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## Funding Students Instead of Institutions

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# A New Compact for Higher Education in Virginia

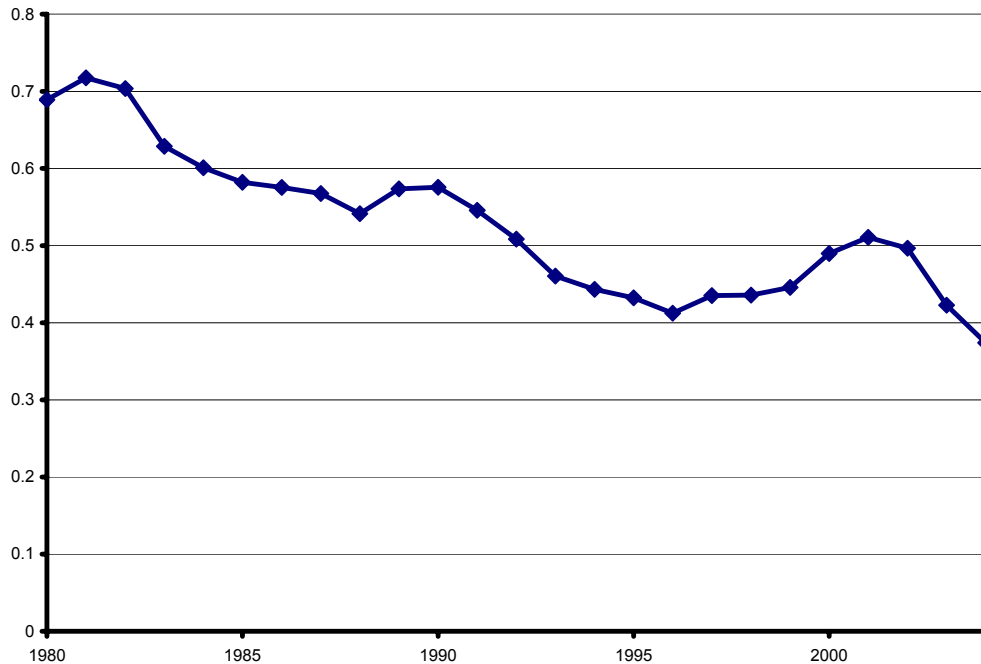
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## 1. Introduction

This brief paper describes a plan to restructure the relationship between state-supported colleges and universities and the Commonwealth of Virginia. Since 2001, state-supported colleges and universities have had to absorb significant budget cuts as the state brought its expenditures in line with its revenues. The institutions have been allowed to raise tuition to soften the effect of these budget cuts. As a result, the percentage of each institution's budget supported by state general fund appropriations has declined. We have been here before.

**State Share of E&G Expenditures**



The figure above shows the recent history of the percentage of Education and General (E&G) expenditures supported by state general fund appropriations for the College of William and Mary. While the levels would vary by institution, the general shape of the line is similar for any state-supported institution. The figure shows that state support falls as a share of expenditures during and after recessions (1982-1984,

1990-1991, and 2001- 200?). The share of state support recovers during cyclical expansions but, perhaps surprisingly, not to its previous levels. The result is that the share of state support has ratcheted down over time.

This picture does not bring smiles to the faces on campuses or at the state capitol. The pattern it shows does not suggest evil intent on anyone's part. It reflects the combination of four forces: (1) periodic declines in state revenues, (2) legitimate demands on state revenues for purposes other than supporting higher education, (3) a requirement to balance the biannual state budget, and (4) the fact that increases in college tuition are politically more palatable than increases in other state revenues. The figure shows clearly how colleges and universities have become progressively more dependent on direct charges to students and support from private donors. The forces driving this change are not likely to stop. It is time for all the parties to recognize this and manage the changes these forces imply.

When the percentage of state support declines below 50% college administrators are inclined to say they are "state-assisted rather than state-supported." This semantic distinction is not very useful, because it does not describe any real change in the relationship between the state and the institution. In this paper, we describe a plan to create a real difference between what we will call a state-allied institution and the current state-supported model. This plan would meet the objectives of the state, and of the institutions themselves, better than the current system.

## **2. The Foundations of a new Compact for Higher Education in Virginia**

**State-Allied Institutions as Public-Private Partnerships** – The first element of the compact is a new model of a state-allied college or university as a public-private partnership. Essentially, each state-allied institution would have to be recreated as a new legal entity. This legal entity would have a governing board partially chosen by the governor and partially chosen by the institution. State-supported colleges and universities currently have active private fund raising arms that are, for many purposes, completely separate from their state-supported operations. The new legal entity would combine the private and state portions of the current institutions. The legal details and protections associated with this combination are beyond the scope of this paper, but we do not believe that they include any deal breakers.

