

## Session 1:

# The Challenges Confronting Public Universities.

**Frank Milne**

**Department of Economics**

**Queen's University**

The public universities in Canada, UK, and Australia have come under increasing stress over the last two decades. (Compared to the Canadian et al university systems, the major public universities in the U.S. have been very well funded, but there have been signs of increasing stress in the U.S. public universities in the last two decades.) The post World War 2 model of university funding assumed a relatively small university and college system, with a small student and faculty population, which could be funded by government grants and limited, or in the extreme, zero fees. Government funding was not an onerous drain on the budget. But as the economic demands for a more professional and technically competent work force increased, governments were forced to confront an expanding tertiary education budget that competed with a rapidly growing health care budget and other social spending. The trade-off was difficult politically, and most governments took the easy way out by decreasing funding per student, and denying that quality was reduced – the cuts merely brought “efficiencies”. In addition, governments have introduced, or increased student fees to partially compensate for government funding cuts; there have been deregulated fees for a small number of programs, and artificially low fees for other programs in the same institution. Some governments have encouraged universities (especially in Australia and the UK) to expand programs for deregulated, foreign fee-paying students. Foreign student fees have been seen as a “cash cow” to cross-subsidize the under-funded domestic student places. The overall impact of this contradictory confusion of policies has been a steady erosion in total funding per student in many programs, large and growing class sizes, declining faculty morale, and increasing evidence that the university systems have declining quality. Alongside this growing poverty, we have well-funded deregulated programs: this artificial (government induced) funding dichotomy produces perverse incentives in the university, and distorts the quality of education received by students studying different, or related, disciplines in the same university.

I will not dwell on the history of the systems, nor the details of the current stresses in the systems - they are well known, and have been discussed in this session<sup>1</sup>. Rather I will focus on a few key issues (this is not an exhaustive list) that should be considered if one is discussing reforms that may improve the system. For brevity I must skim over these issues – but I will give you some key references that I have found stimulating and instructive.

## **1. A Theoretical Map: Without it You will get Lost:**

Any discussion of public policy, and financing in particular, requires a clearly specified and carefully thought out theoretical framework to guide the discussion (Daniels and Trebilcock - this conference - provide a sketch). It provides a roadmap that can be used to examine the basic policy options and test the sensitivity of the conclusions by varying the parameters and assumptions. Without it, one can get lost in the complex issues of private and public funding for teaching and research.

I have found Nick Barr's book *Economics of the Welfare State*, (2004), especially Chapter 14 on Higher Education funding, a thoughtful guide to thinking about university funding issues. Even when you may disagree with one of his conclusions, you can locate the key issues that are contentious; it may be an empirical or a theoretical issue, but that should lead to a deeper and more thoughtful discussion, and hopefully better policy. Barr's discussion of fees and contingent loans should be read and considered carefully. They involve some subtle issues on equity and efficiency that should be understood before either one dismisses them, or attempts implementation.

Also he stresses the virtues of flexibility, decentralization and diversity in the system. This fits in nicely with fees, base grants etc and institutional diversity and competition. Its antithesis is an inefficient, meddling, government bureaucracy, trying to pick winners (and failing), and overseeing a demoralized, subservient tertiary education system.

## **2. Funding Options: Many and Varied: The Devil is in the Details:**

The key issues in funding tertiary education are to identify the public and private benefits, and the impediments to private provision for students and research funding. This is a difficult exercise, as we do not have very good qualitative and quantitative measures for some of the externalities. Although there are many funding systems and combinations of systems that try to address ways of tackling these externalities, their strengths and weaknesses should be understood clearly. This is a non-trivial exercise: any scheme should be stress-tested for flaws; and investigated for inefficient gaming by students, the universities and colleges, and the government bureaucracy and politicians.

