Introduction

Universities are making the headlines a lot these days, and much of the publicity is distinctly unfavorable. While some bad press relates to student drinking, campus riots, athletic scandals, and the many remedial courses being taught by colleges, the dominant topic is the rapid rise in costs. Tuition is increasing far faster than the rate of inflation or even people's incomes, prompting calls from politicians and ordinary citizens to "do something" about it. This book is about the modern American university, and particularly the origins of and possible solutions to the problems of rising costs and declining efficiency that afflict the academy.

The sharp increases in college tuition in 2002 and 2003 were not unusual. This rapid growth has exceeded the inflation rate consistently for most of the twentieth century. Moreover, in modern times it has also exceeded the growth in family incomes, making college attendance an increasingly traumatic event from a financial perspective. While college administrators claim, with some justification, that "American universities are the best in the world," it is also true that they are the most expensive. Do they need to be?

College costs are soaring for a number of reasons, but one cause predominates: The productivity of university personnel is almost certainly falling, and it is clearly falling sharply relative to the rest of the economy. While it takes far less time for workers to make a ton of steel, type a letter, or harvest a bushel of corn than it did a generation ago, it takes *more* professors and college administrators to educate a given number of students.

Why is productivity falling? The basic problem is that universities are mostly nonprofit organizations, subject to only muted competitive forces, and lacking market-imposed discipline to economize and innovate. University presidents, deans, maintenance supervisors, department chairs,

and other administrators do not benefit from reducing costs. Major policy issues are typically decided in committees, where advocates of the status quo (often faculty with tenure) usually have the upper hand. With third parties such as government and private donors footing much of the cost, there is little fear that higher prices will trigger a consumer backlash. It is no wonder that per-student costs of instruction are dramatically lower at the typical for-profit university, where market discipline is much stronger.

Third-party payments make consumers relatively insensitive to costs. Students receiving grants or subsidized loans are far less sensitive to tuition increases than they would be if they were paying their own way. Where entrepreneurs in a free, unsubsidized market seek to cut costs and lower their prices to lure new customers away from businesses that are raising theirs, there is very little of that in higher education. Few university presidents I know, for example, advertise on television that their institutions offer as good a product as their competitors but at a lower price. To do so would incur the wrath of other presidents, causing the offenders to be ostracized among their peers at meetings of the American Council of Education and other trade groups, and lowering their chances for academic advancement.

All of this reflects the absence of a clearly defined "bottom line" in traditional, not-for-profit higher education. Did Stanford University have a good or bad year in 2003? How would we know? A few vague indicators, such as the college rankings done by *U.S. News & World Report*, give us some hints. But in the for-profit world, constant, precise indicators, such as stock prices and frequent statements of profit and loss, give much more tangible measurements of success.

In many ways, the higher education "industry" resembles the health care industry. In both, third parties, such as government agencies, insurance companies, and private foundations, pay most of the bills, making consumers far more indifferent to the price of services than they would otherwise be. In both, many providers operate on a nonprofit basis, with a nebulous "bottom line." And in both, not surprisingly, the prices of services have risen dramatically over time, making it more difficult for society to maintain a given level of services.

In health care, a steady rise in demand for services, fueled by a growing and aging population and more third-party payments, has provided a seller's

market that has allowed for tremendous price increases. As health care costs (as a percent of national output) grew in the 1990s, President Bill Clinton and his wife Hillary Clinton promoted a massive restructuring plan that failed politically, but was nonetheless followed by the growth in a large number of cost-cutting innovations, including the rise of health maintenance organizations (HMOs), preferred provider organizations (PPOs), increased insurance deductibles and copayments, and more stringent insurance or Medicare/Medicaid limits on use of prescription drugs and various medical procedures. Although Congress declined to enact legislation, the mere threat was sufficient to prompt the industry to develop its own cost-cutting measures.

Is the same thing about to happen to higher education? There are some signs it may be: nontraditional, online instruction is growing enormously, enrollments at for-profit universities are booming, and company-provided certification of skills is becoming increasingly popular in certain fields. These are all responses to the rising cost of traditional higher education. There is every reason to believe these trends will continue and intensify, prodding traditional universities into changing their ways.