This new creation – the state-allied institution – would receive private funds in the form of donations and tuition. The major change involves tuition. Tuition payments currently are state revenue, called non-general fund revenue. This would not be true under the new arrangement. This change is important for two reasons. First, since tuition payments are state revenue, there are no guarantees that the institution will be able to use them. In times of budget duress, the state can claim any state revenue. This makes it very hard for institutions to plan and is very damaging to the educational program when the state has to claim these funds.

Colleges and universities operate in markets that mix private and public institutions. These markets have little respect for state boundaries, and they are very dependent on easily transferred human talent. College personnel can teach, perform research, or serve as administrators at private institutions and at state-supported institutions in other states. Our publicly supported institutions also compete with major corporations, banks, law firms, and a myriad other private and public sector employers. Talented individuals are mobile, and when state budget necessities keep salaries fixed and facilities in disrepair they are more likely to move. Virginia's budget problems often coincide with fiscal difficulties in other states, but they are not shared evenly, and private colleges and universities are exempt from most of the problems.

The fact that colleges and universities are so dependent on people with mobile talents makes life at a state-supported institution like a roller coaster ride. When state resources are flowing, institutions build new programs, hire very talented faculty and administrators, and increase educational opportunities for their students. When resource flows slow or reverse, programs have to be eliminated, the faculty and administrators the institution most wants to keep may leave, and the educational opportunities for students dry up. The uncertainty the state budget process introduces makes long range planning difficult, which complicates the institution's problems in maintaining or increasing the quality of its programs.

Second, since tuition payments are state revenue, the state, for political reasons, can control tuition levels. We believe that tuition should be viewed as a price, and it is not usually a good idea to set prices politically. Central control of tuition, through freezes and reductions, is a relatively new phenomenon in Virginia. And yet in its short history, central control already has created problems. State budget procedures call for institutions to submit a set of new initiatives for possible state funding. When institutions controlled their own tuition, they could plan ahead to ensure that sufficient revenues were available to incorporate any state-funded new initiatives without having to constrain core activities. After tuition was frozen, however, most incremental funding was tied to new initiatives. The result of a few years of this practice is a quite predictable shortfall in funds needed to carry out the basic mission of the state-supported institutions. In the language used in Virginia this is called the "base budget adequacy" problem.

With control of their own tuition, and assurance that they alone could spend tuition revenues, institutions could avoid base budget adequacy problems. In addition, the state college system includes institutions with very different missions and that face very different market conditions. A centrally controlled tuition policy is very unlikely to have the flexibility to be appropriate for each institution.

At a national level, the combination of budget stringency coupled with political control of tuition increases seriously threatens the quality of public institutions. For every dollar private institutions spend per student, public colleges and universities today spend less than 55 cents, down from 70 cents in 1979.

**Funding Students Not Institutions** – To this point, the appeal of the plan to institutions is clear. They get more autonomy to make decisions, in particular decisions regarding tuition. What is in it for the state? To answer this question, we need to describe how the state would fund higher education under a system of state-allied institutions. Our plan calls for the state to fund students directly instead of indirectly as it does now.

Currently the commonwealth gives three kinds of assistance to students: (1) need-based financial aid, (2) across-the-board subsidies to in-state students in the form of reduced tuition made possible by state appropriations covering operating costs, and (3) across-the-board subsidies to all students made possible by state appropriations for buildings and other capital.

The first kind of aid generally is available to students from low-income families and comes to the student directly. Through grants and subsidized loans the federal government provides a large amount of financial aid. State funds supplement this aid, but need-based financial aid does not represent a very large share of state funding for higher education. Virginia is not very different from most states. Spending on need-based financial aid is less than 5% of Virginia appropriation for higher education operating costs.

The second kind of aid is the across-the-board subsidy to operating costs that is available to any student qualifying for in-state status. By law, out-of-state students attending state-supported colleges and universities in Virginia have to pay an amount that meets or exceeds the full operating cost of providing their education. Because the state provides funds directly to the institutions, in-state students pay significantly less than the full cost of their education. In the 2001-2002 academic year the general fund subsidy for operating costs for an in-state student averaged over \$8,750 at four-year institutions.<sup>1</sup> This subsidy allows the institutions to charge in-state students a significantly lower tuition than they charge out-of-state students. Unlike financial aid, this subsidy is available to students regardless of their income. The last form of aid is the subsidy implicit in state funding for campus buildings and other capital projects. This subsidy is provided to all students, in-state and out-of-state. An institution's tuition would have to be higher if it financed its own buildings.

