state funds by Code. Revenues are kept within the state treasury and invested by the State Treasurer. Interest earnings, or yield, on these revenues are considered general fund dollars and are credited to the general fund balance of the Commonwealth.

The Department of Treasury estimates yield on tuition and fee revenue at approximately \$33 million annually (estimate based on 1997-98 balances). Auxiliary enterprise balances are also treated like tuition and fee revenue in that they are deposited to the state treasury and appropriated. However, one significant difference between auxiliary revenues and tuition and fee revenue is that institutions are credited with yield so long as they demonstrate that they fully recover costs from auxiliary enterprise operations and support portions of the education and general program that provide overhead services to auxiliary functions (e.g. payroll, finance and accounting, etc.).

Business has full control of its revenues. It invests those revenues pursuant to internal guidelines usually with the goal of maximizing return while minimizing risk. This return on investment provides additional operating and capital resources for the firm to operate. It is recommended that institutions be allowed, where able, to manage their own tuition and fee revenues and hence maximize their revenues. If institutions are unable to manage their revenues (e.g. may not have sophisticated Treasury functions within the organization), then they should build up the functions in order to adequately and appropriately maximize the investment of such funds or, at least, be credited with the yield on such balances.

Not only does this give institutions additional resources on which to operate, it also provides control to Treasury and Finance functions for financial management dealing with cash flow and investment funds.

## *Accumulated Balances*

Even though institutions that meet management standards are allowed to retain balances to spend in the next year, there is often a concern that, as a result of economic conditions, political climate, or other reasons, balances may not actually be retained. In addition, institutions may fear that accumulated balances will be perceived by policy makers as an indication of over-funding.

Because of these concerns, institutions are reluctant to accumulate balances for future purposes. This is not a practice we should encourage. Like any business or organization, long-term planning is integral to progress. In order to plan for change and improvement, many times resources must be identified over the long haul. If institutions are not allowed, with 100 percent certainty, to

keep accumulated balances, the incentive will be to spend and not to save. We need to change this paradigm.

### *Eliminate the Consolidated Salary Authorization*

The Commonwealth has had a long-standing policy of funding faculty salaries on the basis of national peer group comparisons. The Consolidated Salary Authorization (CSA) governs faculty salary increases. In order to be sure that funds for salary increases are in fact spent on salary increases, the CSA requires that actual average faculty salaries be no more than one percent greater or less than the appropriated average salary for a given year. In the context of a block grant model, where funding for salaries shall be an integral part of the block grant, there will not be a need to benchmark salary increases nor to monitor actual results against that benchmark. Instead, it will be up to the institution to make decisions regarding its priorities and to allocate the block grant as it sees fit.

Eliminating the CSA will allow institutions to provide salary increases as necessary to retain and attract faculty without rules and regulations that dictate tolerance levels. Without such rules, the institutions will be in better control of their resources and will more easily be able to react to changed needs with regard to salaries and demands on other resources.

Central agencies will still be able to monitor faculty salary trends by examining expenditure data on all classes of employees. If such trends provide policy makers with cause for concern, institutions could be required to explain their actions and decisions about resource allocations. If corrective action is necessary, it can be taken on a post audit basis.

### *Eliminate Employment Restrictions*

Currently the Appropriation Act stipulates a maximum employment level (MEL). It is an upper limit for employees in the educational and general program. This binding restraint can sometimes severely limit an institution's ability to react to changing employment needs. Fiscal pressures are usually the best constraining factor for employment levels, and the state should not dictate the appropriate level of employment for each institution. Instead, the financial resources and management operations of each institution should define that level.

Employment levels can still be monitored, and if trends provide policy makers with cause for concern institutions shall be held accountable for their actions and required to explain their decisions.

### *Unrestricted Use of Tuition and Fee Revenues from Additional Enrollment*

Institutions should be allowed to keep the tuition and fee revenue associated with new enrollment. Since additional enrollment will not be funded under the block grant, but instead only as a consequence of deliberate enrollment planning decisions, the incremental revenue associated with enrollment growth should be available to the institutions to accommodate that growth. It is recommended that institutions be allowed to keep additional tuition & fee revenue associated with new enrollment and such revenues should be retained undesignated. In the context of a block grant, institutions should have the ability to allocate incremental tuition and fee revenue according to internal priorities rather than having the state dictate the purposes for which those funds will be used.

