INDIANA UNIVERSITY PURDUE UNIVERSITY INDIANAPOLIS
IUPUI

MEMORANDUM

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SUBJECT: Responsibility Center Management Action Team Report

DATE: May 3, 2007

Please find attached the report of the RCM Action Team. We have met periodically over the several months since receiving the charge and have engaged in sometimes spirited but always thoughtful debate in reaching the final set of recommendations. I take this opportunity to commend the efforts of each member of the team. Their contributions are evident in the final document. Should you have follow-up questions, please do not hesitate to contact me.

RESPONSIBILITY CENTER MANAGEMENT ACTION TEAM REPORT
MAY 2007

Goals of the RCM Action Team Report

- Review improvement options for the budget planning process for academic units
- Review opportunities for increased simplicity of the assessment calculation for units
- Propose a course of action for consideration

Recommendations

1. We recommend a true flat tax which would be a fixed percentage of either budgeted income or budgeted expenditures. Of these two, we prefer a tax on budgeted expenditures. Actual income or expenditures might be preferable but it would introduce an undesirable two-year lag. We prefer the tax on expenditures as an incentive to contain costs. This tax would provide the budget for the support centers and for the Chancellor's Reallocation Fund. We recommend implementation of the flat tax on a hold-harmless basis and at the lowest breakeven tax rate possible for the support centers. An allowance based upon historical figures could be included in the tax rate for unavoidable and campus-wide expenditures such as rising health benefits, rising fuel costs, or other unfunded mandates. The tax rate may have to be set, initially, at a slightly higher level to buffer and accommodate the unknown impact of the 'unavoidables' but the portion of the tax devoted to support center costs should be fixed over time, subject to periodic review every five years or so. If the tax rate is set high enough to incorporate an average of the past three to five years of 'unavoidable' expenses plus the normal support center costs, it should be possible to keep the overall rate fixed for an extended period of time such as four to five years. This could allow support centers the flexibility to build up reserves against unexpectedly high future costs. As with all such policies, periodic review is a necessary part of implementation.

Setting the rate—There is concern that, in recent years, the academic RC's have suffered from declining net revenues (Income minus Assessments) but that Support Centers have been somewhat shielded from these painful adjustments. If so, it seems that the initial rate should be set on the basis of current Support Center expenditures but there should be a phase-in of three to five years to a lower rate that is commensurate with the rate that would have been set had the flat tax been implemented in 2002. That would give the Support Centers a period to adjust their expenditures to fit a lower (net) revenue as the academic RC's had to do between 2002 and 2007. A thorough evaluation of the last five years of Support Center expenses compared to RC expenditures should precede this exercise so that the final rate can be set appropriately.

2. Feasibility/alternative—Some on the Committee felt that there would be substantial decanal resistance to moving to the flat tax. Should that be the case, a more limited alternative is to adjust the weights on the three drivers. The student FTE, faculty/staff

FTE and space drivers have had equal weight despite changes in costs over time. Because of rises in fuel costs and health benefits, the latter two factors are currently driving higher costs. ADFI can associate support center costs with each of the three drivers and determine a set of weights that more accurately reflects the role of the drivers in support center costs. These weights would be fixed for a period of years but might be reevaluated every five years or so. If the more fundamental reform of moving to a flat tax cannot be achieved, this tweaking of the weights might at least mitigate some of the current problems of perceived inequities.

<u>Rationale for a Flat Tax</u>

General-- Public Finance, the branch of economics that specializes in government tax and expenditure policies, indicates that the most *efficient* tax is one that has the lowest feasible rate on the most comprehensive base, as this leads to the smallest distortion in behavior~~s~~ and the least effort at evasion. In our case that would argue for a breakeven tax rate on the widest possible base, such as all expenses. This would permit better long term planning and enhanced transparency. Each of these aspects will be discussed in more detail below.

Flat tax as an efficient tax: By using the lowest tax rate possible, there is the least incentive for trying to *game the system*; hence less effort should be devoted to such unproductive activity.

Flat tax on expenses: We prefer using a comprehensive measure of total expenses as the basis of the tax. While income (and/or a combination of income and expenses) could also be used as the basis of the tax stream, using expenses might be simpler and meet less resistance than using income. It also focuses attention on controlling costs rather than limiting revenues.

