Financial Incentives in Quality Rating and Improvement Systems: Approaches and Effects[1]

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Financial incentives are monetary awards within a state quality rating and improvement system (QRIS) which are generally intended to help support the costs of improving program quality and/or of maintaining program quality. Awards can be structured to encourage programs to participate in a QRIS, to serve low-income children, or to improve quality. Awards can help parents access higher quality programs, and/or to promote educators to seek higher qualifications and help support educator compensation commensurate with qualifications. There are several common types of incentives: quality improvement grants, quality achievement awards, wage and retention awards, scholarships and tiered subsidy bonuses.

Quality Improvement Grants

Nearly all QRIS offer improvement grants. Improvement grants are generally related to a program's quality improvement plan (QIP), are commonly time-limited (one or two years), can be conditioned on advancement in the QRIS and can be intentionally focused on all levels or lower or upper levels of a QRIS, depending on the state's goals. For example, Indiana's improvement grants are available to programs at the next-to-the-top level and designed to help support the costs for programs seeking accreditation, which is required for the top level of its QRIS.

The amount of an improvement grant varies among states from $250- $5,000 (Tout et al 2010, Mitchell 2008). In most states, the improvement grant is by application, varies with program need and often has an upper limit. In both Pennsylvania and Ohio, the grants vary by a combination of setting, enrollment size and quality level and their use must be accounted for in relation to a QIP.

Two states use the income tax system (Maine and Oklahoma) to deliver financial support for quality improvement. Essentially a program that owes state income taxes, i.e., proprietary centers and family child care homes, can receive a tax credit for a portion of the expenses of improving quality (Stoney & Mitchell, 2007). Such tax credits can be structured to also benefit proprietary programs that do not owe tax and programs that are tax-exempt, if the credits are refundable. (Credits in Maine and Oklahoma are not refundable.)

[1] Note: There are two main sources for compiled information on QRIS financial incentives: *Compendium of QRS and Evaluations* has 2009 data (pp. 177-186); *Comparison of Financial Incentives* has 2008 data with somewhat more detail and links to state QRIS websites.

Quality Achievement Awards

About half of existing QRIS offer ***quality achievement awards***. Of those, about half are one-time payments to recognize a program for achieving a particular level in the QRIS. The others are annual ongoing payments related to achieving and maintaining a particular quality level. These ongoing awards are designed to help support the cost of operating a program at a particular quality level. They are not tied to specific children, but can be structured to reward programs that serve high-need children or those in high-need communities. The amount of these awards varies widely among states from $250 to over $60,000; most are less than $2,500. The largest awards are in Ohio and Pennsylvania.

Louisiana offers QRIS quality achievement awards via the state income tax system, structured as refundable tax credits. Early learning and development programs that participate in the Louisiana QRIS, called Quality Start, receive a refundable tax credit based on the number of stars they earn (above the first level) and on the number of children they serve through the Child Care Assistance Program or children in foster care (these categories were used because there is a reliable state data source). The awards are available to both for-profit and non-profit programs. The annual amount *per eligible child* ranges from $750/child for a 2-star program, up to $1,500/child for a 5-star program. Thus, a 5-star ECE program that serves 30 subsidized children would receive an annual award of $45,000.

Wage and Retention Awards

The fact that early educators' compensation lags behind that of equally qualified workers in other occupational sectors is well known. Several states have supported wage initiatives for some time. Some of these are paid directly to individuals while others are paid to the ECE program, which is then accountable for using the funds to increase compensation. There are pros and cons to each method related to the tax treatment of the funds. When awards go to the program, they are added to the individual's wages and taxes are withheld as usual. When awards are paid to individuals directly, the recipient may need to pay quarterly estimated taxes (depending on the size of the award).

More recently these wage and retention incentives are being connected to the state QRIS, usually by conditioning access to the reward to those working in a program participating in the QRIS. Several QRIS include financial incentives that help support compensation and retention. Wage and retention awards are generally intended to reward individuals for the credentials and qualifications they have achieved and help programs retain qualified staff. The value of these incentives in QRIS ranges from $200-$1,000 in Maryland to $600-$4,000 in Pennsylvania.

Louisiana offers QRIS wage and retention awards via the state income tax system, structured as refundable tax credits that are received when the practitioner files his or her tax return. Child care teachers and directors are eligible for a refundable tax credit if they work for at least six months in a program participating in Quality Start at any level (1-5). This credit intentionally does not vary by Star level and includes Level 1 so as to support retention and continuity, rather than drive higher qualified staff to higher rated programs. The annual amount is based on education levels and ranges from $1,500 to $3,000.