### Institutional Accountability

The aforementioned provisions for deregulation/decentralization are premised upon increased accountability, not only through more stringent audit procedures and the creation of best practice criteria, but also in requiring certain student outcomes (covered in further detail in the incentive funding section of this proposal). Increased accountability will be critical to assess the success of institutions' abilities to manage outside of a centralized system.

In November of 1998, The Council adopted the following list of administrative best practices:

- Careful selection and training of administrative personnel;
- Organizational structure that provides appropriate division of duties;
- Thorough and continuous monitoring, control, and reporting of operating budgets versus actual operating results;
- Well-communicated written policies and procedures;
- Annual self-assessments led by the university controller; and
- An extensive internal audit function that provides both financial audit and management services functions.

These best practices are intended to be used in conjunction with, and supplemental to, the existing management standards and other existing management tools. The purpose of these best practices is to offer a series of performance objectives that:

- Relate to the conduct of the financial and administrative operations within and throughout each fiscal year;
- Reflect commonly held views and experiences as to policies, procedures, and practices that, when applied on a consistent and thoughtful basis, help protect a college or university from unexpected financial reverses or other negative circumstances;
- Contribute over time to producing the most effective financial and administrative support for an individual institution; and
- Can be both affirmed by senior management of an institution and confirmed through appropriate review by internal audit staff and the Auditor of Public Accounts.

Since the mid-1980s, colleges and universities in Virginia have been required to conform to five "Commonwealth Management Standards" as a pre-condition to certain management and financial benefits. They are intended to serve as "indicators" of the presence of an effective foundation of policies, procedures, systems, staffing arrangements, training, and management oversight that would enable an institution to carry out effectively overall disbursement and revenue cycles. It is expected that these management standards, as well as the Council approved best practices, and new best practice guidelines associated with procurement, personnel, and real property management would be integral to the management and audit functions of the institutions.

If an institution fails to manage its human, fiscal and capital resources in appropriate manners as dictated by such standards, it shall fall into receivership. This means that the institution would lose its deregulated status and again become part of the state's centralized processes whereby its management would be closely scrutinized and a recovery plan required. Should the institution not take corrective action, and within a reasonable amount of time begin to demonstrate positive outcomes, the Commonwealth would seriously consider closure. Like any business, if it fails to manage its resources effectively and efficiently and its product suffers, it goes out of business. A truly deregulated environment brings this consequence as well.

This process would not be one that takes place in a short period of time or on an ad hoc basis however. The Council would systematically examine institutional performance on an annual basis in order to identify areas of potential concern. The Council shall examine how well an institution performs with respect to the best practice criteria, internal controls and procedures, and state fiscal policies and standards. In addition, the Council shall examine institutional success in the context of other measures as well. Such measures shall include, but not be limited to, the following:

- Has the institution met its enrollment plan without compromising acceptance standards?
- How does the institution fare longitudinally with regard to the performance measures adopted in the context of the incentive funding portion of the model?
- How does the institution fare on other performance indices such as the Department of Planning and Budget performance measures and various national rankings?
- Has the institution met its goals and objectives set out in the institutional strategic plans?

Departure or variation from positive trends would be indicative of problem areas. Such warning signs shall require the Council to step in. In its initial inquiry, the Council shall require an explanation for the variation and a corrective action plan. In this context, the Council would closely monitor the corrective action taken by the institution and would expect, within an agreed amount of time, that improvement shall take place.

If an institution fails to deliver on its corrective action plan and positive results are not demonstrated, then the Council shall recommend that the institution lose its block grant status, including the corresponding deregulation/decentralization. The institution shall, as a result, fall into receivership. Significant public exposure would come with such an action. This, by its very nature, is a significant sanction for lack of performance. If after significant intervention through receivership, the institution still fails to perform to expectations, then the Council shall have the authority to recommend closure.

### **Technical Adjustments**

At its February meeting the Council directed staff to include in the funding model provision for technical adjustments to the block grant. As part of its budget development, the Department of Planning and Budget (DPB) currently makes routine technical adjustments to the base budget of each public college and university. These adjustments entail such things as adding or deleting one-time expenditures (e.g., Y2K) and the annualization of salaries. Recommendations for such adjustments could be obtained from DPB and/or developed internally by Council staff. In addition, allocations for technology and equipment purchases related to the Higher Education Equipment Trust Fund should be removed as funding for these items are otherwise provided.