Flat tax as a better tax for long term planning: If deans and their associates and advisers know what the tax rate is in advance, they can determine *a priori* if a new (or existing) initiative makes sense from a fiscal perspective. Of course, there may be projects, courses, etc., that do not make strict fiscal sense, but are important from the perspective of the mission of the unit to do regardless. However, a flat tax would enable those involved to make a better and more accurate plan about the level of subsidy required. In such an environment, *planning and budgeting* becomes more rational and less speculative. If Deans can anticipate a certain dollar amount in after tax dollars, it is easier to determine, from a fiscal perspective, whether or not it makes sense to undertake (continue) a new (existing) project.

The linkage between RCM and planning would be enhanced with a flat tax and more importantly, it would appropriately shift the focus from the short run to the longer term. As a result, the strategic planning envisioned by the designers of RCM can be more fully realized.

Flat tax as a better tax for transparency: By committing to a fixed percentage of taxation to fund the support centers and the campus' (and the campus' share of the university's) share of the total expenses, the campus commits to a multi-year set of parameters, which mandates the ultimate level of transparency and accountability. All of the deans, directors, et al., can calculate a fixed percentage of their total expense, and therefore there are no surprises in terms of support center assessments. Of course there may still by unanticipated unavoidable expenses; as long as they fall within a normal historical range, however, they should cause no special difficulties.

Flat tax as a tool for supporting a share the pain-share the gain environment: In the flat tax environment, the support centers get what they get (the fixed percentage of expenses) and have to live within their budgets or help the academic units create new revenues. This creates much stronger systems for the support centers to control their costs and to help the academic units grow their revenues. Currently, the support centers, at least in principle, get their fixed slice of the pie—regardless of whether the pie is growing or contracting. Therefore, the academic units are left with the residuals (which, in recent years have been shrinking). In practice the Chancellor and Vice Chancellor for Administrative Affairs have asked support centers to absorb some of the rapidly rising overhead expenses. But this is on an *ad hoc* rather than a planned basis.

Support Centers should be permitted to keep reserve funds, but they must also be held accountable to cover any shortfalls. This provides the incentives and opportunities for support centers to do multi-year planning and have a basis for meeting any fiscal deficits. If the tax also includes an allowance for an average level of 'unavoidables', that would enable support centers to build up surpluses in good years to smooth out higher than average cost years. If support centers build reserves that are considered to be too high, then the campus might develop guidelines for minimal and maximal reserve funds.

Support Centers should be subject to regular, periodic reviews. We envision something similar to the program reviews conducted for the schools and departments. Clearly, the reviews of the support centers would differ in some important ways, but they should include historical benchmarking and comparisons to best practices among a set of national peers or nationally available benchmark data. It is worth noting that this recommendation has been made in each review of RCM the campus has undertaken, but has not been embraced in theory or practice. It would also provide a more objective framework for performance and resource allocation among the support centers. While it may not make sense to review every support center, certainly it is worthwhile to conduct objective reviews of the major one**s** such as UITS, CFS, HR, ES, etc.

Implementation Issues

As discussed in the introduction, the main downside to shifting to a flat tax is the adjustment period and the anxiety associated with the calculations with a hold-harmless change across the campus. This seems to be a small cost relative to a better planning platform, better comprehension of the incentives as well as better incentives, enhanced transparency, a more efficient tax system, and a joining of incentives between the academic and support centers.

We favor using budgeted expenses as the basis of the tax; using actual expenses would impose a two year lag. We also favor just taxing either income or expenses as taxing both would complicate the process. We also recommend against using a multi-year moving average—even though in theory, it would smooth out fluctuations in expenses—because it would add complexity to the process and reduce the transparency of the tax. Issues such as clinical income make the tax on income route difficult.

Another complication if we use income as the basis for the tax is Indirect Cost Recovery income (ICR). ICR should be explicitly exempted from the tax for two reasons: First, it is already subject to a 20% campus tax rate to fund the RIF. Second, the campus has made it a high priority to increase the amount of externally funded research, and taxing those efforts would tend to reduce the incentives to seek extramural funding. Taxing expenditures also avoids this issue.

