

School Finance Redesign Project



center on reinventing public education

INCENTIVE-BASED FINANCING OF SCHOOLS

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The School Finance Redesign Project

The School Finance Redesign Project (SFRP) encompasses research, policy analysis, and public engagement activities that examine how K-12 finance can be redesigned to better support student performance. The project addresses the basic question, “How can resources help schools achieve the higher levels of student performance that state and national education standards now demand?”

Check in with us periodically to see what we’re learning and how that information may reshape education finance to make money matter for America's schools. You can find us at www.schoolfinanceredesign.org.

Jacob Adams, Principal Investigator

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Introduction

Many discussions of education finance attempt to separate the funding of the schools from the policies that govern operations. The idea is that it is possible to determine the level of spending and its distribution across students, schools, and districts at one time and then to decide on the policies and regulations that guide the system in an independent set of policy decisions. History shows that, as a general rule, this cannot be done effectively and the attempt frequently leads to very bad policy outcomes.

The most prominent example lies at the heart of the school finance policy debates. Student performance at a number of schools and districts is not acceptable and must be raised. But, it would be (and is) bad policy simply to direct resources at districts where student achievement is observed to be too low. Doing such is frequently justified on the basis of providing the resources needed for the schools to mount the programs needed to overcome low performance. Yet, by structuring funding so that districts that succeed in raising performance then lose resources creates an incentive for schools to fail—or at least not to succeed too much. Many states currently have such elements in their finance structure.

The fundamental issue in this is that there are three reasons for low performance. First, students in some schools may, for whatever reason, come to a school less prepared than those elsewhere. In such cases, even when the school does an average or above average job at educating the students, student achievement can remain low. Second, the performance of the students may simply reflect the fact that the school is doing a poor job educating their students, so again the student achievement remains low. Third, and related to the previous reasons, students and/or school personnel may not be sufficiently motivated to perform up to capacity.

These cases may each be present in any given school and are frequently difficult to distinguish. But, it would generally be a mistake for the financing policy to assume one is dominant without also including the means for identifying which factor is operating.

The concern about how financing relates to policy objectives goes deeper. It is important that the financing system put in place positive incentives to meet our objectives and that it does not introduce perverse incentives. We do not want to encourage over identification of special education students or to encourage wasteful behaviors more generally. We do want to encourage students, teachers, and schools to strive for high performance and to develop the potential of all students.

An outcome or incentive-based system is a substantial departure from the current school finance system. It cannot be assumed that the school personnel currently have the capacity to react successfully to such a different system. Thus, it is important to think of a transition path that emphasizes building capacity to structure, apply, and evaluate alternative incentives.

Finally, it is clear that our experience with many aspects of a renewed system is limited, and our knowledge base is insufficient to be sure of the outcomes. Therefore, any reform of the finance/policy system must include an explicit program for improving our knowledge of the outcomes it produces and for refining and readjusting the policies.

Standards-Based Decisionmaking

The role of state and local authorities has changed over time. In an effort to improve the quality of education, or at least to ensure that all students receive a minimum quality of school experience, states have historically developed a variety of policies and regulations designed to guide the actions of local districts. However, over time many have questioned whether regulations of the educational process can be particularly effective, particularly in leading to general improvements of student learning.

All policies involve a mixture of state, district, school, and classroom decisions and actions. But the implementation at the local level is crucial to the outcomes of any policy. If the best policy from the state never has an impact on the activities of districts, schools, and classrooms, we will not see any impact on students. Moreover, if the local circumstances call for varying programs and actions, a statewide policy applied to varying local circumstances is likely to have varying impacts, some of which are undesirable. At the very least, such a statewide policy will almost certainly be wasteful.

This concern about the impacts of central regulations and policies is the underlying motivation for the standards-based approach. Under this altered view, education policy should begin with an explicit statement of the learning goals of schools, detailed by subject and grade. Based on this, instruction is oriented to ensure that students meet these goals, and measurement and accountability are based on accomplishment of them.

What we can best determine from the state level is the outcomes that we desire. The state is best equipped to define the learning outcomes that are desired and expected from all students in the state.

The state is less equipped to define how these outcomes might be obtained. The heterogeneity in districts and their capacity and needs makes it difficult to specify the best approach to obtaining any given outcomes.

These observations imply that local decisionmaking on the means of obtaining any given state outcome goals is desirable where practical. The state should clearly identify the outcome objectives, but it should devise means to engage local districts and schools to develop approaches for achieving these.