Our plan calls for the commonwealth to give the first two kinds of aid directly to students. This would change the way the state delivers across-the-board aid for operations. Under our plan *every* in-state student who enrolls at a state-allied college or university would be eligible for a tuition grant. The size of the tuition grant would be determined by the state. Financially, the proposed system could be equivalent to the existing system. A simple example will help illustrate the change we propose. In this example, the institution currently charges \$5,000 to each in-state student. Under the new

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<sup>1</sup> All data are from the State Council of Higher Education for the 2001-2002 academic year. There are 117,436 full time equivalent in-state students at four-year institutions. The total general fund expenditures at four-year institutions were \$1,029,711,084. This yields general funds expenditure of \$8,768 per full-time equivalent in-state student.

system, the institution would raise its in-state tuition to \$13,750. In-state students would not be hurt by the change, however, because they would all qualify for a state tuition grant of \$8,750. This makes the net tuition charge to the students, the per student costs to the state, and the per student revenue of the institutions the same under both systems.

	<u>Existing System</u>	<u>New Compact</u>
<b>In-state annual tuition</b>	5,000	13,750
<b>State appropriation (per student)</b>	8,750	0
<b>Tuition Grant</b>	0	8,750
<b>Net Tuition</b>	5,000	5,000
<b>Revenue (per student)</b>	13,750	13,750
<b>Cost to the State (per student)</b>	8,750	8,750

While the economics of the two systems are very similar, the politics are very different. In the current system, the across-the-board subsidy covering operating costs is hidden. It is given directly to the colleges and universities. The fact that much of this subsidy goes to students from high-income families with little, if any, need for a subsidy is not apparent. Providing the subsidy directly to students will make the choice between across-the-board subsidies and need-based financial aid much more transparent.

In addition, under the current system, college presidents spend quite a bit of time lobbying the state to increase their institution's budget in good times and preserve it in bad times. Perhaps without recognizing it, these college presidents are lobbying for increases in the across-the-board subsidy. If they are successful in obtaining these increases, some of the money they obtain may well have gone to increased need-based aid. Under the new compact, the major champions for across-the-board subsidies lose their incentive to lobby for this type of aid. It is quite likely that the mix between need-based aid and across-the-board subsidies would change in favor of more need-based aid. This is something that many experts on financial aid policy have advocated for some time.

Shifting the method of subsidization from tuition-reduction to direct student grants benefits the Commonwealth in three ways. First, like the schools themselves the Commonwealth has a stake in preserving access to higher education and in maintaining the high quality of its institutions. Under the current system, when the state cuts E&G funding, its public universities face an unpleasant set of choices. At least initially, tuition increases rarely recoup the lost revenues, so the quality of their programs begins to suffer. If financial aid is not increased, higher tuition shrinks the pool of talented in-state students who can afford a university education. Institutions elsewhere, such as the University of Wisconsin, have tried to maintain the quality of their program by reducing the *quantity* of spaces available for in-state students. Directly reducing access to higher education is not an acceptable answer either. Classifying tuition as school revenue, and de-politicizing it, insulates the state's colleges and universities from much of the harm

done by the state financing roller coaster. In that sense it mitigates the harsh quantity-quality choice faced by schools in a climate of budget austerity.

Second, the transparency of providing direct student subsidies may help facilitate decreases in state spending on higher education when budget pressures dictate. Reducing a subsidy that is paid to every student, some of whom have no demonstrated need, may be easier than taking funds away from institutions. When an institution's budget is reduced, the institution's representatives, its administration, alumni, and students descend upon Richmond lobbying to restore the cuts. Given that members of the legislature often are alumni, these lobbying efforts frequently succeed in moderating or reversing the cuts. On the other hand, the same cut could be achieved by reducing the across-the-board portion of the student grant while still meeting an accepted percentage of student need. Lobbying would still occur, but it would be on behalf of families with high incomes who had just lost some of their state subsidy. While this group would no doubt include many students, the transparency of their pleas for a constant subsidy at a time of budget crisis would make the argument difficult.

Our proposal makes it clear just what the government is subsidizing when it directly funds state-supported institutions. Nobel Prize winning economist Milton Friedman asked the question this way in 1968, "Why should the families in Watts pay taxes to subsidize the families in Beverly Hills who send their children to UCLA?" This is a very good question. We think it will be easier for the state to make clear decisions about just how far it wants to reduce its support for higher education if it is clear who receives this support and in what form.