It is important to acknowledge that IUPUI has evolved since RCM was first implemented almost twenty years ago, and it will continue to do so. Therefore, it is imperative that we continue to conduct regular reviews of RCM and be open-minded about future configurations of RCM as well as our other administrative structures.

For those who have not been involved in the implementation of RCM from the start, we provide background information below to provide a context for our recommendations.

Background

IUPUI was created in 1969 as a partnership between Indiana University and Purdue University with Indiana as the managing partner and the Indiana Board of Trustees as the governing body. The history of IUPUI is the history of an under-funded state-assisted public, research university, which grew out of a political compromise of combining the outreach efforts of Indiana and Purdue with the pre-existing core of the health side (Medicine, Nursing, Dentistry), as well as the Indianapolis campus of the IU School of Law. Both financially and politically, government support for higher education declined in the late 1980s and 1990s (Levine, 2001) and added pressure to the rising research enterprise of the core campuses of IU. Given the academic history and decentralized status of the campus, coupled with a diminishing role of state support, a move to RCM (Responsibility Center Management) was a logical approach to implement at IUPUI. In fact, IUPUI was the first public university in the USA to implement RCM or any other decentralized financial management system. (See Robbins and Rooney, 1995; Lasher and Green, 1993; and Stocum and Rooney, 1997.)

Another part of the history of IUPUI has been its entrepreneurial spirit of doing more with less and doing good work generally on a shoestring budget (with a few notable exceptions). The cumulative effect of this chronic under-funding has been to create an environment of innovation and creativity, but also an atmosphere of fiscal duress and perceived inequities in the allocation of state support. When RCM was implemented, it was done on a "hold-harmless" basis such that each academic unit received state support that was a plug-in number (i.e., the difference between their expenditures the prior year and their earned income, i.e., student fees and tuition the prior year). This was done solely for political ease of implementation: it took off the table the budget and political battles that would have erupted had the campus had an intentional debate about what is the "right" or preferred amount of funding to allocate to a sociology major (or faculty member) vs. a law student vs. a medical student vs. somebody in social work, etc. This more idealized notion of allocation of the limited state support would have generated such a quagmire that we might still be debating this in anticipation of "going live" almost 20 years later.

Interestingly, the Bloomington campus used student fee income as the plug-in figure for their implementation of RCM. This has the advantage that Bloomington can always tell the legislature what the state appropriation is being used for and there is a clear consistency from year to year. Of course it does not matter in terms of the reality of the situation. Whether one uses the tuition income or the state appropriation as the plug-in figure, assessments have risen (because of unavoidable expenses) and that would cut into tuition income as much as into state appropriation funds. The basic problem is the rapid rise in overhead costs. Furthermore, using student fee income as the plug-in value fails to create incentives to generate new tuition/fee income.

In the meantime, essentially all of the deans have turned over since RCM was implemented. Similarly, the Chancellor, the EVC, and several of the other VCs have retired and been replaced by the next cohort of leaders at the campus administration level. Many faculty members have retired as well and many other new faculty have been hired. With all of these transitions, there has been erosion of the institutional knowledge and understanding in general and about RCM in particular. With the hire or promotion of each new dean, s/he does a calculation (some in Excel and others on the back of the proverbial envelop) on the share of state appropriation per FTE (students typically but faculty sometimes). The inevitable result is that the deans can point to "irrefutable evidence" that their unit is under-funded in either absolute and/or relative terms. The subsequent gnashing of teeth is on the inequities of this, the unfairness of RCM and the need for the campus to do something for their unit and its unique or special needs!