Contingent loan systems and fee deregulation are serious options that have been suggested. The issues surrounding such schemes are subtle and can have profound impacts on university quality if they are misapplied. For example: In the late 1980's, Australia introduced contingent loans but heavily constrained the universities by micro-management. Universities were rewarded with a fixed fee scale on student graduation. Given that the government had little interest or control over quality, this incentive system had appalling and predictable consequences for quality, reminiscent of the problems of a Soviet tractor factory. The Australian government also deregulated foreign student fees so that the under-funded universities were desperate to bring in as many foreign students as possible to cross-subsidize the under-funded domestic students. The government deregulated most graduate courses. Predictably the universities were induced to lower quality in the undergraduate courses to make the fee paying graduate courses more attractive. The system is under stress with low salaries (by international standards), crowded classes and poor faculty morale (see the revealing and detailed survey by

Anderson, Johnson and Saha (2002)). The university administrations face a terrible conflict of interest: either they admit the quality problem and risk losing critical fee-paying foreign students, or they ignore the problem and demoralize their faculty.

In a second “reform”, the Australian government converted colleges into universities in a simple reclassification. Currently, Australia has a wide range of “universities” catering to all sorts of quality standards and academic and trade training. It is clear that the “one size fits all” funding system was an abject failure. Now the government is trying to unscramble the mess they and previous governments have created. The latest, in a series of fads, being floated in the Australian press, is that the Australian system should follow California and have a multi-tiered system of private, major public universities and colleges. This would reverse the previous attempts at uniformity. Whether Australia’s parochial education bureaucracy understands the subtleties of the Californian, or other similar US state systems, is highly unlikely.

Australian tertiary education policy and its evolution, is a classic example of policy making without a theoretical road-map.

Another example of the dangers of government reform that could go wrong, is the suggestion by Daniels and Trebilcock that the Ontario government should rank departments and programs, rewarding “quality” departments with increased funding. They use the British ranking system as a model. This system was an attempt by the UK government to compensate quality research and teaching as a funding supplement to the government standard funding formula for all universities. Given no student fees, the UK introduced an inefficient government system trying to mimic the market for quality with a highly differentiated grading system that has more than a whiff of Whitehall bureaucratic fine distinctions and “Yes Minister” snobbery. With deregulated fees and a system of contingent loans, such schemes for rewarding quality teaching are redundant. All the evidence is that government “quality” measures of teaching are highly contentious, invite capture by established universities with political influence, are very expensive to implement, and are unnecessary in a market system (see Smith (2000a) and Barr (2004a)). If you want markets, then let them work. The record of Governments systems for picking winners is very poor. Such systems have a dangerous tendency to protect privileged incumbents. Let real competition work via students choosing to pay for the quality and teaching styles they want – it works in the US. Harvard and Princeton do not have Washington bureaucrats peering over their shoulders, nor do their faculty endure endless weeks of absurd form-filling (as has happened in the UK and Australia): those top US universities deal directly with their students, faculty and alumni. They have effective student evaluation surveys that they publish and students can observe.

The British system is inefficient for allocating research money. As Daniels and Trebilcock admit, the system has introduced perverse incentives for departments manipulating the indices by CV hunting and other games. Canada has a well-functioning, research funding system that rewards individual researchers and group projects. The system uses well-accepted international principles of peer evaluation for research funding. This allows good researchers to form groups endogenously in universities and avoids centralized attempts to enforce group formation. If university administrations play

games, then good researchers can leave with their research money for a more constructive university environment. In overly bureaucratic and centralized university systems there is far too much rent seeking by university administrators and not enough competition for good faculty and students.

As a supplement to the existing federal research granting bodies, Ontario could add its own research funding system to make Ontario universities more attractive for top researchers: it should not be seen as a substitute for the federal research grant bodies, but a complementary system.

As a parting comment, I should observe that the contingent loan schemes in the UK and Australia are national systems. An Ontario contingent loan scheme can work for Ontario students. But given that the major Ontario universities are national and attract Canadian students from all Provinces, how do we deal with tracking students from other Provinces, or Ontario students who leave the Province? This should be given careful thought.

