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## Why does performance budgeting underperform?

By

*Paul E. Lingenfelter*

*Paul E. Lingenfelter is President Emeritus of the Association of State Higher Education Executive Officers, formerly Deputy Director for Fiscal Affairs at the Illinois Board of Higher Education, and the author of "Proof," Policy, and Practice: Understanding the Role of Evidence in Improving Education. He has chaired the NSSE National Advisory Board and the boards of the National Student Clearinghouse and the National Council for State Authorization Reciprocity Agreements.*

### Abstract

*Despite limited evidence of their effectiveness, for nearly fifty years performance funding formulas have been an appealing strategy for improving results in higher education. The strategy underperforms because it over-estimates the power of financial incentives, underestimates the power of other budgetary forces, and incompletely understands the relationship between funding and significant improvement. More effective budgeting strategies would avoid perverse incentives and achieve improvement both by better using existing resources and by expanding support for initiatives of demonstrated effectiveness.*

In 1974, at the very beginning of my career in state higher education policy, a group of thoughtful state policy leaders in Tennessee began experimenting with performance budgeting formulas for higher education. They believed this approach might help improve outcomes in higher education as well as lead to greater public support.

Performance budgeting formulas (sometimes called performance funding) can vary widely. Typically more funds are awarded for improvements such as increasing the percentage of students graduating, achieving specialized accreditation, obtaining more research grants, enrolling more Pell Grant recipients, et al.

In the quarter century after 1974 budgeting based on performance generated a mixed record. It was adopted by many states but then abandoned. In an extensive collection of books and articles around the turn of the century, Joseph C. Burke and his colleagues (2008) analyzed this pattern, summarizing both the complexity of the issues and the reasons for typically unsatisfactory results.

Then, over the past 20 years Performance Budgeting 2.0 emerged, a set of new strategies to yield better outcomes, seeking to learn from the shortcomings of Performance Budgeting 1.0. We now have another burgeoning literature advocating various approaches, presenting case studies, and asserting or questioning the impact of performance-based budgeting. At best, the record is still mixed (Dougherty, et al. 2016.)

Performance budgeting strategies continue to be proposed and resurrected for good reasons. Policy makers, everybody actually, will always like the idea of getting better results from money spent. But neither the amount of money provided nor the terms by which money is provided, can by themselves yield better results. The role of incentives in influencing performance is complicated, and their power is limited. It is hard politically to significantly change the existing allocation of resources. And performance improvements depend on both the amount of money available and how it is used.

### **The Limited Power of Incentives**

A political leader once told me: “Money changes behavior, and a lot of money changes a lot of behavior.” A similar theory, “You get what you measure,” has motivated both performance budgeting and accountability strategies such as No Child Left Behind and assigning letter grades to schools. Both positive incentives and the threat of sanctions influence behavior, but their power is often over-rated, and their effects can be counterproductive.

Money as an incentive will generally increase the supply of something that is relatively easy to provide. The key words here are “relatively easy to provide.” Funding formulas that are based entirely on college enrollments motivate institutions to recruit and admit more students. When there are weak qualifications for student enrollment, weak requirements for student retention and graduation, and inadequate support to retain and graduate at risk students, this kind of “performance funding” has yielded a lot of unproductive enrollments. Data from the National Student Clearinghouse Research Center show that the highest rates of non-degree completion by substantial margins are found in for-profit colleges (some of whom have employed a “recruit and admit” business model) followed by community colleges, which typically have open enrollment policies. College Board studies find such institutions also have the highest rates of default on student loans. (National Student Clearinghouse Research Center, 2019) (College Board, 2020.)

Providing financial incentives for improvement is less effective when it is harder to achieve the desired results. The research of behavioral economists has found that increasing the size of incentives both fails to improve and may actually degrade performance when a task becomes more challenging. (Ariely, 2011). At some point higher stakes generate debilitating, even perverse behavior.

Similarly, the threat of sanctions can be counterproductive when the task is difficult. When the stakes are raised for failing to meet a difficult standard, more energy is likely to be

devoted to lowering the standard or cheating than to achieving progress. This has been demonstrated many times in responses to high stakes testing and graduation requirements in K-12 education.