Beyond the list of technical adjustments currently made by DPB, if classified salaries are not decentralized, then they will continue to be a non-

discretionary and centrally determined component of the institutions' E&G budgets.

### **Inflationary Growth Factor**

Another decision reached by Council at its February meeting was that the block grant shall be adjusted to account for inflationary growth. Adjustments for inflationary growth are typically accomplished through the use of a price index. Put simply, a price index tracks the change in price of a representative "market basket" of goods and services over time. Changes in the price of the same quantity and quality of goods and services over time constitute inflation because more nominal resources (money) are required to obtain the same level of real resources (goods and services).

Because a *representative* market basket of goods and services varies according to who is being represented, different price indices are calculated to measure the inflationary pressures encountered by different individuals or entities. For instance, the Bureau of Labor Statistics' Consumer Price Index (CPI) tracks changes in the prices of the typical household's purchases (e.g., food, housing, transportation, medical services), whereas the Producer Price Index (PPI) tracks changes in the prices of the typical firm's purchases (e.g., labor costs, raw materials, insurance).

From a methodological perspective, if a price index is to accurately reflect inflationary changes, the market basket it is predicated on must closely match the consumption patterns of the individual or entity of interest. This is true, not only of the types of goods and services purchased (e.g., bread vs. heavy machinery), but also of the relative weights associated with each category of good or service (e.g., the proportion of a consumer's total purchases that go to heating oil in Vermont vs. Georgia). If the goods and services, and the relative weights are not representative of the individual or entity of interest, the price index will provide potentially misleading information on the inflationary pressures experienced by that individual or entity.

There are three main price indices that could be used to account for the inflationary pressures experienced by institutions of higher education in Virginia:

- *Consumer Price Index (CPI)* --- The CPI is produced by the U.S. Bureau of Labor Statistics (BLS). It measures average changes over time for a fixed market basket of goods and services purchased by the typical American consumer. The components of this market basket include food, clothing, shelter and fuels, transportation, medical services, and drugs. BLS publishes separate indices for four regions--Northeast, Midwest, South, and West, as well as specified metropolitan areas.

Advantages: The CPI is well known and frequently used to measure changes in consumer purchasing power.

Disadvantages: As BLS clearly explains, "the CPI is generally the best measure for adjusting payments to *consumers* when the intent is to allow them to purchase, at today's prices, the same market basket of *consumer goods and services* that they could purchase in an earlier reference period." This means that the representative market basket of goods and services used to compute CPI is unrepresentative of the market basket of goods and services purchased by Virginia's public colleges and universities. As a result, it would present a completely misleading picture of the inflationary pressures encountered by those institutions. In addition, BLS does not publish state specific CPIs.

- *Implicit Price Deflator for State and Local Government* --- Implicit Price Deflators for State and Local Government are produced by the U.S. Bureau of Economic Analysis (BEA) and WEFA. As part of its calculations of Gross Domestic Product, BEA produces a price index that tracks price changes in typical state and local government purchases. A similar index is produced by WEFA, a private firm. The WEFA index is currently used by DPB as part of the Standards of Quality model when making budget recommendations for elementary and secondary education. Both indices are produced at the national level only.

Advantages: The biggest advantage to the Implicit Price Deflator for State and Local Government is that, the WEFA version is currently being used by Virginia state government to make recommendations for growth in the state elementary and secondary education budget in much the same way that the Council proposes to use a price index for recommendations regarding public higher education budgets. As a result, it already has some acceptance.

Disadvantages: Because the Implicit Price Deflator for State and Local Government is predicated on the typical purchases of state and local governments generally across the nation, it much like the CPI, does not accurately reflect the market basket of goods and services purchased by institutions of higher education. In particular, it would be heavily weighted toward purchasing patterns for elementary and secondary education, public safety, public assistance, and transportation. As a result, it too would provide misleading information regarding the inflationary pressures encountered by those Virginia's public colleges and universities.

- *Higher Education Price Index (HEPI)* --- The HEPI is produced by Research Associates of Washington. It measures "the effect of inflation on the current operations of colleges and universities." The primary components of the market basket of goods and services used to compute the HEPI are professional salaries, nonprofessional wages and salaries, fringe benefits, services, supplies and materials, equipment, library acquisitions, and utilities. The HEPI is also produced only at a national level. However, for a fee Research Associates will make available a spreadsheet that details the

components of the index and can be used to re-weight the index to reflect local purchase patterns.