Many states have followed exactly this course—specifying and holding districts responsible for meeting standards while loosening up on the underlying regulations about how to achieve these.

The use of categorical funding interacts importantly with standards-based reforms. The extensive use of categorical programs inhibits local decisionmaking because it constrains funds to be used in very specific manners and requires accounting for the proper use of these resources. By removing local decisionmaking, such a financing approach implicitly assumes that local districts and schools will not make appropriate decisions.

The reason for this assumption about inappropriate local decisions is usually not stated. It could be that it is assumed that they do not have the capacity to make good decisions—because of poor preparation, poor selection of decisionmakers, improper ideas about objectives, poor motivation, or other reasons. Or, it may be that this is designed to ensure that certain funds do

not enter into the resources subject to contract negotiations and bargaining. Or it may be simply a political solution that permits state decisionmakers to point to specific actions designed to improve schools.

A very different motivation, however, is that different districts are recognized to have varying educational needs. Thus, districts with, for example, heavy English Language Learner populations, may get specific funds to meet additional educational costs. By giving categorical funds related to underlying district characteristics, there is an attempt to match resources with needs. As discussed below, this motivation for categorical spending interacts with the general form of the school finance structure.

Principles

The financing ideas follow some simple principles.

1. Policies should set up incentives to improve student performance.
2. School personnel should have the latitude to make decisions on how things are done but should be held responsible for the results.
3. School personnel must have the capacity to make good decisions, and, where this is lacking, policies should be instituted to develop their capacity.
4. Needs and circumstances vary widely across districts in all states, and policies should recognize this underlying heterogeneity.
5. While there are specialized needs of disadvantaged populations, the necessity of improving all of the schools remains, and, to the extent practical, policies should encompass the full range of schools within the state.
6. Incentives should be directly related to outcomes. Funding should not be based on inputs that are under the control of the districts because such input incentives distort the behavior of districts without necessarily improving student outcomes.
7. The state must have reliable and valid information about performance and school outcomes, and this must be an integral part of making the school system an evolving and improving system.
8. Accountability, incentives, and transparency must go hand in hand, and separating these components is likely to lead to bad outcomes.
9. New policies should be introduced in a manner that supports direct evaluation, and this evaluation should be a required element of the policy development.

Schematic of an Incentive-Based Finance Package

There are alternative approaches for meeting the previously stated principles. But the following elements suggest that the kinds of finance policies that have a chance of improving student outcomes integrate a series of distinct elements. While some elements might be separated or substituted (e.g., using a block grant system for special education), in general the system

would lose effectiveness and appeal if other key elements were eliminated. Thus, the components are separated into necessary and modifiable components.

Necessary Components

The “necessary components” constitute a base level of financing and policies that go together. The key thing about them is that they provide an integrated group that would be significantly harmed by eliminating parts of the program.

An accountability system that assesses value-added at the school and classroom level.

The state must have the ability to track individual students and their performance over time and across districts. Teachers should also be identified with individual students. With these data, it is possible to calculate achievement gains for individual students and to assess the value-added of schools and teachers.

A basic funding system that provides necessary resources to districts and schools to succeed. This would provide funding attached to individual students but provide extra funding based on environmental factors: expectations of special education, district cost differences, transportation allotments, expectations of disadvantaged needs, language needs, and so on. The funding should be sufficient to develop programs and hire personnel that can yield high levels of achievement.

A reward system that provides extra resources for teachers and administrators that obtain high value added (as distinct from high overall levels of student achievement). Districts that obtain high value added should receive rewards in terms of additional funding. Similarly teachers that obtain high value added should receive bonuses. The exact form of any teacher rewards would be determined by individual districts within state guidelines that required objective measures and use, at least to some extent, of data on individual student achievement. The state would provide a “bonus pool” that would send funds to districts that employ acceptable performance bonuses.

Examples of such performance systems are becoming more plentiful. The Teacher Advancement Program (TAP) operates in the regular public schools of 13 states and incorporates teacher pay based on their students’ performance (National Institute for Excellence in Teaching 2007). In 2006, Florida began the STAR (Special Teachers are Rewarded) program where it put \$147 million into a bonus pool for any district that developed a performance pay plan that fit within state guidelines (Hanushek 2006b). The state guidelines did not prescribe a specific plan but instead set minimum requirements such as bonuses for the top 25 percent of a district’s teachers based on gains on the annual assessments of students. Districts had to apply to the state board and were accepted into the program based on their plans for performance rewards. In 2006, Governor Rick Perry of Texas established the Governor’s Educator Excellence Awards program that would fund teacher awards for improving student achievement by up to \$330 million by 2008-2009. Like Florida, plans have to be locally based and to receive approval of the state department, but the awards depend upon overall school achievement improvement. Other states and locations—Denver, Minnesota, and others—are also well into experiments with different versions of performance pay plans. Finally, the U.S. Department of Education established the Teacher Incentive Fund with an initial \$99 million to support localities that establish reward systems based on increases in student performance.