### **The Greater Power of Inertia**

To the recipients of budgeted funds the most important issue in every budget process is not improvement, but who gets what amounts of money for what purposes. This is true whether the budget is for divisions of a for-profit corporation, components of a small business, or parts of government. It is true when states or communities lobby to get federal grants, research centers, or military installations. And it is true when colleges and universities and their supporters in the political process approach the higher education budget.

Consequently, the most powerful factor influencing budgets, no matter what formula or approach is employed, is the “base,” the budget allocation of the current year. Rightly or wrongly, because the base budget was legitimized in the previous decision process, it largely defines the “fairness” of future budget decisions.

The highest priority for the people, institutions, or communities benefiting from any budget is to avoid the loss of revenue. If the total budget is growing or shrinking, the next highest priority is to sustain their “share” of the budget. Finally, they want to increase their “share,” an objective often opposed by every other entity receiving funding. Consequently, the status quo is the path of least resistance in budgeting. Political resistance grows in proportion to the size of proposed changes from the current budget base.

The power of the existing budget base is common knowledge, widely recognized since the political scientist Aaron Wildavsky published his classic analysis of budgeting in *The Politics of the Budgetary Process*. The insights of his 1964 analysis have been confirmed by studies of budgeting practices in many countries over many years.

Budgetary incrementalism, Wildavsky argued, reflects, not an irrational acceptance of past practice, but a rational and pragmatic recognition that it is difficult both politically and intellectually to justify substantial, non-incremental changes to previously established budgetary decisions. In his critique of the program-planning budgeting systems (PPBS) then in vogue, Wildavsky suggested it is *more* irrational to imagine that new analytical techniques can be overwhelmingly superior to and more persuasive than the budgeting judgments made in the recent past. (Wildavsky, 1974.)

The “base” is not all powerful, of course. Sometimes a shift in political power will work to the advantage or disadvantage of some components of the budget. Significant changes in the demand for some public service can lead decision-makers to increase or decrease funding. A relatively small component of the budget for which there is limited public demand, might even be totally eliminated. And as is well known, when states have confronted a fiscal crisis, higher

education has frequently been cut more than other parts of the budget. Such cuts have been defended because colleges and universities can replace lost state revenues with tuition increases. This actually confirms the power of incrementalism: total funding remains relatively stable while the fraction of the cost paid by students and their families increases.

The power of incrementalism is easily observed in negotiations over performance funding formulas. The first attack on non-incremental change is to make the performance-based component of the formula as tiny as possible. If that is unsuccessful, the next strategy will be to make certain that multiple components of the formula are performance based. I have observed institutions carefully analyse the financial impact of performance budget proposals and work very hard to be sure that “losses” from one element of the formula are offset by “wins” from another.

If performance budgeting elements account for a significant share of a budget formula, the formula tends to become complicated with many elements. The net result usually is that performance funding fails to significantly alter the previous allocation of resources. It also adds greatly to the cost in time, money, and incomprehension associated with greater complexity in the design and implementation of the budget formula.

### **How Does Money Shape Performance?**

As a general matter, it is easier for organizations to perform well when they have plenty of money. Likewise, when there is less money available, it will be more difficult to perform well.

The underlying theory of performance funding assumes that adequate resources, now ineffectively employed, are already available for generating better performance. Tying some amount of future funding to better performance is intended to motivate the desired performance improvements, either due to the potential for gain or to avoid the loss of future funding.

This is not a crazy theory, but it is worth noting that providing more money *after* performance improves presumes that motivation, not money was the missing ingredient. When adequate resources are already available, providing future rewards may not be the most efficient approach to getting better results. (Dan Airely’s critique (2011) of bonuses in the private sector is instructive.)

At times money, not motivation, may be the missing ingredient. Although every institution and organization can find ways to more effectively use existing resources, this is certainly less true for some than for others. Consequently, performance budgeting strategies favor institutions who have more discretionary resources above those who have fewer.

Regardless of the relative wealth or poverty of an institution, it would be wise to examine the reasons performance is unacceptable and to address those reasons directly. For example, some institutions have increased student retention and graduation rates by carefully examining the situations where students get off track and strategically intervening to keep them enrolled. It turns out that the motivation to serve students better has both intrinsic and extrinsic rewards because both enrollments and revenues grow with better retention.

