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ALIGNING STUDENT AND INSTITUTION INCENTIVES IN HIGHER EDUCATION FINANCE

EXECUTIVE SUMMARY

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Executive Summary

Nationally, the primary driver of revenue for colleges and institutions is the credit hour, a measure of short-term student enrollment. Credit hours produce revenue for institutions through primarily through the tuition transaction (student payment, with or without financial aid offsets) and in some cases by determining the amount of state funding received as well. This "cash-for-credit" model fosters institutions that can increase revenue through raising prices per credit, increasing student enrollment, or selling more credit hours per student. This financial structure does not, however, provide a sustainable and scalable revenue source for other things that public higher education needs to do—focus on low-income students who cannot afford the full cost, offer courses in technical and scientific disciplines whose costs exceed tuition rates, invest in advising and long-term academic planning, or award credit for what students have accomplished at other institutions or through alternative instructional pathways.

As states continue to focus on increasing educational attainment and fulfill the growing technical and advanced workforce needs, policymakers are examining and making changes to the funding system that shapes how they invest in higher education outcomes.

Higher education budget descriptions

There are three common ways of talking about higher education budgets, each with different implications for incentives:

1. **Total institutional budget:** Includes virtually all revenues and expenditures that pass through institutions, many of which may not be related to core instructional or educational programs—dormitories, hospitals, research centers, athletic programs, etc. This budget shows the full range of financial priorities that an institution and its leaders are balancing, each with a different business model and set of competing incentives.
2. **"Core" educational budget:** The cash-for-credits component of the business. It includes direct expenses for instruction as well as indirect expenses for administrative and institutional support. On the revenue side, it is primarily tuition and government appropriations.
3. **Student budget:** Referred to as "sticker price", "net price" or "cost of attendance." Includes elements that are part of core revenue for institutions (tuition and fees) as well as those not reflected on institution budget sheets but effect a student's bottom line. Tuition and fee expenses in the student budget are core revenue for institutions (e.g., books and supplies and living expenses). The student budget usually includes designated financial aid sources, but excludes the subsidies resident students receive at public institutions (state general fund appropriations to public institutions).

A well-structured finance system should take each of the three budget perspectives into account, but often are geared more toward one than the other.

Aligning Incentives

The current higher education finance system provides numerous competing incentives and priorities for students and institutions, both in terms of short-term and long-term goals. These are purely financial considerations that institutions and students have to weigh against each other and against their academic goals. Institutions are looking to maximize their revenue through tuition, auxiliary services (including food service and bookstore revenue) and state appropriations; students seek to minimize their expense through lower tuition costs and other direct expenses (books, supplies) and increased financial aid support. The competing incentives can provide inherent barriers to the common overall goal of student completion. For example, institutions have incentives to expand credits to degree, while students want to minimize the number of credits needed to complete.

State legislatures, systems of higher education, private foundations and more recently the federal government are increasingly interested in testing new ways to pay institutions and support students. Key types of reform include:

- Changing **state and local appropriations** through outcomes-based funding to focus on gaps in existing financial structures, especially with regard to degree completion and service to low-income students. Tennessee is one state that shifted its state appropriations in such a manner, replacing its outcomes based funding model

- Changing **tuition and financial aid** so that students have more support for short-term choices (to enroll in summer or in 15 credits per term, for example) that will help meet long-term goals (like completion). Examples of these types of reforms include: revisions to Indiana's financial aid program to focus on student progression (30 credit hours per year for full eligibility) and states like Illinois, Minnesota and Washington that structure financial aid programs to cover up to 15 credit hours per semester.

- Revising the **higher education service model** in such a way that packages curriculum in larger units. A key example of this approach is the CUNY Accelerated Study in Associate Program (ASAP). This model provides a block schedule and curriculum, and from a financial perspective, more predictable pricing and aid as well as a consistent schedule to allow students to find employment and balance other non-school demands.

More Effectively Align Incentives Toward Student Completion

Shifting the incentives of the financial model for higher education to better support the enrollment and success of low-income students will require state and federal policymakers to adjust policies in a way that reinforces these goals. Following the lead of the most innovative states and projects, policymakers and higher education advocates might look to solutions that:

- **Change the rules of the game,** recognizing the limits on what institutions can do on their own;
- **Account for risk and reward value-added outcomes,** since the most challenged students need the most help;
- **Address both institutional and student financial constraints,** and do not just shift problems from one to the other;
- **Close the financing gaps,** and avoid duplicating incentives that are already sufficiently rewarded; and
- **Create incentives in the short-term,** for students and institutions that finance progress toward long-term goals.