A set of decision rules that allow latitude to individual district decisionmakers while ensuring that they are responsible for value-added results. District personnel must be able to make appropriate educational decisions. They must be able to hire personnel and organize instructional programs to achieve success. Thus, efforts must be made to eliminate the input and process regulations that pervade the current school code. The elimination of input restrictions includes substantial limitation on the use of categorical funding of specific programs and policy elements.

Moreover, work with contracts and teacher assignment policies is necessary. Decisionmakers—principals, superintendents, and others—must be assessed, rewarded, and retained in large part on their ability to mount an effective program that delivers high value added. At the same time, the outcome standards are not a subject of local decisionmaking but instead remain with the state.

A funding system that adjusts over time to reflect changing needs of districts and students. If the funding of districts is highly volatile and if the rules change frequently, it is not possible to develop solid, long-run programs. Thus, developing a funding program that offers both timely information about resources that will be available and stability of the resources is important.

An option for local districts to supplement state funding on an equalized basis so that parents can become more involved in expressing preferences for schools and in holding districts responsible for results. There is considerable evidence that involving citizens directly in funding decisions for schools has important benefits. First, it allows parents who are most intensely interested in schooling to actively choose how their schools operate. Secondly, it brings an added amount of accountability because schools that do not use funds wisely will not tend to be supported. At the same time, as dramatically pointed out by the *Serrano v. Priest* court case and its many successors, there have been wide disparities in the ability of local districts to raise funds. Any local funding (perhaps within some overall bounds) would be raised according to equalized property values, so that the fiscal advantages of some wealthy districts are neutralized and do not yield educational disadvantages to students.

Expanded options for choice to permit parents to directly interact with schools in a meaningful way. The opening up of options for choice through charter schools and through other options should be encouraged. These choice schools should receive funding and rewards under the same terms as regular public schools. The availability of choice is essential to maintain competitive pressures on public schools to perform well. It also keeps the accountability system from being eroded.

State responsibility for ensuring that there is capacity in the system to achieve results. Schools that are failing clearly lack the capacity to do well. This lack of capacity could result from unprepared personnel, lack of information about effective programs, lack of leadership, or other things. The state should take on the responsibility for building up the knowledge base about program effectiveness, including the design of performance incentives. It should also be more aggressive about the characteristics of teacher and principal preparation because most teachers and administrators are trained at state institutions of higher education.

An on-going state evaluation system that provides information about the programs, districts, schools, and teachers who are doing well and who are doing poorly. The optimal way to design the various incentive schemes and finance arrangements along with the basic

educational programs is simply unknown at this time. While there is some information to build upon, it is not sufficient to support the full development of the “best” system. In reality the finance and policy system should be thought of as an evolutionary one. Knowledge from the experiences with current developments should be a regular component of modifications over time. Today, new policies are introduced not so much because of information that the past ones were not working but more because of the faddish introduction of different ideas. Without an active evaluation and research program, there is little expectation of systematic improvement over time. Moreover, these activities are naturally done primarily by the state, because of the externalities in information and because of the necessity to develop good analytical designs that span different programs.

Performance, finances, and programs that are transparent at the school level. It is now common to get information about student achievement at the school level. NCLB maintains reporting of student proficiency for schools and subgroups of students in each school. This information is insufficient, however, to provide for active consumer involvement. The system should provide routine information about value-added of schools to achievement, about the financing of schools (in actual flows to the school), and about the choice of curriculum and programs instituted at the school.

Modifiable Components

These components involve a set programmatic elements for which major options are available.

The special case of special education services. The provision of services for special needs students has been greatly enhanced by federal (IDEA) and state laws. A number of difficulties have developed, however. Many state funding approaches yield problems with over-identification of students. There are a variety of pressures that fail to ensure successful programs. More importantly, there is often concern that special education and regular education unduly compete for resources.