Advantages: Because the HEPI is predicated on a market basket of goods and services that is specific to higher education, it clearly is the most representative of the inflationary pressures encountered by institutions of higher education. Moreover, because it would be possible for staff to re-weight the index to reflect the typical purchasing patterns of local colleges and universities, it is possible to revise the HEPI to make it the most representative index for Virginia's institutions of higher education. This means, of the available three indices, the HEPI would provide the most accurate picture of the inflationary pressures encountered by Virginia's public institutions of higher education.

Disadvantages: To date, the HEPI has not been used for inflationary adjustments of government expenditures within Virginia. Moreover, it is not as well known, and therefore may be less readily accepted by key decision makers/decision-makers, as the other two indices.

Another directive given to staff by Council at its February meeting was to include maintenance reserve funding in the block grant. The Council considered the following three options in this regard:

- *Include funding for Maintenance Reserve in the block grant and calculate future resource needs according to the inflationary growth factor.*

Advantages: As with the other components of E&G, this provides institutions a stable and predictable source of funding for this expenditure category. Accordingly, they could more effectively do long term planning for deferred maintenance.

Disadvantages: Currently sophisticated, long-standing, and well-accepted methods are in place for calculating resource needs in this area. However they entail relatively intrusive, highly centralized procedures. Based on a detailed room-by-room and building-by-building inventory, staff produce institution-specific estimates of future resource needs regarding maintenance reserve requirements. Increasing funding in this area by using an overall inflationary growth factor may significantly understate, or overstate, resource requirements. In addition, not targeting these funds in the block grant would mean that institutions would have discretion to allocate these resources.

- *Include funding for Maintenance Reserve in the block grant and calculate future resource needs according to general programmatic criteria (such as staff recommendations derived from SCHEV Facilities Condition Report).*

Advantages: This option ensures that appropriations for this important area would be commensurate with resource requirements by assuring systematic review of the adequacy of maintenance reserve funding.

Disadvantages: As with the previous option, institutions shall have discretion to allocate these resources.

- *Exclude funding for Maintenance Reserve from the block grant and calculate future resource needs according to staff recommendations derived from SCHEV Facilities Condition Report (current procedure).*

Advantages: This option would control appropriations for this important area by subjecting institution planning to central direction.

Disadvantages: Institutions would acquire no greater planning capacity for these resources than they have now. Long term planning could not effectively be pursued.

### **Base Budget Adequacy Adjustment**

Once an initial assessment of base budget adequacy is conducted and any funding inadequacies addressed, the block grant approach adopted by Council would provide "steady state" funding for Virginia's public colleges and universities by protecting their current budgets against inflationary erosion and providing them with far greater flexibility regarding the management of those budgetary resources. Although the block grant provides stable, progressive, and long-term funding, it remains true that changes in circumstances over time can require readjustment. The recurrence of incentive funding in base budgets acts as effective insurance against deficiency. Still, the Council shall establish criteria to determine periodically whether emerging inequities, future conditions, or system objectives would necessitate reassessment of an institution's base budget adequacy.

To accomplish this goal staff shall periodically review the adequacy of each institution's base budget. Such reviews could be made for all institutions routinely or on a rotational basis.

Additionally, Council shall identify specific "triggers" which, if met, shall initiate a base budget adequacy review. Options for such triggers include significant changes in:

- *Institutional Mission* --- For instance, if Council approved a new graduate program in a previously exclusively Baccalaureate institution, thereby raising it from a Baccalaureate I to a Master II level.

- *Programs* --- An example of such a change would be opening a new School of Engineering, or a major shift in program offerings.
- *Enrollments* --- Current enrollment projections indicate that the system as a whole will grow by five percent between now and 2007. Council analysis should be refined to the point of anticipating the distribution of this new enrollment and its system-wide affect. Where the effect is unevenly distributed across various institutions despite planning, an institution should qualify for a review of base budget adequacy when its enrollments increase (e.g., 1 or 2 percent) beyond a specified limit.
- *New Construction* --- Expenditures for operation and maintenance of existing facilities are included within the categories of E&G expenditures that comprise the block grant. These sums may not provide sufficient resources for operation and maintenance when new capital construction and new facilities are created and, therefore, may not be sufficient to protect the Commonwealth's investment in capital assets. Until the capital outlay process is revised, this will be an important concern.