The third advantage the tuition grant system offers the state is control over the amount of state subsidy each student is eligible to receive. Under the current system, a student can qualify for subsidized in-state tuition for credits well in excess of the number needed for graduation, or for his or her third master's degree. While education is a good thing, the state is not obligated to subsidize multiple degrees at a particular level. The state may wish to limit the number of semester hours for which a particular student is eligible to receive a tuition grant. These limits should be liberal, leaving room for mistakes and experimentation, but it is sensible for there to be limits. At present there is no limit on the amount of state subsidy that goes to individual students.

Adopting tuition grants as the only form of state support for operating expenses will change the incentives facing institutions in many ways. For example, the proposed system treats institutional growth quite differently than the existing system. Currently, an institution that chooses to grow does so at some peril because its state appropriation may not grow as rapidly as its student body. If the state appropriation does not increase with growth in in-state students, it is not to the financial advantage for an institution to increase the number of in-state students it admits. On the other hand, there is no financial penalty for growth in the out-of-state student body. As a result, the current system has an incentive for institutions to decrease the percentage of their student body coming from the Commonwealth. Because of this, in some instances, institutions are planning to meet the current budget cuts by trying to attract more out-of-state students. The proposed

system changes this. If the state made a commitment to fund tuition grants for all in-state students, growth in in-state students would be, from a financial viewpoint, as beneficial as growth in out-of-state students.

If the Commonwealth made an open-ended commitment to fund tuition grants, the incentives for institutional growth would be quite strong. More likely, and preferably, the state would limit the number of grants for each institution. These limits should be set several years in advance both to make the Commonwealth's financial commitments more predictable and to enhance the institution's ability to plan for any growth. Also, the discussion surrounding the projected size of an institution's student body would allow the state to coordinate plans for capital projects needed for the institution to accommodate planned growth.

Determining the size of the tuition grant will be difficult. There is some appeal to the notion that the tuition grants should be the same for all institutions. In this case the system will be very simple to explain to prospective students. This is unlikely to be accepted by institutions because the current size of the per-student across-the-board subsidy varies considerably by institution. Institutions will argue that it would be unfair for all institutions to have the same tuition grant because it is more expensive to produce certain educational programs, for example Ph.D. programs, than it is others. This means that a system based on tuition grants that differs by type of institution (tiers) is likely to be the fairest system.

The classification of institutions into tiers will be politically very sensitive, but we think that it is possible to create such a system, especially if the schools that currently receive the smallest per-student appropriation from the state see an increase in the new system. It will be important for the system to recognize occasional changes in the mission of institutions, but it is also important for these changes to be made as part of a state approved plan for the system of education. Once the tiers are determined, it will be important for them to be set for some time. The placement of institutions in tiers should not be a source of continual political discussion.<sup>2</sup>

We suggest also that the system should have some flexibility regarding the across-the-board subsidy for capital. At present, institutions submit plans for new capital projects to the state in priority order. The political process then determines which projects can be funded in a given year. The uncertainty on the capital side associated with the timing of capital spending is at times more difficult for a college or university than the uncertainty in operating funds.

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<sup>2</sup> There are three institutions in the Commonwealth that might be able to make a case for continuing to have a state appropriation as well as having their students eligible for tuition grants. Norfolk State and Virginia State, the two historically black institutions in the state, currently receive higher than the average state appropriation per student. This treatment is consistent with a recognition that the group of students these institutions educate is very expensive to deal with. Virginia Military Institute also receives a higher than average state appropriation per student. This is consistent with a very expensive educational model at a military academy. We think that it would be appropriate to continue to treat these institutions differently than the others.



A state-allied institution might want to bring a building on line well before the political process would authorize it. Because of this, state-allied institutions would be better off if they had the authority to undertake capital projects they could finance on their own. If the institution thinks that a new facility or a building renovation will significantly enhance the quality of the education it can offer, it might well make the decision to add the costs of financing the project to its tuition. In other cases a state-allied institution might well be willing to wait for the political process to determine the timing of capital spending. Finally, there is no reason to think of capital projects as all or nothing. The state and a state-allied institution could share the costs of a capital project. The state of Delaware routinely engages in this sort of cost sharing with the University of Delaware. The important point here is that institutions should have the ability, if they can finance it, to control the pace of building on their campuses.