One approach is to provide block grants plus insurance. A fundamental problem with much of the funding of special education is that it changes the “price” of identifying students. Indeed, if districts can come out financially ahead by identifying an additional student, they are encouraged to over-identify—particularly given the ambiguity of categories such as “learning disabilities.” If, however, the district is given a fixed amount of money, say based on population, that is not changed with adding new students, the incentive to over-identify goes away. At the same time, some very expensive disabilities can put small, or even larger, districts in impossible financial circumstances. This problem can be solved, however, by having the state fully insure districts for very expensive children through picking up the costs of such students directly. (Note that the very expensive conditions, such as blind-deaf, are more readily audited and diagnosed).

This block grant approach is not, however, the only option. Nationally, one of the most successful ways to deal with these has been the provision of scholarships to students identified with needs that could, at the family’s choice, be used with outside vendors for special education. When instituted in Florida, this has led to increased parental satisfaction with programs and has dramatically eliminated the within-district concerns about resource allocations. (The amount of the scholarship varies with the identified condition and its severity. Because students will potentially leave with the scholarship, the district does not have an incentive to over-identify

disabilities). Special education vouchers have proved to be very popular with parents and districts.

In any event, a remaining problem with special education, no matter how funded, is a general lack of outcome focus. Much of the law and regulation about special education is best characterized as process oriented, and there are few incentives for achieving high-level learning gains for special education students. Little experience is available about measuring and rewarding performance in special education, but this is clearly a priority area for research and experimentation.

The special case of English Language Learners (ELL). Students lacking a command of the English language are a significant problem for schools in many states, and extra funding is clearly needed to mount programs that can help move these students into an English language program. However, there is a major problem if funding simply follows identification of problems with the English language. Such a system, without other constraints, again changes the price of success, since a district will lose funding if they prove successful.

One obvious approach in funding ELL students is, after some determination of need, setting a fixed length of support—say, three years. The district gets the funds for three years but not after. This kind of program, of course, requires again having a student information system that tracks individual students.

A particularly significant problem is the high mobility of students across districts. If funding is fixed for the student, one district could take the fixed funding without providing good English language instruction, leaving subsequent districts without funding. If on the other hand funding is fixed by participation in a district, the incentive to support mobile students declines.

One possibility is to block grant funding for ELL students, perhaps based on some set of student characteristics, and then provide incentives through the accountability system. That is, by setting rules for when students must become fully included in the testing and accountability, districts have direct incentives for serving this population. However, the issues of mobile students remain important if each district is viewed independently.

The special case of failing schools. When the state evaluates schools and finds them to be failing, it can pursue a variety of approaches to help the schools to improve, including a range from offering outside consultation to state take-over or reconstitution of the school. Currently available experiences do not provide clear guidance.

Part of the issue is identification of the correct schools (i.e., those who are doing a bad job as opposed to those just having a very needy population). Current policies do not do a particularly good job at distinguishing between these.

Most clearly, truly failing schools have a capacity problem. The current staff is unable to get things moving very well. And it is incumbent on the state to consider how to improve the capacity. Evidence does not indicate that simply providing extra funds will accomplish much, although extra funds may be a component in the context of other re-organization.

Clearly, however, all of these things will take time to achieve their purpose. The group that does not have time is the current students of the school. Something must be done immediately because these students have been hurt and do not have time to wait for a general fix.

Students in failed schools—say, those that receive a bottom ranking on the state report cards for two years out of three—should be given scholarships (vouchers) that can be used to obtain admission at another school whether public or private. Any private school accepting scholarship students would agree to take the scholarship—which is set at the district average spending on schools—as full tuition for attendance and would agree to provide test information on students.

Note that NCLB has a similar provision but it does not have a good measure of school performance, it does not become operative until the fourth year of failure, and it has yet to be fully enforced.

Weighted Student Funding

A recent proposal that has received broad discussion is the use of “weighted student funding” as an organizing principle for school finance discussions. This approach would subsume a variety of current funding programs and rules including most if not all categorical programs.

A large portion (or all) of current funds in base funding would follow individual students, eliminating the common usage of multiple categorical funding programs. These funds would then be supplemented by additional amounts reflecting varying needs. For example, a typical student may receive a base funding amount of say \$8,000 per year. And, a student with need of English language instruction may receive \$9,000. Other categories of students, defined in terms of educational needs, may receive other amounts. But, as discussed, it is important that funding does not follow directly from district choices. For example, if added funding follows directly to a district that identifies a particular student as, say, learning disabled, then it is likely that districts will tend to over-identify learning disabled students.