Escalating tuition reflects two other developments of modern times. The first is a rise in price discrimination, which occurs when different customers pay different prices for the same service. Tuition is discounted by scholarship aid. Over time, that aid has grown substantially, so the actual average price to the consumer has risen somewhat less rapidly than stated tuition suggests. Price discrimination has allowed many universities to take advantage of the fact that affluent students are usually less sensitive to costs than poorer ones. By charging the wealthier students more, total revenues are enhanced. Also, at many selective-admissions universities, parents will often gladly pay high tuition if their child's only other option is to attend less prestigious schools. Universities have increased "sticker prices" aggressively to charge some students whatever the market will bear.

The second factor boosting tuition is an increasing cross-subsidization within universities, with institutions diverting resources away from undergraduate instruction. Professors who two generations ago would have taught twelve hours a week now teach six or possibly nine hours. The reduced teaching load is supposed to allow professors to do more research. Traditionally, undergraduate education has been heavily subsidized by third

parties (through scholarships and loans); now, undergraduates are increasingly subsidizing other university expenses such as research, student activities, bigger administrative structures, and more costly intercollegiate athletic programs.

All of this leads to another issue that is often misrepresented in the popular press and by universities themselves: the nature and impact of public support. Three-quarters of students attend state universities, which receive substantial support from state governments. While the tuition charged by these schools is well below that of private universities, it has been rising rapidly. University presidents blame this on inadequate governmental support, but the evidence suggests that very little of the additional financial support recently given to state universities has actually been used to reduce the cost of undergraduate instruction. That is, more generous state support does not usually translate into lower tuition costs. Nor does it enable more students to attend college. Lavishing more state funds on higher education does not significantly affect the number of students going to college, or how much they pay for their degrees.

The evidence discussed in this book is consistent with the following scenario: University presidents ask legislatures for more funds to keep costs down for students and improve educational opportunities for those with modest financial means. Sympathetic legislators generally accede to those requests. The universities then use most of the money to fund large salary increases, add staff members (thereby lowering productivity), build more luxurious facilities, and expand research projects, instead of teaching as promised. The same thing, with some variation, occurs with respect to donations to privately endowed universities.

In their quest for funds, state university presidents also argue that higher education support is an investment in human capital, and in a knowledge-intensive economy, good universities are vital for economic growth. This sounds plausible, particularly since college graduates earn sharply more than nongraduates, and the differential has expanded over time. Yet the evidence suggests the opposite: When other factors are held equal, *the more state governments support higher education, the lower the rate of economic growth in the state.*

Why? Two explanations come to mind. First, increased government support for universities forces higher taxation on private sector activity that,

on average, is produced more efficiently in competitive market environments than in university activity. Money is shifted from highly productive to less productive activity. Second, as noted above, much of the increased support does not go toward expanding students' access to learning, but rather to providing higher incomes and lighter workloads for university personnel. In the jargon of economics, the incremental funds support faculty and staff "rent-seeking"—that is, getting payments beyond the amount needed to provide goods and services—and the redistribution of income from the productive to the less productive.

How can more spending on higher education lower economic growth, though, when high wage premiums are paid in labor markets for highly educated persons? In part this relates to the diminishing returns that have set in for "investments" in universities. It is plausible that, on average, those investments are good, but at the margin they are not. That is, the first $100 billion spent on higher education is money well spent—as an economist would put it, it has a good rate of return. But the second $100 billion only has a so-so rate of return, and the third or fourth payment may have a zero or even negative rate of return, less than what could be earned by using the funds differently.

College-educated workers are relatively well-paid partly because higher education is a screening device for employers, a means of dramatically lowering the costs of searching for employees with leadership potential, technical skills, imagination and drive, and dependability and intelligence. In other words, college-educated workers earn more not because they've acquired valuable skills in college; rather, it is because the college admissions process is a valuable way of identifying talented individuals. A bachelor of arts degree from the University of Pennsylvania means something—the recipient almost certainly is literate and has high cognitive skills and moderately good work habits—qualities not always present in typical high school graduates. Employers will pay a premium wage for such a worker, knowing he or she is far more likely to have these desirable attributes (among others) than someone lacking a college degree. They are buying not just specific knowledge and skills accumulated by students in pursuit of their degrees, but broader qualities of intelligence, integrity, perseverance, and leadership that have little to do with learning acquired in college. Much of the "human capital" of the typical college graduate was not acquired in college itself.

The high earnings differential between high school and college graduates means that the financial benefits of earning a college diploma typically outweigh the costs of getting it—not only the direct cost of paying for college, but also the income forgone by studying rather than working. In other words, at the individual level, higher education is typically a good investment, even though the marginal return to the community may be very low. Indeed, it is the high earnings differential (a college degree roughly doubles a worker's income) that has allowed universities to raise their tuition dramatically.