Bowen's (1980) Revenue Theory stated that institutions raise all the money they can and spend all the money they raise in the pursuit of excellence, prestige, and influence. Thus, the achievement of these pursuits has lead to ever increasing expenditure trends. The decentralized budgeting system of RCM has not abated this ever-increasing expenditure trend at this institution and its academic units. While we would all readily agree on the need for new funding and the disappointingly low levels of state support for the campus overall and for each academic unit, there is no inherent fairness or unfairness to the allocations of state support among the academic units. They are the cumulative effects of the original "hold-harmless" allocations, the reallocations of some state support at the campus level to fund new initiatives (the Chancellor's Reallocation Fund and a financial aid pool are two such examples), and several "hold-harmless" reallocations to include a simpler assessment basis with only three drivers rather than the eighteen used initially. Adjustments for issues like funding unavoidables (such as rising health benefit costs, the implementation of Peoplesoft, bad debt and more recently rising fuel costs and the lost of state funds for new building maintenance) and the reallocation of assessments and appropriation following the creation of new units such as Informatics have led to further distance between the actual plug-in figure for state appropriation for each unit and any notion of a fair share. IUPUI is not unique where new academic programs have been added without dismantling old ones to fund the new (Massy and Wilger, 1992) and emerging technologies have ushered in demands that have continued this trend and increased expenditures without concomitant new sources of State revenue. There is nothing inherently fair or unfair about the results, but there has been close attention paid to the fairness and the protocols over the years so that a good faith effort has been made to do the best one could without an infusion of new State resources.

This introduction explains that the allocation of the taxes/assessment and state appropriation is entirely historically and contextually grounded AND it never makes sense when any one dean (director, chair, faculty member, etc.) calculates their fair share of appropriation and/or assessments. The tax issues and RCM are just one of an array of fiscal challenges IUPUI has faced in the past and will continue to face in the future.

In prior years, RCM Review Committees have recommended consideration of a flat tax (see Rooney, 1992; and Rooney 1997). Following the 10-year review of RCM, and its recommendation for a flat tax, the Chancellor appointed a Flat Tax Task Force charged to consider and propose an implementation strategy for a flat tax at IUPUI. This process was progressing well until several of the deans realized that a hold harmless implementation of the flat tax would mean that some units would see their tax go up and others would see their tax go down. In all cases, these changes would be funded by a reallocation of state appropriation as the plug-in amount such that no unit would be positioned in a better or worse manner following the implementation of the tax—at least in the first year.

Of course, any change in tax regimes has dynamic effects in the following years that can be roughly predicted. But we cannot shelter individual schools from those consequences without losing the advantages of utilizing RCM. Some of the deans objected to losing some of the state support—even though their taxes would have fallen by an offsetting dollar amount, because they saw state support as more solid, predictable streams of revenues than earned income, so they voted in a risk-averse manner to kill off the implementation of the flat tax many years ago. We raise this only to illustrate that there are political and psychological aspects to moving to such a system—even if it makes complete sense from a budgeting and planning perspective! It is worth noting that even those deans, as well as others, who voted against the flat tax, supported the notion that a flat tax would enhance budgeting and planning.

The Action Team discussed several aspects of RCM that have arisen in the past, including most recently in the President's Task Force on RCM earlier this year. The key issues from our perspective are whether or not RCM encourages course raiding and whether or not the tax-assessment model can be improved upon. We also discussed ways of improving the accountability and transparency of the RCM system and its units.

The issue of course raiding has been discussed in each of the campus and system reviews of RCM. We agree with the primary finding of the earlier studies on this matter: there are always aspects of new course development that might be viewed as “course raiding.” These are frequently an issue of shifting faculty interest and perceived pedagogical value-added (e.g., by offering a statistics course or computer course within the discipline rather than accepting those from other units). However, explicit efforts to reallocate credit hours and the concomitant income for purely fiscal reasons needs to be reviewed regularly. We believe that these pressures erupt periodically—regardless of the financial management system, but that they still need to be addressed. IU/IUPUI has a course remonstrance system which needs to be kept alive and ultimately arbitrated by the campus’ chief academic officer.

Similarly, the issue of taxes or assessments is a frequent hot topic when RCM is being discussed. IUPUI has had several experiments with different methods for implementing the tax system. The original model emphasized accuracy with many “drivers” and a set of simultaneous equations, but sacrificed timeliness and comprehension/transparency in a well-intentioned effort to more precisely measure and allocate various expenses. This model was later simplified but was still more complex than necessary and certainly beyond the comprehension level of the faculty, staff, and most of the administration. A pseudo flat-tax replaced this. It was a *pseudo* flat tax in that the old tax base remained but increases were generally done on an even (flat) across the board basis (with “circuit breakers” for units that experienced substantial drops in enrollments**)**. Then, we reverted to an allocation method based on three main drivers (Student FTE, Employee FTE, and Square Footage).

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Respectfully submitted,

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