The term “weighted student funding” actually connotes a wide range of programs. Some people use the term weighted student funding in the manner described here as rolling together different funding streams into one. Others, however, also presume that this means that funds are distributed directly to schools, bypassing district decisionmaking. Thus, it is sometimes used as a shorthand for further decentralization of decisionmaking (Thomas B. Fordham Institute 2006). Still others see this as driving the way funds are allocated to charter schools and other educational entities. Because of this ambiguity, we refrain from using that label and merely refer to the basic idea as needs-adjusted base funding.

What are the advantages and disadvantages of this type of funding? On the advantage side, it first makes the funding that is available transparent so that it is well known to all what resources flow with each student—something that is not currently known. Secondly, it eliminates accounting (and spending) money in narrowly defined ways, thus offering flexibility in programmatic decisions. These outcomes are quite compatible with the principles and elements of an effective finance system previously stated.

The disadvantages, however, can be considerable if such a funding approach is not linked to outcome accountability and if such a funding approach is employed where decisionmakers do not have control over spending and programmatic decisions. In other words, simply focusing on the distribution mechanism for basic funds—such as eliminating some of the necessary elements discussed above—is a recipe for a bad outcome. In particular, if the only thing that happened today was a change from the current basic aid/categorical funding system to a weighted student

funding, it is very likely to lead to worse student outcomes. Why? The current accountability system does not identify or reward student value added to any significant degree. And, district and school decisionmakers are still constrained by contracts, state regulations, and state educational laws so that they frequently have limited ability to redirect any added resources in productive ways. Finally, much of the current leadership was not trained or chosen in terms of their ability to make effective resource allocations and choices that improve student achievement.

Adequacy of Funding

Most school funding discussions begin and end with a discussion of the level of funding—often today dressed up under the title adequacy. A variety of approaches have been used to determine the spending that would equate to an adequate education. The idea behind each is simply using some method to equate a level of spending to a desired, or adequate, level of student performance.

Both aspects of this quest—fixing the adequate level of performance and equating that level to the necessary spending—are problematic.

The adequacy discussion has been closely related to court cases where the level of performance is typically motivated and defined by constitutional requirements for the provision of schooling in each state. Of course, no state constitution specifies a level of achievement. Instead state constitutions use hortatory language. If a product of an early constitution, the ambiguity is virtually always present.

An industry has grown up to provide estimates of the total amount of funding to achieve a set of student achievement standards. The level of achievement in various studies includes achieving proficient levels under No Child Left Behind or meeting goals set by the state under its learning standards. Unfortunately, none of these methods can provide reliable estimates of the costs of achieving levels of performance that exceed current performance by very much.¹

Most importantly, given the current inefficiencies in the operations of schools, it is virtually impossible to project what the current level of achievement would cost under efficient provision. Changing the system to provide even greater output makes this estimation problem even worse.

Additionally, spending on schools is always a political decision involving a variety of trade-offs with other goals and objectives of society. There is no way to define the amount that should be spent on schools in a scientific manner. Decisions on funding schools—like those for health, police, prisons, highways, and so forth—must involve weighing benefits and costs of alternative funding plans.

Conclusions

School finance cannot be divorced from school policy. If the objective is to raise the performance of students, the finance system must support that.

¹ See Hanushek (2006a) for a discussions of the problems that make these various estimates unreliable.

Unfortunately, many current finance systems do not focus directly or effectively on achievement goals. They represent a combination of historical practices, conflicting components, and elements that actually work against higher achievement.

If schools are to improve and if we are to meet our achievement goals, the finance system must be harmonized with the policy structure. It must provide and support improved incentives within the schools.

The importance of the interlocking nature of finance and policy is perhaps most clearly seen in the situation in California. California is among the lowest performing states in terms of student achievement, and it also spends below the median for states. Yet, an exhaustive project to diagnose the problems concluded simply: “It is clear...that solely directing more money into the current system will not dramatically improve student achievement and will meet neither expectations nor needs. What matters most are *the ways in which the available resources are used.*”² While California may be an extreme case, it clearly illustrates the overall principle.

Quite clearly, the way that funds are distributed to schools introduces incentives for the behavior of districts and schools. Ignoring that introduces a structure that limits both efficiency and performance.

² The Getting Down to Facts project involved 22 separate investigations of a different aspects of finance, governance, and performance of California schools. The overview of the results can be found in Loeb, Bryk, and Hanushek (2007) and the complete set of papers can be found at: <http://irepp.stanford.edu/projects/cafinance.htm>.

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