If university graduates can expect substantial financial benefits from their training, why should third parties like governments and private donors finance most of the cost of college? Why should low- and modest-income families through their tax payments give children from affluent families opportunities to solidify and expand their already relatively opulent lifestyles? Why should governments subsidize education when the marginal social return on that investment may be very low or even negative? Why should private individuals give money to universities to lower costs to students attending, when the students will reap huge financial benefits? Why not finance universities largely from student tuition?

Three arguments are used to justify external support of higher education. The most important is the so-called "positive externality" argument, as economists call it. According to this theory, universities have positive "spillover" effects, benefits that accrue to people other than the providers or recipients of university services. A well-educated population, for example, will likely make more informed decisions about public policies, individuals to elect to office, and so forth, leading to better governance. Yet it can be argued that colleges have negative spillover effects as well. Campus riots and disorders harm innocent third parties. "Politically correct" efforts by universities to stifle free expression can actually reduce discourse and disrupt the orderly communications that make democracy work. And there is an opportunity cost to supporting universities—those funds could otherwise be spent on valuable medical research, or national defense, or other highly productive areas.

Some empirical evidence suggests that the negative externalities may be greater, on balance, than the positive ones. For example, the ultimate expression of feeling toward a community comes when people move into

or out of it. Moving into a community is a vote of confidence in that town, an indication that life there is better than in other locales. Similarly, out-migration is a sign that one believes life in that community is worse than elsewhere. Statistical evidence suggests that, holding other things equal, there is net out-migration from "university-intensive" states into ones where less effort (measured in various ways) is put into higher education. That is consistent with the notion that universities, on balance, have negative externalities.

The second argument in support of government subsidies is that our nation has long championed equal economic opportunity, and a college education is an important step to higher income, a necessary element of social mobility. Poor people cannot afford to go to college without state support, and will not have equal opportunities in life if they cannot afford a college education.

While this argument deserves respect, it also has severe weaknesses. If higher education conferred large financial benefits on students, banks and other lenders would readily make higher education loans without government loan guarantees—borrowing for college would be little different than borrowing to buy a business that is not making much money now but likely will in a few years. Even more important is the previously cited lack of correlation between governmental higher education support and the percentage of the populace going to college under current funding arrangements. At the minimum, the "equal educational opportunity" viewpoint argues for giving assistance to *students*, not to *institutions*, which often use funds for purposes not intended by the donors—an idea that I will return to later.

A final argument for governmental support is that universities perform functions beyond teaching that should not be charged to undergraduates. One particular function is to extend the frontier of knowledge through research. That research often leads to the development of vaccines or drugs that extend our life expectancy, innovations that enhance and diversify our productivity, and even works of art that help us define and interpret our lives.

This argument, however, is also somewhat flawed. To be sure, universities do research, some of it very useful. There is some doubt, however, whether the university is a better venue for most research than, say, private laboratories or nonprofit institutes. Much research has commercial potential,

providing profits for the patent or copyright holders, and thus should appropriately be privately funded. Thus, it is not surprising that the proportion of basic research (that is, the quest for new ideas and discoveries) that is performed in university settings in America has declined over time, as private firms and other organizations take up more of this work. Besides, universities generally receive grants that ostensibly cover the cost of specific major research endeavors. Finally, some university research is relatively trivial and unproductive, done more for the sake of getting faculty members promoted than truly expanding the stock of human knowledge.

The arguments for public subsidies of higher education are, at the very least, highly debatable. A better than decent case can be made that perhaps government should, in general, largely get out of the higher education business, ending state subsidies and tax advantages for private donations. Moreover, the evidence is pretty persuasive that massive governmental infusions of funds, along with tax-sheltered private contributions, have contributed to the upsurge in higher education costs. Generous government support has also led to some unqualified students attending college. Many of them drop out, sometimes defaulting on their loans. Others linger on four-year college campuses for five or even six years at taxpayer expense.

As tuition mounts and concerns grow that American universities are not delivering their services efficiently, consumers can and do look for substitutes. More and more students are studying online. For-profit universities are growing exponentially, with the market valuation of the largest of them, Apollo Group (which runs the University of Phoenix), exceeding $13.6 billion and making roughly twenty cents on each dollar of revenue after tax. These schools are competing mainly for nontraditional adult students, but they can be expected to expand aggressively into the market for educating eighteen- to twenty-two-year-olds, a group that will stop growing in a few years. Similarly, relatively lower-cost community colleges may begin to take market share from the more expensive comprehensive universities. Computer whizzes now sometimes forgo expensive university computer science degrees, opting instead to pass company-administered examinations showing expertise with Oracle, Microsoft, or other computer-based systems.

