Pennsylvania House of Representatives
Republican Policy Committee

Westmoreland County Community College
Youngwood, Pennsylvania
November 15, 2007

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Good morning. I want to thank the House Republican Policy Committee, and in particular, Chairman Turzai and Representative Stairs, for inviting me here this morning to talk to you about funding for higher education in the Commonwealth. I would be remiss if I did not note that Representative Stairs is a distinguished alumnus not just of Penn State, but of the College of Education.

I speak to you today in my role as a researcher who studies college finance, not as a representative of Penn State. I came to the university in December of 2001, and since then it has been a turbulent six years of funding for postsecondary education in our state. In the early part of this decade the Commonwealth suffered from a downturn in the economy that greatly constrained state revenues. As with many other parts of state government, the public colleges and universities felt the effects of the downturn.

I will use my own institution as an example. In fiscal year 2002, Penn State received an appropriation from the Commonwealth of $335 million. Over the next two years, we received four cuts in our appropriation, including two mid-year rescissions. It took until last year before our appropriation returned to the FY 2002 level. This year's appropriation, at $349 million, is just $15 million above the level of six years ago. In real, inflation-adjusted dollars – adjusted for the Consumer Price Index, this year's appropriation represents a *decrease* of 11% from the level six years ago.

At the same time we have endured this funding pattern, enrollment in the university is up 5% as we have strived to meet the increasing demand for slots at Penn State. Our costs have continued to rise, as they have for other sectors of state government and the private sector, driven by such things as health insurance and energy costs. So we have been forced to stretch the appropriation from the Commonwealth further and further every year. Today, our appropriation from the Commonwealth represents less than 10% of our overall budget. Even if you look at just

our general funds budget, which excludes our medical school in Hershey and Penn College of Technology, the Commonwealth's share of our revenues has declined from over 60% three decades ago to just 22% today.

To replace this support, Penn State has undertaken a number of initiatives in recent years. President Graham Spanier formed a task force a few years ago that identified $14 million in internal cost reductions, cuts that were made without harming our core teaching, research, and service missions. Fund raising and external research have grown at the university as we seek additional financial support from these sources.

But the biggest and perhaps most visible change is in student charges. Since 2001, tuition and fees for first-year students who are residents of Pennsylvania have increased 74 percent. Let me repeat that: *74 percent in six years.* While we are proud of our national leadership in a number of areas – including that the program in which I teach in the College of Education is the top-ranked of its kind in the country – I do not believe anybody in the administration at Penn State is proud of the fact that we are now the most expensive public university in the country. But they would argue that the increases were necessary to maintain the high quality of education we provide to our students.

One impact of these price increases is that we have seen an erosion of low- and moderate-income students at Penn State. During this period, the population of low-income students declined 4%, middle-income students dropped 9%, while the number of students from higher income families increased 33%. In addition, the average loan debt of our graduates is 25% higher than the national average.

Having highlighted these facts, I need to remind you again that I am *not* here as a representative of the university. I do not think this is how Mr. DiRaimo or President Spanier would have scripted my remarks if I were. My point in talking about the fiscal picture facing Penn State (which is at least in part reflective of many of the other public institutions in the state) is to provide a foundation for my remarks regarding the funding of higher education.

There are 50 states in our nation, and if you examine them, you will find 50 different methods for funding postsecondary education. But broadly classified, states fall into two main categories. In the first, states utilize a formula-based approach, where such variables as student enrollment at different levels and in different majors, building square footage, number of employees, etc., are plugged into a formula and an expected appropriation amount is cranked out.

In the second method, many states, including Pennsylvania, use more of an incremental process, where the appropriation for one year is based largely on funding levels in the prior year, with the increase (or decrease) for each institution tied largely to the broader state revenue picture. In some instances, a special initiative may be recognized and funded, but for the most part appropriations for each institution are predicated on funding levels the prior year.

In addition to these two methods of funding higher education institutions, some states have also utilized something called *performance funding.* In performance funding, a portion of the overall appropriation for higher education in the state is set aside, and individual institutions

(or systems) are allocated funds from this pool based on their performance in a set of measures established by the legislature or state higher education board.

Tennessee was the first state to implement performance funding, almost three decades ago. Other states slowly began to adopt it, and a survey conducted by the Rockefeller Institute at the State University of New York at Albany has tracked this. By 1997, 10 states had adopted performance funding schemes, and the number peaked in 2001 at 19 states. The most recent survey, in 2003, found that the number of states implementing performance funding had declined to 15.

It is also important to note that almost all states allocate a very small percentage of their higher education budget through performance funding. A study conducted in 2001 by the State Higher Education Executive Officers association found that states allocated 4% or less of their appropriation via performance funding.