### **3. University and College Governance: It is Harder and More Subtle than You Think:**

In the wake of Enron and other corporate scandals, and the introduction of the Sarbanes-Oxley Act in the U.S., corporate governance and its subtleties have become a hot policy and research topic. The closer you investigate the notion of corporate governance, the more you realize that the detailed, one-size-fits-all formula is flawed. This applies equally to non-profit institutions (for example see Hansmann (1996) and Glaeser (2003)), and tertiary education institutions, in particular (for an interesting set of papers on the complex issues involved, see Ehrenberg (2004)). If one investigates the top U.S. private (non-profit) universities, you will find a delicate balance of interests: the interests of students and faculty are fairly obvious, but additional groups of interested parties are, the alumni attempting to protect the value and reputation of their degrees, private donors, and government grant agencies. There is a symbiotic relationship between the sources of funding, interests and the governance structure. This structure interacts with the teaching, research, fundraising and goal formation of the university. An example of a dysfunctional relationship is Australia. Given the close control of funding and other issues by the government, university administrations have been induced to pay little interest in their alumni (apart from PR exercises directed at fund-raising activities), and have been distracted by the constant stream of directives and fads that flow from the federal Department of Education. The university administrations (following the lead of the federal Department) are induced to regard faculty as just another class of expendable, lowly employees (see Anderson, Johnson and Saha (2002) for a revealing survey of faculty attitudes to their administrations and the Department of Education). The impact on faculty morale has been predictable; Australian universities have a major HR problem, which along with internationally uncompetitive salaries, has induced a high quality academic brain drain. Given Ontario's close proximity to the highly competitive US academic market, it would be suicidal for Ontario to follow Australia's lead and antagonize its good academics, particularly given the predicted faculty shortages – see point 7 below.

Assuming increasing deregulation of the university system, there will be stresses on the existing governance systems of public universities. These systems have been overly responsive to government incentives and pressures, compared to the interests of alumni, faculty and students. As the system becomes more dependent on student funding and alumni fund-raising, the university or college will need to be attentive to student demand for courses and keep a watchful eye on teaching quality, class sizes etc. Also it will have to be careful to monitor the perception of quality: remember that a reputation can be destroyed quickly, but takes a long time to build. Beware of glib PR: advertising tricks may work for a while, but employers, students, their parents, and alumni who are vigilant in protecting the value of their degree, will wake up eventually to PR games that attempt to disguise reality. The reaction will be very painful for the institution in terms of reduced revenue generated from student fees and research funding, and from the anger of the alumni who feel betrayed.

One last comment: there is a fashionable argument going around that, if there is deregulation, then we will see profit-maximizing companies taking over the college and university system by driving the non-profits out of business. I think that the argument is superficial and false. Non-profits have existed in a number of areas for a very long time (before tax breaks for non-profits), and in competition with for-profits –for example, hospitals, charities, private secondary schools and universities. The reasons for the existence of non-profits are subtle – see Hansmann (1996), Glaeser (2003), Kirp (2003), Bok (2003) and Ehrenberg (2004). I do not have time to rehearse the arguments here, but I suggest that any attempt by governments to impose, or encourage, a single governance structure on the current system, could be a long-term disaster.

#### **4. Private or Public Systems? A False Dichotomy:**

The perception from outside the U.S. is that it has sharply differentiated private and public tertiary education systems. This dichotomy is overdrawn: the reality is subtle. The famous U.S. private (non-profit) universities (eg. Harvard, Princeton) obtain substantial research funding from government sources. Given the huge costs of equipment intensive research in the sciences and applied sciences, it would be very difficult to fund intensive, ongoing research from private sources, let alone the difficulties involved with patents, and other property rights issues. Already this is a major issue in private drug and bio-research funding, and has spawned a literature puzzling over the positive and perverse incentives that such private funding introduces. Even the nominally public universities generate a substantial and growing percentage of their revenue from student fees, private sector research and fund-raising. This is a world-wide trend in the Anglo-Saxon world, and is beginning to appear in European universities. Any system in the future will be a mixture of public and private funding systems: the real issue is to try to construct the right mix of public and private cooperation, and make the systems complimentary and not perverse. (For a discussion of some of the subtle problems involved see Bok (2003).)