**Setting Tuition at a State-Allied College or University** - Under the new plan a state-allied college or university would be free to set tuition as it saw fit. When the new plan is inaugurated tuition would increase just as it has when the state reduced its general fund support in the past. Since general fund support for operations is completely eliminated under the new plan, as our example above illustrated, the list-price tuition increase could be quite dramatic. Yet it is important to note that the increase in net tuition -- the list-price tuition minus a student's tuition grant -- would be very modest on average. In fact, if the tuition grant turns out to be identical to an in-state student's share of the general fund appropriation, there would be no change in net tuition.

More likely, the new system would be inaugurated as part of a plan to reduce state expenditures, so the tuition grant would be less than an in-state student's share of the general fund appropriation for operations. As long as there were sufficient increases in state spending for need-based grants, access to higher education would not change. The same set of students would be able to afford a higher education. The major change is that the state would be providing a smaller average subsidy to Virginia students.

One common objection to institutions gaining free control of tuition is that highly selective schools might be able to raise *net* tuition significantly. As long as these schools agree to maintain current high percentages of in-state students, significant tuition hikes are unlikely. There are a large number of in-state and out-of-state colleges and universities vying for Virginia's high quality students. Ensuring a high quality student body is very important to college faculty and administrations. To succeed in this competition, an institution has to present to students an appealing price/quality combination. Under the new plan, because of the tuition grant, state-allied colleges and universities would maintain their current advantage in this competition compared to in-state private institutions and out-of-state institutions. A state-allied school that raised tuition too much would erode this advantage, and knowledge of this would provide a brake on any one institution's desire to raise tuition.

There are great advantages to institutions in moving to a system that allows them to set tuition with the understanding that this tuition forms a secure revenue base. As we have argued, under such a system they could make much more realistic long-range plans

than they can when they are directly affected by the state budget roller coaster. The effect of being dependent on state funds would be limited. There would be no more uncertainty associated with changing state appropriations for operations. Need-based grants could be a target of state budget cuts, but institutions could offset these if the cuts adversely affected the quality of the in-state applicant pool.<sup>3</sup> There would still be some uncertainty about the timing of capital projects, but if the institution felt it could afford to accept some of the costs of these projects, it could limit this effect too.

Under the new plan, budget uncertainties are shifted to the students through the size of the tuition grant. The state could limit the adverse consequences of this type of uncertainty by fixing the size of the tuition grant by student cohort. Under such a plan, the size of the tuition grant for first year college students would be set for those students for four years. The next year's first year students might have a different sized grant, but it too would be fixed for four years. This way a student could have a better sense of what his or her state support would be for an entire college career. We should hasten to add that the fact that students bear the brunt of the budget uncertainty is not a major change. Properly understood it is a change in timing only. Suppose that the state reduces its budget for higher education the equivalent of \$200 per student. Under the existing system, in the year of the cut, the institutions will have to absorb the cut by reducing spending. In the following year, the institutions will increase tuition, shifting the costs to students. Under the new plan, the students feel the cut the first year as well as the second one. The only difference is the timing.

It is important to point out that the relationship between state support and college tuition would be changed considerably under the new plan. Currently, when state support for operations is reduced, tuition increases. Otherwise the institution has to cut the quality of its offerings or reduce the number of places for in-state students whose tuition in no way reflects the cost of their education. Under the new plan, it is quite possible that just the reverse might happen. If an institution holds its list-price tuition fixed, its net price would rise with a decrease in the tuition grant. Importantly, however, the tuition revenue of the institution would not be affected. There is no automatic need to increase tuition. In some competitive situations, an institution might not be able to thrive with a higher net price for Virginia students. Such an institution might choose to *decrease* its list-price tuition or at least moderate its planned increase. Market pressures, based on the competition from other institutions, will strongly affect tuition.

### **3. What the New Compact Is and What It Isn't**

The new compact for state-allied colleges and universities is not a plan to privatize the current set of state-supported institutions. The state-allied institutions would agree to keep the same in-state/out-of-state ratios for their student bodies that they currently have. The Commonwealth of Virginia has an important interest in seeing that opportunities for a good higher education are available for the residents of Virginia. The

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<sup>3</sup> To the extent that state-allied colleges and universities still tried to influence the state legislature, it would be in their best interest to try to lobby for increases in need-based aid.

Commonwealth has made major investments in college campuses around the state as well as continuing appropriations for operating funds to see that these educational opportunities are available. This plan does not suggest that the Commonwealth is getting out of the higher education business. It does, however, recognize that public funding for operating its higher education system is likely to decline as a share of the total cost of education. This will mean that more of the cost of acquiring a higher education has to be borne by students. The plan is an attempt to accommodate this trend by giving institutions more freedom to deal with the change.