Devising the procedures and methods to apply base budget adequacy assessment will be an involved process. In some instances, such as faculty salaries, peer group comparisons may be the appropriate method. In others, more involved assessment of program-specific unit costs or projected changes in operating and maintenance needs may be required. In addition, procedures shall have to be developed for reviewing the triggers themselves. For instance, enrollment growth should not correlate with reduced entrance standards. These methods and procedures must be subsequently elaborated but well ahead of the time frame in which such reviews would occur.

### **Incentive Funding**

At its February meeting, Council decided that a specified percentage of state higher education funding should be set aside to create a pool of monies that shall be used to reward an institutions' performance in relation to student outcomes and other areas as determined by the needs and interests of the Commonwealth. The focus of performance efforts shall be on outcome measures rather than input measures.

To create this incentive structure SCHEV shall devise a composite index of weighted averages across several outcome measures. The outcome measures will be institution-specific performance targets or "expected" values. Such institution-specific benchmarking shall control for the diversity of mission characteristic of Virginia's public colleges and universities. Once a single weighted performance metric is derived for each institution, however, relative comparisons among institutions shall guide the allocation of performance funds. In other words, although an institution's performance will be *measured* only

against its own targets or expected values and, therefore, only in the context of its own unique mission, once measured, performance funds shall be proportionately allocated across institutions

The following measures shall be used in the initial approach to incentive funding: graduation rates, retention rates, scores on “exit exams,” post-graduate placement, faculty productivity, and, for the VCCS, successful “transition” rates.

#### Starting Fall, 2000

- *Graduation Rates* --- Graduation rates will be calculated using actual six-year graduation rates following the cohort of full-time first year students in comparison to a “predicted” graduation rate using statistical predictions based on entering student characteristics (college board scores, high school GPAs, etc.) which provides a measure of institutional value-added. [N.B. The use of the six-year rate takes into account, and preserves the advantage of a four-year success rate, but serves to provide the most comprehensive data for analysis.]
- *Retention Rates* --- Retention rates will be calculated using actual retention (number of full time first year students who return for their sophomore year) in comparison to a “predicted” retention rate based on statistical predictions using full time, first year entering student characteristics. [The retention rate calculation performed at the start of the second year is based on industry standards, for which extensive documentation and analysis is available. The measure taken at this point reflects on the institution’s performance throughout the nominal four-year undergraduate course of study.]

#### Starting Fall, 2002

- *Passage Rates on Exit Exams* --- Passage rates on exit exams (Professional Licensure Exams, GRE Subject Tests, and other disciplinary measures for which the SCHEV staff can identify parallel cut scores—comparable levels to pass rates on licensure exams) will be used as a proxy measure for value added during the college experience.
- *Post Graduate Placement* --- Post graduate placement information will be collected using a modified version of the current graduate survey being used by the institutions which will continue to be sent by the institutions to all graduates eighteen months after graduation.

### Starting Fall 2003

- *Faculty Productivity* --- Faculty productivity measures tied to specific university missions will be used to look at research (publications and funded grants), teaching and service efforts.
- *“Transition Rates”* --- Transition rates will be developed uniquely for VCCS to recognize the unique roles this institution plays in the Virginia Higher Education System. Transition rates will look at workforce development training including certificate programs and Associate degree programs – both student and employer satisfaction as well as actual job placement rates. Transition rates will also look not only at the percentage of student transferring to four year institutions but also at their relative performance in the four year institutions – e.g. VCCS GPA in comparison to GPA at senior institution.

### Future Performance Measures

Assessment technology related to learning outcomes is progressing sufficiently swiftly to allow the development of more specifically value-added assessments within the next few years. SCHEV staff are involved in several projects bringing together national leaders in assessment to work with the large number of states currently pursuing or interested in pursuing performance-based funding. Most of the instruments developed ten to fifteen years ago were problematic in that they were too generic. In addition, they tended to have a very high correlation with general intelligence measures and were not directly connected to the course work students had taken and thus could not provide a very direct measure of value-added. New efforts tied more directly to student performance appear to show promise of being more useful for achieving the kind of accountability states' want while also being useful to the campus for program improvement. As the viability, suitability, and utility of these new approaches become clearer, SCHEV staff will bring these approaches to the attention of the Council of Higher Education and colleges and universities with suggestions for modification to the incentive funding measures.