Scholarships
Most state QRIS offer scholarships that help support the cost of increasing an individual's credentials and qualifications. Generally, these scholarships pre-dated QRIS and were available to any educator. More recently states have been focusing scholarships on individuals working in a program participating in the QRIS. Some further target support to the acquisition of recognized credentials and college degrees (as compared to training). Scholarships help individuals pay the costs of higher education. As such, these are important quality incentives and help support the cost of improving program quality. They do not contribute financially to supporting the direct cost of maintaining program quality.

More than 20 states, some with and some without a QRIS, offer scholarships using the Teacher Education and Compensation Helps (T.E.A.C.H. Early Childhood®) model. T.E.A.C.H. is an approach that spreads the cost of higher education among the scholarship recipient, the recipient's employer and the T.E.A.C.H. program, providing early educators with funding needed to earn credentials and degrees at community colleges and universities, as well as paid release time and a bonus or a raise. [2]

Tiered Subsidy Reimbursement/Tiered Bonus
Tiered subsidy reimbursement is a payment to a program based on enrolled children whose families have secured a child care subsidy. The payment is either a flat dollar amount or a % increase paid in addition to the basic child care subsidy rate. The tiers are generally related to the levels of quality in the QRIS, increasing as the levels increase. To ensure that the tiered amount does not drive up the price the program charges to private paying families, it must be structured as a <u>bonus</u> - in addition to the basic subsidy rate, not as part of the rate itself.

Further, the value of a tiered bonus depends on the value of the basic subsidy rates. If the subsidy rate ceilings are high compared to average tuition fees in the market, those subsidy rates may be sufficient to cover the cost of the lower levels of quality. In that case, the tiered bonus may only need to be offered at the higher levels of the QRIS. This also serves to support higher quality programs serving low-income children. Alternatively, if a state has set subsidy rate ceilings low, then tiered bonuses have to be quite large to be effective and offered at all levels of the QRIS.

Evidence of Effectiveness of Incentives

There is very little research on the effectiveness of incentives and no contemporary research on the effectiveness of incentives since the advent of QRIS. One study examined the effects of tiered reimbursement in jurisdictions with increased rates conditioned on national accreditation. The study found that a 15% increase was the threshold for any effects on achievement of accreditation (Gormley & Lucas, 2000). Two states – Arkansas and Washington – in their Early Learning Challenge grant applications, proposed to study the impact of provider incentives and rewards (Stoney, 2012). These may yield evidence.

[2] For information, go to http://www.childcareservices.org/_downloads/TEACH_OnePage4_12.pdf

While not always offered as a financial incentive in QRIS, the T.E.A.C.H. Early Childhood® scholarship program has been evaluated fairly extensively; its webpage[3] provides the following evidence for the impact of this model:

> *Each year, on average more than 20,000 teachers, directors and family child care providers receive T.E.A.C.H. Early Childhood® scholarships.*
>
> - *Nearly 75% of participants receive scholarships to earn two- or four-year degrees*
> - *Scholarship recipients complete over 100,000 college credit hours*
> - *Participants demonstrate mastery of coursework, with a grade point average of 3.2*
> - *Annual earnings increase by 3% to 15% for T.E.A.C.H. program associate degree scholarship recipients*
> - *Turnover rates for T.E.A.C.H. associate degree scholarship recipients average less than 10% annually.*

One intended effect of incentives is increasing program participation in a QRIS. There is some evidence for the effectiveness of incentives overall. Looking at QRIS participation rates (in states with voluntary systems) shows that generosity of financial incentives appears to correlate with participation, i.e., the higher the awards, the higher the participation. For example, Maryland offers several types of incentives: tiered reimbursement (10% - 40%), one-time accreditation grants to programs ($200 - $1,000) and one-time achievement awards to individuals ($200 - $1,000). Participation is about 2%. New Hampshire's QRIS offers simply a one-time quality recognition award ($250 or $500); participation is about 7%.

In contrast, Ohio offers annual quality achievement awards ($600-$36,000) and tiered reimbursement bonuses of 5% to programs at the top two levels of its QRIS. Participation in Step Up to Quality is about 24%. Pennsylvania offers time-limited improvement grants ($300-$6,000), annual quality achievement awards ($800- $63,000), annual staff retention awards ($600-$4,000 per staff) and tiered reimbursement for levels 2-4 (daily add-on of $.50 to $2 per child). Participation in Keystone Stars in Pennsylvania is over 60%, which is the highest among voluntary QRIS.