While the compact is not a privatization plan, it does provide for the colleges and universities some of the freedom enjoyed by private institutions. For example, this plan redirects the activities of the supporters of the institutions in a productive way. Currently, considerable time and effort are expended protecting the budget in Richmond. Much of this lobbying is, in a polite way, part of a competition among the state-supported colleges and universities over a relatively fixed amount of money for higher education. Such activity would not be necessary under the new plan – it replaces this political competition with market competition. This frees up an institution's lobbying efforts to be directed toward increasing its private fund raising.

Private fund raising by state-supported institutions in Virginia has been a success story. Loyal alumni and other supporters have provided funds that allow Virginia students to receive a world-class education at a cut-rate price. This type of activity should be encouraged. Public-private partnerships such as the state-allied institutions described here should be even more attractive to potential donors. In the current situation, some donors feel that they are being asked to bail out the state, or that their donation will allow the state to cut the institution's budget. With the relationship between the state and its institutions clarified, such problems disappear. As a separate legal entity, the state-allied institution also may become eligible for foundation support and grants unavailable to the traditional state-supported college or university.

For the state-allied institutions to have the autonomy they need to compete, they must have more budget independence than currently exists. College and university employees currently are state employees and receive some state-supported fringe benefits; most notably they are eligible for state retirement. Budget autonomy need not hurt existing employees. State-allied institutions could provide non-state retirement options for their employees while maintaining the state plans for those who prefer to remain within the state system. In addition, as state agencies, colleges and universities are bound by some state restrictions in areas such as procurement. The new plan would simply accelerate current plans to decentralize decision-making. These changes should be encouraged in any event.

This proposal is not a finished policy statement. There are many details to be worked out. Our hope is that this document will start a discussion. The time is right. Slowly and haphazardly, state support for higher education clearly is diminishing. Inevitably this puts more of the burden of financing higher education on students. We could be like Pollyanna and think that this trend will reverse itself, but we think it is

better to design a system that faces up to the long-term budget realities. We think a system that shifts state funding from institutions to students and creates state-allied institutions with much more autonomy to manage their own affairs will allow higher education in Virginia to flourish.

#### **4. Summary**

The two essential features of this plan are the creation of new legal entities that would control revenues from tuition and endowment funds, and making Virginia students the direct recipients of state grants for higher education. These changes would give the schools and the state direct control over the types of decisions that are arguably the most appropriate for each to make.

Virginia's colleges and universities would gain a predictable revenue stream for long-range planning and an enhanced ability to attract endowment funds and grants. Secure revenues would help ensure that the institutions could continue to offer a top-quality education in a very competitive higher education market. The power to set tuition still would be constrained by the market and by the continuing requirement to enroll a high percentage of in-state students. A substantial in-state tuition discount likely would remain, this time determined by the schools themselves who would have to trade off the need for more revenue against the desire to maintain a high-quality and diverse set of in-state students.

The state would control the size of its direct contribution to in-state students, and how that aid is allocated between need-based grants and across-the-board grants. In a time of budget crisis, or in an environment in which other demands on state funding are rising in priority, the state could adjust its commitment to higher education without damaging the institutions that provide it.

If the new state-allied institutions are better off, and the state contribution to subsidizing higher education shrinks, who pays the cost of this reform plan? Since the bulk of state aid currently consists of hidden across-the-board subsidies, this plan likely transfers some of the burden of funding higher education from the state to higher-income Virginia families. In times of budget crisis, the most sensible place to cut higher education spending would be in the across-the-board portion of student grants. If need-based aid were spared, the burden of cuts would be concentrated on those who could most afford it.

Yet this burden shift likely will be mitigated by a number of important by-products of the plan. Vesting the state subsidy in students themselves will reduce the wasteful lobbying by colleges and universities over their share of the fixed state support budget. Those same college resources will be redirected toward productive activities to increase private sector support. Increased private support will reduce dependence on tuition revenue and enable schools to absorb more of the cost of providing their services.

Getting off of the state funding roller coaster is essential if Virginia's colleges and universities are to maintain or increase their quality relative to peer institutions elsewhere. If schools control their own revenues and manage the type and timing of their capital projects they will be far better positioned to compete for the talented students and highly skilled professionals who determine their institution's quality. Enhancing that quality is another dividend that benefits all Virginia students regardless of their ability to pay.