## **5. Funding Research: Beware of Perverse Incentives:**

To amplify on the problems of perverse incentives, and the impact they can have on teaching and research, let me explore briefly an example drawn from the Canadian funding of scientific research in popular or faddish areas. Governments, in response to industry pressure or popular enthusiasm have funded new initiatives, usually in the sciences. As a way to “improve university incentives” the schemes have involved universities being induced to share the costs of the new venture. The impact of these schemes has been to bleed funds from other areas in the universities. (Similar problems are occurring in the U.S. – see Ehrenberg, Rizzo and Jakubson (2003)). Far too often, governments have misjudged market trends, or new “breakthroughs”, leaving the university with well-funded disciplines, but declining student demand, while high demand areas struggle with reduced funding. If the government wishes to fund new initiatives, they should do so with additional money, avoiding the temptation to micro-manage and divert internal university funds. Government performance in this area has been poor. They respond to short term political pressure, and the most astute PR campaigns. This is inefficient compared to a thoughtful, long-term system of research funding that is wary of passing fads, and values the impact of building up a stock of varied skills and research expertise over wide range of areas. The hard choices in research funding are over important, very expensive, research infrastructure- in those cases the government must make decisions whether some projects are just too expensive to fund, or they should be multi-country projects.

I should add, that government schemes that allow private research money to lever their contributions with university or government funds, and induce universities into commercially related research areas, should be examined very carefully. See Bok (2003), Kirp (2003) for discussions of the perverse incentives that can be introduced if there are not adequate safeguards.

## **6. Quality Indicators and League Ladders:**

Some people like ranking universities or Business Schools; rather like an index from the Guinness Book of World Records. But unlike the tallest woman, and the man who drank a yard of beer in the least time, university quality is a vector of characteristics, many of which are hard to measure and can involve highly subjective elements. Furthermore, the index requires a weighting scheme to aggregate the vector into a scalar. Clearly the choice of the vector, the measurement of the components and the weighting scheme can lead to indices with very different outcomes. As David C. Smith (2000a) observed, such indices are of limited use, and are downright dangerous in the hands of people who wish to use them for ulterior motives. I agree with the recent statement from the Dean of the Wharton Business School, that such rankings can be counterproductive. (The multitude of Business School indices and rankings are a bad joke – they can be manipulated by the schools and provide perverse incentives for Deans playing ranking games.) It is better to publish honest lists of characteristics and data for students to see what program of study, or college, or university, suits them in matching their abilities and interests, rather than play status games via fairly arbitrary indices.

## **7. “How will I know if there are enough excellent profs?”**

The title of my last comment is drawn from the title of a study by the late Professor David C. Smith, a past Principal of Queen’s University. Smith’s (2000) report made clear the demographic trends for students and faculty through the first decade of the millennium. His short message was that there will be a major, quality, faculty shortage this decade. Smith’s analysis holds for the U.S., and most of the Anglo-Saxon world. (For Australia see a similar observation by Hugo (2004)). In many disciplines, we have shortages: the excess demand for faculty has been masked by artificially restricted government funding. This situation cannot continue, without further serious quality declines in many disciplines. Smith did not take into account additional demands for PhD’s in key disciplines from the private and public sectors; nor the rapidly growing demands for talented expatriates from China and India. Given the high percentage of foreign students in North American PhD classes, and the propensity for them to seek the best salaries and conditions regardless of country, the international competition for quality faculty will be fierce.

### **Conclusion:**

My list is cursory, requires significant expansion and is short on specific proposals. But I think the real issue is to have a coherent roadmap with the issues clearly specified. The policy details are tricky to work out and implement, but we do have examples from various countries of what seems to work and what fails.

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**Footnote:**

<sup>1</sup> The literature on the problems in the U.K., Australian and Canadian university systems is voluminous. There are numerous government reports commissioned in all three countries. For recent references, I would recommend Nicholas Barr's writings on the UK system (2004) (2004a) and more generally Barr and Crawford (2005). See also Alison Wolf (2002) for a demolition of myths connecting education spending, centralized control of tertiary education and economic growth. See Milne (2001) (and the bibliography) for an unvarnished historical view of the evolution of the Australian system and the origins of its current quandary. For Canada - and Ontario in particular - I recommend the introduction and papers from the recent John Deutsch Institute (Queen's University) conference *Higher Education in Canada*; and the Rae Commission's recent discussion paper (and its bibliography).

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