The one exception to this, and the most ambitious effort has been by the state of South Carolina, which announced in 1996 that it was going to move to a system whereby 100% of the state appropriation would be allocated in this manner. However, within a few years the state had to compromise on its initial goal. It encountered problems with comparing institutions across sectors, the ability of institutions to provide the data, and the political viability of a system that could threaten the livelihood of a public college or university. Five years after implementation, a legislative panel concluded that, "as a practical matter only 3 percent of state funds for public colleges are distributed based on performance."[1]

The report on performance funding by the Rockefeller Institute concluded that states are moving away from performance funding. Let me explain why I believe this is occurring, and for those states that still utilize it, the amounts allocated through the process are very small. You could establish a performance funding system that has very specific measures, and if it worked as you would want it to, you could tie the great majority of institutional appropriations to those measures. But in doing so, you would provide a very strong incentive system to the institutions to modify their behavior in order to maximize their score on the indicators used.

The difficulty with this process is that the indicators may potentially conflict with one another, leading to institutions to strive to perform better in one arena, but moving them away from established goals in another. For example, many states are interested in improving the graduation rate of bachelor's degree students. So a logical performance indicator on which to grade colleges would be the percentage of students graduating within four years. In fact, Pennsylvania implemented a bonus funding program like this a few years ago.

But the problem with a measure like this is that it provides a *disincentive* for institutions to enroll students who may need extra help and extra time to graduate. Students from lower-quality high schools where academic preparation may be weaker, those from lower-income families, or part-time students – all could help to suppress an institution's four-year graduation

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[1] *The Chronicle of Higher Education*, 6/15/01

rate. So rewarding institutions on improving graduation rates may result in the enrollment of fewer of these students.

Another goal may be to encourage public institutions to enroll more Pennsylvania residents by tying funding levels to the proportion of in-state students enrolled. But this would constrain tuition revenue received from out-of-state students, thus potentially negating the value of the increased funding received for the in-state students.

You could begin to construct a set of measures that sought to minimize these behavioral disincentives, but as you can imagine, the more complex the measures are, the more difficult it will be for institutions to modify their performance to meet the goals. This has been identified as another barrier to the effective implementation of performance funding. If the measures put into place are so complex that they create countervailing incentives, you are unlikely to be able to get institutions to change their behavior in ways that are aligned with broader state goals.

Another problem with performance funding is that it potentially may create a system where "the rich get richer and the poor get poorer." Unless carefully crafted, performance measures may simply reward high-performing institutions for behavior in which they are already engaged. And the lower-performing institutions, which may need additional financial support in order to improve their ability to meet state goals, are the ones who are denied that funding.

This leads to an important political consideration, one that I believe ultimately becomes a real barrier to implementing a true performance funding system. Many public colleges and universities have very strong constituencies in the state legislature, and a system that threatens to deny funding to one institution may run into political roadblocks. For example, if the legislature put into place a performance funding system that threatened to deny funds to Westmoreland County Community College, I would imagine that Chairman Stairs, representing this district, may raise some concerns. Similarly, a system that threatened funding to Penn State may not be supported by Representatives Hanna, Conklin, or Benninghoff – never mind the rest of the members of the House whose districts contain other Penn State campuses, research facilities, or extension offices.

So this leaves us with the obvious question of, "Well, if performance funding does not work, what should we do?" The Rockefeller Institute report described an alternative called *performance reporting*. This is a process whereby higher education institutions are required to report to the legislature and/or the state higher education board quantitative measures about the performance of the institution in a variety of areas. This may sound to you like performance funding, but the difference is rather than tightly coupling the reported information to appropriation levels, the information is used instead to inform the appropriations process. The relative performance of the institution is used as part of a more holistic assessment of how much of an increase in the appropriation it should receive.

I think the legislature and the governor do have the right to expect that the Commonwealth's colleges and universities – public and private alike, since private institutions also benefit from appropriations – demonstrate how they are meeting the needs of the state and its citizens. I believe that you can establish effective performance reporting mechanisms to satisfy this need. The best way to go about this is through a joint effort of the legislature, the

Department of Education, and the institutions themselves to come together to establish appropriate and useful measures. These measures can be used to create an ongoing dialogue between the governor, the legislature, and the institutional leaders during the annual budgeting process, to assess how well our postsecondary institutions are meeting state needs and how state funding can help them do this.

To work effectively, however, a performance reporting system like this should also assess whether the Commonwealth is funding our colleges and universities at an appropriate level to accomplish the stated goals. In other words, performance reporting can and should be a two-way street; not only should we assess the institutions on the adequacy of their performance, but we also should assess the Commonwealth on the adequacy of appropriations in support of those goals.

I thank you for your attention today, and the opportunity to address the Education Committee. I would be happy to take any questions you may have.