Combined Effects of Incentives

Ultimately, the purpose of financial incentives in a QRIS is to help to fill the gap between the cost of operating a quality program with equitable staff compensation and the sources of revenue available to support the program, which is principally tuition paid by non-subsidized families. Thus it is the <u>combined effect</u> of all the financial incentives that matters. Pennsylvania is the leading example of multiple effective incentives, offering quality improvement grants, generous annual achievement and educator qualification awards, as well as scholarships and tiered subsidy.

Louisiana is another good example of the combined effects of financial incentives in support of a QRIS and one that uses an uncommon approach for delivering them: the state income tax system. The School Readiness Tax Credits[4] are a package of four refundable tax credits: one for

[3] http://www.childcareservices.org/ps/teach_pu4.html
[4] http://www.qrslouisiana.org/tax-credits

families, one for programs, one for educators and one for businesses. In addition to the program and educator credits described above, the Louisiana School Readiness Tax Credits include two other incentives:

- Families are eligible for a higher state child and dependent care tax credit (DCTC) based on the star-rating of the program in which they enroll their child(ren). The family tax credit increases the amount of Louisiana's existing DCTC for children under six. The credit is aligned with the Star rating of the program. The increase ranges from 50% for a 2 star program, up to 200% for a 5 star program. Annual maximum amounts range from $575 to $3,150. [5]
- Businesses that invest in child care programs receive a higher tax credit based on the Star rating of the program in which they invest. Louisiana has four such tax credits for businesses, all based on the Star rating of the program they support. These credits include investments to: 1) construct, renovate, or expand a child care center, purchase equipment for a center; maintain or operate a center; or 2) pay an eligible program for child care for their employees; or 3) pay an eligible program to reserve spaces for employees. Credits range from 5% of eligible expenses for a 2 star facility to 20% for a 5 star, with maximum eligible expenses of $50,000/year. Further, businesses may also claim a dollar-for-dollar (i.e., 100%) tax credit for donations made to Child Care Resource and Referral agencies. The annual maximum for this credit is $5,000. The intention was to create a modest new revenue source for CCR&Rs to support their QRIS work. [6]

The experience across state QRIS seems to indicate that effective financial incentives address the major cost drivers of quality: compensation, quality improvement and quality maintenance. The set of incentives together can begin to fill the gap between the cost of producing quality and the current revenue sources available to programs. Financial incentives are most useful when they are aligned with the overall goals of state's QRIS, e.g., to increase the proportion of low-income (subsidy-receiving) children in higher quality settings. States that require programs to participate in QRIS to be eligible to receive subsidy, or that limit receipt of subsidy to programs at higher QRIS levels, are crafting financial incentives in line with this goal. New Mexico, Oklahoma and North Carolina are examples.

Structuring financial incentives into a QRIS is a powerful strategy but is usually not sufficient without other investment. Financial stability of an ECE program depends on the "iron triangle": 1) tuition fees adequate to cover expenses, 2) full and timely fee collection and 3) full enrollment. [7] When a program increases its quality, it also increases its cost. State policy can support quality for programs participating in the QRIS (or those at higher levels) through a

[5] While Louisiana's School Readiness Credit is the most generous, three other states provide quality add-ons to their child care tax credit for families: Arkansas, Maine and Vermont.

[6] Colorado also has a Child Care Contributions Tax Credit (CCCC). Any taxpayer who makes a monetary contribution to promote child care in Colorado is eligible for a 50 percent tax credit when filing a Colorado income tax return. The credit generated $22 million in contributions in 2009. The evaluation of the credit found "for every dollar that the state invests in the child care industry via the CCCC, $4.65 is added to the Colorado economy through private contributions, federal matching dollars, and the multiplier effects of the spending." (Development Research Partners, 2011, page ii)

[7] For a more detailed discussion of this issue see *The Iron Triangle: A Simple Formula for Financial Policy in ECE* http://www.earlychildhoodfinance.org/downloads/2010/IronTriangle_10.2010.pdf

robust array of financial incentives. State subsidy policy can also help. One way is to base subsidy payments on enrollment (rather than attendance) to ensure that the full tuition will be collected for each subsidized child enrolled. Another is to establish eligibility for a full-year to support continuity for the child and financial stability for the program. Because only a small proportion of children are eligible for and receive subsidy, financial incentives must be structured more broadly.

Finally, sharing the cost of quality is an emerging approach that builds on QRIS financial incentives. For example, if all highly rated programs are eligible to offer state-funded pre-K, that revenue source is added to the mix that supports quality. Head Start-child care partnerships can share costs as well as extend comprehensive services. Promoting Shared Service Alliances[8] among groups of programs can increase the efficiency of each program and can save costs by spreading them among programs, using the savings for quality improvement. Taking a comprehensive approach to financing is key to improving and sustaining quality programs for children.

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[8] For more information, go to http://opportunities-exchange.org/