State Council of Higher Education for Virginia

PERFORMANCE FUNDING MODEL (BLOCK GRANT PROPOSAL)

The Challenge

Deregulation is the removal or suspension of rules or controls. Removing line item budget controls imposed by a state budget office, thereby enabling a university to shift funds from one purpose to another illustrates the term.[1] Decentralization is a shift in the locus of authority from a higher to a lower level. It is the shift of powers from the system to the campus. Decentralization differs from deregulation in that the rules do not change, but the level at which they are enforced does.[2] Virginia has been discussing deregulation/decentralization, since the early 1990's. Much of the conversation has centered on institutions' desires to be freed from bureaucratic constraints that have limited their ability to maximize resources and operate efficiently. The conversation 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 comes benefits to the state.

As in private business, in order for organizations to effectively 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.

The block grant funding model is premised on this exact notion. Allow decision making to happen on the campus and hold campus administration and faculty accountable for the activities and outcomes that result. 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 for which it measures institution success, is integral to this model. A predictable audit process is also integral to the process.

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[1] MacTaggart, 9.
[2] Ibid., 11.

The Recommendation

It is recommended that along with a base-funding amount, provided in the form of a block grant, institutions be deregulated to the extent possible from central processes. Such deregulation in Virginia would come not in the form of exemptions from law, but instead in the form of freedom from regulations promulgated in administering such law. The state would provide general best practice guidelines/principles, for 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 would be reported to Boards of Visitors, who, via their governing responsibilities, would be held accountable for requiring corrective action if deemed necessary.

The following reflects the proposed deregulation that would allow institutions fully to control resources and allow the state to hold institutions fully accountable for outcomes.

Procurement.

The Procurement Act is law. Institutions, under this proposal would 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 the procurement: 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 tedious reporting requirements, and released from mandatory contracts. What instead should occur, is the state should set guidelines for best practices in the context of procurement activities (e.g. to keep costs low and ensure 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.

Like the Procurement Act, the state Personnel Act is law. Institutions, under this proposal would still be subject to the Personnel Act, but would not be required to follow state regulations as promulgated by such central agencies as the Department of Personnel and Training. Activities such as when performance evaluations are conducted, how many hours wage employees are able to work, the amount of time a position must be advertised, probationary periods for new employees, mandatory advertising in RECRUIT, etc. are burdensome and often obstruct institutions' effectively attracting and hiring qualified employees. Institutions, like businesses, must be able to manage their workforce—this includes support employees as well as faculty.

In order to deregulate personnel, institutions would 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 felt 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 to MCV that inhibited its 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.

Instead of the current personnel system, the state would 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 state Procurement 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' plan 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 would reflect best practices in the area of property management. Institutions would then be required to establish pollicies and procedures for effective management of real property. Institutional actions would 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.

Treasury estimates yield on tuition and fee revenue at approximately $33 million annually. 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 by state Treasury.

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.

The current system provides a disincentive for institutions to accumulated balances at the end of each year. Inherent in the current finance and budget system is an incentive to spend all the funds received. Even though institutions that meet management standards (which are nearly all institutions) are provided the balances to spend in the next year, no institution feels one hundred percent certain that this in fact will be the case. There is always some doubt that due to economic conditions of the state, political climate, or other reasons, institutions may not in fact be able to retain such balances. If there is a fear of losing the funds, the college will likely not have the incentive to save for long-term projects or planning.

Another reason institutions fear to accumulate balances is the perception by policy makers that the institution may have more than enough money to operate and therefore, when deliberating about budget amendments, etc. the institution may not be viewed in a positive light—in other words, policy makers tend to view accumulated balances over-funding.

As a result of these two phenomena, institutions have a disincentive to accumulate funds 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 based on national peer groups. The Consolidated Salary Authorization (CSA) governs faculty salary increases. In order to be sure that funds for salary increases are in fact provided for 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, whereby funding for salaries will be contained in the block grant, there will not be a need to benchmark salary increases nor to monitor actual results against that benchmark. Under the proposal, it will be up to the institution to make decisions on its priorities and to earmark 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 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 trends on all classes of employees. If trends indicate a concern, institutions should be required to explain their actions and decisions about resources. If corrective action is necessary, it can be taken on a post audit basis.

Eliminate employment restrictions.

Currently the Appropriation Act states a maximum employment level (MEL). It is an upper limit for employees in the educational and general program. Although MEL is also stated for auxiliary enterprises and sponsored programs, the Act only displays these limits as estimates recognizing that workforce size will vary depending upon needs in the auxiliary enterprise programs and with federal grants provided for sponsored research. MEL is a true limit for the E&G program, which means that institutions cannot hire more than the state MEL. This is a restraint on institutions that can sometimes prohibit their ability to react to changing employment needs at the institution. Fiscal pressures are usually the best constraining factor for employment levels, and the state should not dictate the appropriate level of employment for an institution. Its financial resources and own management operations will define that level.