Meanwhile, legislators and private donors have become somewhat more skeptical of university administrators' claims that they need more

money. The 2001 recession and the stock market decline led to reductions in the growth of both public and private support for higher education, squeezing budgets and being offset only partly by bigger tuition increases than usual. In response, some universities are being forced to take steps to rein in their costs.

The continued growth of nontraditional alternatives to university training may make this cost-cutting exercise more than a cyclical phenomenon. It might lead, among other things, to heavier teaching loads for faculty, the slashing of administrative and other noninstructional positions, the abolition of tenure or the passing on of its implicit costs to recipients, the ending of expensive low-enrollment programs, particularly at the graduate level, the outsourcing or selling of certain noninstructional (or even remedial-instructional) operations to the market-based private sector, and the use of computers and television technology as substitutes for, not merely supplements to, traditional classroom teaching.

Yet the culture of universities is such that these changes will be resisted. Faculty will try to use their power to thwart cost-cutting moves, in some cases forming unions. Impatient legislators may try to "do something" about the problem, putting price controls on tuition, for instance, mandating minimum teaching loads, or abolishing tenure at public institutions. While most efforts will be focused at the state and local governmental level, even Congress will get involved, if the reaction to the 2002–3 tuition hikes is any indication. Congressional action is even more likely now because the Higher Education Act reauthorization is under consideration at the time this book is being released (mid-2004).

Even bolder changes in public policy might be forthcoming. Increasingly audible whispers from some politicians suggest that perhaps state universities should be privatized. A very strong case can be made for reducing public subsidies for universities gradually while increasing scholarship support for students themselves (already happening in Colorado), with this shift in emphasis taking place within five to ten years. With students paying most of the bills at public schools, university administrators likely would be more prone to pay attention to their needs, diverting fewer resources to noninstructional purposes. Fewer students would be closed out of courses (that is, not allowed to attend because of limits on class size). Fewer classes would be taught by foreign graduate assistants hardly fluent

in the English language. Student price-sensitivity to tuition changes would increase, reducing the urge to raise sticker prices dramatically. Competition for students would increase in other ways as well, particularly if the vouchers or scholarships were acceptable at private colleges and universities, as was GI Bill financial aid for veterans after World War II.

Moreover, a scholarship (or voucher) program could include performance standards. A scholarship or voucher could be structured as a loan that would be forgiven if the student graduated, but would have to be repaid if the student dropped out. This would almost certainly lower attrition dramatically, as well as discourage undergraduate students from lingering on college campuses for more than four years.

Finally, such a voucher approach could be structured in a way that would appeal both to liberals on the left and libertarians on the right. Vouchers could be made progressive in nature, with larger amounts going to students from lower-income families, in keeping with the ideal of education as a vehicle to promote economic and social equality. Giving smaller vouchers (or perhaps no vouchers at all) to students from wealthy families would make them less dependent on government for financial assistance. Indeed, the voucherization of higher education largely would end the distinction between public and private universities. State universities, as we know them today, would become privatized, freed of many onerous governmental regulations.

This book expands upon and documents the assertions made above. The first four chapters lay the groundwork, outlining the magnitude of the tuition explosion and its underlying causes, and discussing the reasons for university inefficiency, productivity decline, and "rent-seeking." The section concludes with a discussion of some of the peculiarities of higher education, such as price discrimination, tenure, and the cross-subsidization of activities, and the reasons behind them.

The next three chapters place the tuition cost explosion in a broader perspective, asking such basic questions as, how have American universities changed over time? Why do we need universities? Why must universities require external support? Empirical evidence is introduced that suggests that universities have no positive impact on such quality of life indicators as growth in per-capita income or on in-migration to a region, but may well have negative effects.

In the last third of the book the emphasis turns to identifying solutions for these problems. Chapter 8 details the rise of nontraditional options, such as for-profit institutions and online instructional programs. Chapters 9 and 10 outline two different paths to change. One is evolutionary, with universities moving, reluctantly but largely of their own volition, to reform their ways. The second is more revolutionary, with change induced from outside and movement in the direction of making public support more student-centered and competitive, ultimately leading toward privatization. Chapter 11 is a final summing up and synthesis.