Both institutions and students may need more resources in order to achieve better performance. When need based student aid is insufficient, students commonly take fewer academic courses and work more hours, a pattern that often leads to non-completion. If an institution lacks sufficient resources to provide counseling and effective teaching, an “incentive” to improve performance with existing resources is unlikely to be very productive. Providing more need-based student aid or targeted support to institutions enrolling at-risk students may be the most efficient way to improve results.

### **Formula Funding, Incentives, and the Signaling of Priorities**

Perhaps the strongest argument for performance funding is that it is a way to signal important public priorities in funding formulas. When policy makers identify an unmet priority, encouraging improvement by tweaking the funding formula is a naturally appealing strategy.

Although flexible, eclectic approaches to budgeting can more effectively use money to pursue priorities (see Lingenfelter, 2008), formulaic approaches to budgeting are common and perhaps unavoidable when a large number of institutions or other realities (small budget staff or limited discretion) preclude directly financing improvement initiatives. Even when non-formulaic approaches are feasible, virtually every budgeting system employs some measures of workload and performance.

Especially when the limited effectiveness of incentives in improving performance is understood, *budget formulas should carefully avoid perverse incentives*. A perverse incentive provides substantial rewards for insubstantial work. For example, budgeting systems have commonly measured higher education workloads by enrollment on the tenth day after registration. Others have measured workload at the middle of a term, or at the end of the term when a course is completed with a grade, passing or failing.

Arguably, there is some work burden for every student who enrolls for any length of time, but both the work and especially the benefit achieved is small for students who do not finish a course in which they enrolled. The work required and student benefit are smaller still for students who drop out between the tenth day and the middle of the term. Accordingly, measuring workload by courses completed provides an incentive for student retention and success and a disincentive for enrolling students that an institution is inadequately able or

committed to bring to the point of course completion. Course completion should be the measure of workload in any higher education budgeting system.

Policy makers may wish to signal priorities beyond course completion, such as increasing degree completion, enrolling and graduating lower income or first-generation students, obtaining sponsored research funding, etc. For such priorities and others, policy leaders would be wise to look for other ways of promoting improvement beyond budget formulas. New resources or new incentives may not be necessary for improvement. If new resources *are* needed for improvement, policy makers might reasonably require evidence that improvement is feasible through demonstration projects funded with existing resources, followed by additional investments to achieve better outcomes at scale.

Inspired in part by Complete College America, an organization created in 2009, policy makers in many states made higher rates of college completion a higher public priority. Some states created performance budgeting formulas as a means to achieve that objective. Performance budgeting certainly sent a meaningful signal of the priority, and it may have helped. But it was just one of many calls for improved outcomes, and it is unlikely that it was the most powerful.

The most impressive rates of improvement have occurred when institutions have worked to achieve better outcomes by systematically looking for and addressing the many factors that discourage success in degree completion. One especially notable example is Georgia State University, where additional funding enabled scaling up demonstratively effective initiatives. Georgia State dramatically increased retention and degree attainment rates with a portfolio of strategies including: predictive analytics to spot precursors of academic difficulty followed by counseling and other assistance; extra instruction and peer mentoring to assist academically at-risk students; strategies to assure adequate financial aid, including micro-grants to cover modest financial shortfalls; and learning communities and counseling to foster greater career awareness, skill in navigating the college curriculum, and student confidence and engagement. Such strategies have spread to many other institutions. (Gumbel, 2020), (Renick, 2018), (York, et. al. 2017.)

### **Achieving Meaningful Improvement**

Performance budgeting underperforms because it is too simple a solution for complex problems. It overestimates the power of monetary incentives. Where improved performance can be easily achieved, it spends money where it is not needed. Where improved performance is difficult to achieve, it is unlikely, by itself, to motivate significant change and tends not to provide resources that may be needed. And it is incapable of overcoming the forces that tend to make public budgeting decisions fundamentally incremental.

Significant improvement in educational performance requires a thorough understanding of difficult problems, a serious commitment to progress, adequate resources, and

sophisticated, systemic solutions. Significant improvement is feasible, but there are no shortcuts.

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Performance budgeting strategies have failed to realize the aspirations of their advocates for nearly fifty years. They over-estimate the power of budget incentives and under-estimate the power of budgetary inertia. More effective financial strategies would:

- Avoid formulas that reward unproductive institutional practices;
- Challenge institutions to improve with existing resources; and
- Provide additional support to increase the scale of institutional strategies that improve outcomes.