Employment levels can still be monitored, and if trends indicate a concern, for instance, an increase in administrative employees with a decline in instructional staff, institutions would have to be accountable for their actions and explain the decisions made.

Retain revenues from tuition and fees resulting from additional enrollment.

Institutions should be allowed to keep additional tuition & fee revenue associated w/ new enrollment. Since enrollment will not be funded by the block grant, but instead funded via deliberate enrollment planning decisions, the use of additional revenue associated with enrollment growth should be available to the institutions to accommodate new enrollment. In the context of a block grant, institutions should decide how best to serve the new enrollment rather than having the state dictate that the additional revenue be used for a particular purpose.

Institutional Accountability

The aforementioned proposals 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 the performance funding section of this proposal).

The stringent audit procedures and development of best practice criteria, however, are critical to assessing the success of institutions' abilities to manage outside of a centralized system. The Council adopted in November 1998 administrative best practices. They are:

- 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, institutions would fall into receivership. This means that the institution would lose its deregulated status and 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. In a truly deregulated environment comes this consequence as well.

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 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, the Council may also wish to control for classified salaries from the block grant. Changes in the classified salary structure are mandated by the Governor and the General Assembly and, therefore, a non-discretionary and centrally determined component of the institutions' E&G budgets. As can be seen from the table below, classified salaries typically comprise about 27 percent of all expenditures for non-personal services and 20 percent of all E&G expenditures.

1997-98 Actual Educational and General Program Expenditures (1)

Institutions	Classified Salaries and Fringe Benefits (2)	Total Personal Services	Total Personal and Non-Personal Services	Classified Salaries as % of Total Personal Services	Classified Salaries as % of Total Personal and Non-Personal Services
CNU	$4,484,890	$19,633,110	$26,501,188	22.8%	16.9%
CVC	$2,306,049	$7,866,207	$10,302,145	29.3%	22.4%
GMU	$26,279,267	$118,416,177	$146,846,896	22.2%	17.9%
JMU	$17,364,713	$71,821,434	$89,539,915	24.2%	19.4%
LC	$5,276,150	$17,804,731	$23,500,219	29.6%	22.5%
MWC	$4,843,328	$19,488,357	$25,645,624	24.9%	18.9%
NSU	$11,334,877	$41,083,429	$49,186,440	27.6%	23.0%
ODU	$21,566,282	$83,912,982	$115,101,264	25.7%	18.7%
RU	$11,250,416	$41,688,751	$51,833,900	27.0%	21.7%
UVA	$62,002,691	$197,778,523	$267,874,003	31.3%	23.1%
VCU	$40,439,563	$159,691,209	$226,823,446	25.3%	17.8%
VMI	$4,673,088	$13,323,077	$18,465,337	35.1%	25.3%
VPI	$59,765,201	$211,856,085	$287,835,714	28.2%	20.8%
VPI - Ext/Agr	$16,493,577	$48,022,696	$62,180,618	34.3%	26.5%
VSU	$7,053,423	$22,418,906	$32,760,197	31.5%	21.5%
W&M	$14,203,223	$58,692,085	$76,378,575	24.2%	18.6%
W&M – VIMS	$5,942,500	$11,500,986	$14,068,731	51.7%	42.2%
RBC	$1,161,472	$4,252,240	$5,496,087	27.3%	21.1%
VCCS (w / S.O.)	$64,746,395	$277,120,806	$352,285,292	23.4%	18.4%
Total	**$381,084,302**	**$1,426,371,791**	**$1,882,625,591**	**26.7%**	**20.2%**

(1) Based on CARS year-end data tape.
(2) Includes classified employees (1123). Fringe benefits approximated from aggregate data.

Staff Recommendation: Include technical adjustments to the block grant as part of the funding model to account for such items as one-time expenditures, annualization of salaries, and classified salaries.

Inflationary Growth Factor

Another decision reached by Council at its February meeting was that the block grant would 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, than the other two indices.

Staff Recommendation: Use a Virginia-specific version of the HEPI to calculate inflationary growth in the block grant.

Another directive given to staff by Council at its February meeting was to develop options regarding including maintenance reserve funding in the block grant. The Council may wish to consider 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 would provide institutions a stable and predictable source of funding for this expenditure category.

  Disadvantages: Currently sophisticated, long-standing, and well-accepted methods are in place for calculating resource needs in this critical 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, including this spending category in the block grant would mean that these funds would no longer be targeted. Institutions would have discretion to reallocate these resources to other ends.

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

  Advantages: This option would ensure that appropriations for this important area would be commensurate with resource requirements.

Disadvantages: As with the previous option, institutions would have discretion to reallocate these resources to other ends but would not themselves be responsible for the ultimate planning decision.

- *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 ensure that appropriations for this important area would not be reallocated to other ends.

  Disadvantages: Institutions would acquire no greater discretionary control over these resources than they have now.

Staff Recommendation: Include funding for Maintenance Reserve in the block grant and calculate future resource needs on the basis of general programmatic criteria.

Base Budget Adequacy Adjustment

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 Council should establish criteria to determine periodically whether emerging inequities, future conditions, or system objectives would necessitate reassessment of an institution's base budget adequacy.

One option for accomplishing this goal would be to require that staff periodically review the adequacy of each institution's base budget. Such reviews could be made for all institutions routinely or on a rotational basis.

Alternatively, Council could identify specific "triggers" which, if met, would initiate a base budget adequacy review. Options for such triggers would 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 estimates indicate that the system as a whole will grow by five percent between now and 2003. This system-wide increase is likely to be unevenly distributed across various institutions. Stipulating that an institution would qualify for a review of base budget adequacy if enrollments were to increase by a fixed percentage (*e.g.*, 2 or 4 per cent) would provide a way to accommodate this system-wide growth without compromising access or quality.

- *New Construction*: Expenditures for operation and maintenance of existing facilities are included within the categories of E&G expenditures that comprise the block grant. When new capital construction is approved and new facilities are created, these sums may not provide sufficient resources for operation and maintenance and, therefore, may not be sufficient to protect the Commonwealth's investment in capital assets.

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

Staff Recommendation: Direct staff to establish specific thresholds as "triggers" for base budget adequacy review with respect to significant changes in institutional mission, programs, enrollments, and new construction. In addition, direct staff to devise procedures and methods to review base budget adequacy for subsequent approval by Council.

Performance Funding

A specified percentage of state higher education funding will be set aside to create a pool of monies that will be used to reward institutions for the quality of their performance in relation to student outcomes and other areas as determined by the needs and interests of the Commonwealth. The focus of performance efforts will be on outcome measures rather than on input measures—although input measures will be a necessary component in order to determine value-added as an indicator of performance in the academic area.

After reviewing information from a number of states that claim to be doing performance funding in search of models which might be adapted for the Virginia context, we discovered that most states seemed to be basing performance on input characteristics rather than outcome measures. Therefore, we recommend that the Council of Higher Education will need to start primarily with measures that Virginia institutions have already been using as a result of the Department of Budget and Planning’s performance indicator’s work (modified as appropriate). Thus we would propose starting in the first two years by using retention rates (first year students who return for the second year of college) and graduation rates (five year) as our performance measures.

The analysis of retention and graduation rates will compare actual rates with predicted rates—predicted rates are developed through a statistical model based on entering student characteristics, e.g. high school grade point average, admission test scores, etc.—in order to assess institutional performance. Institutions with retention rates and/or graduation rates 5% above that which was predicted will receive performance funding. This funding would then be added to the base block grant for the institution. *In addition, we recommend using passing rates on national licensing exams and on other standardized national exams (GRE subject tests, etc.) for which we can establish a designated passing rate that would be comparable to the normed rates used for licensing exams. Institutions with passage rates above the normed rates average will eligible to receive performance funding.*

The Council of Higher Education will need to develop several additional indicators that will be used specifically for the two year institutions that will relate to successful job placement of students, preparation for transfer, employer evaluation of adequacy of training, etc.

In future years, the Council of Higher Education might want to add performance measures that relate to quality as reflected in the value-added formula that looks at entry level student abilities in comparison to the abilities of graduates in relation to some specific general education skills and behaviors. Moreover, the Council of Higher Education might create a measure of faculty contribution to research that looks at faculty publications, grants and conference presentations in relation to institutional mission. Numbers of publications, citations of publications, etc. might be looked at in relation to the research/scholarly activity of selected "peer institutions."

In subsequent years, the Council of Higher Education might begin to fund institutions for performance in using assessment information to design significant improvements in the educational experiences of students with funding based on the documentation of the extent of the impact of these improvements. The extent of the impact of various campus improvements would be based on the evaluation of a panel of external reviewers from outside Virginia.

Staff Recommendation: Direct staff to develop specific performance measures consistent with the general provisions adopted by Council.

Council Action

At its regularly scheduled meeting of May 18, 1999 the Council adopted the following resolution, in response to the above-listed proposals.

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.

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 1) to 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.