

WHAT COULD BE AN EFFICIENT MARKET FOR HIGHER EDUCATION ?

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It is only appropriate to begin by thanking Sciences Po for having me, an economist, in this celebration. Sciences Po is one of the greatest schools of Europe and the world, and it is, therefore, with some trepidation that I dare to speak here today.

I will devote my address to argue the proposition that the higher education domain should develop increasingly in the direction of becoming a real field of competition. I will do this with reference to Europe where the proposition holds, I believe, in a strong way. I know that the purpose of this conference is not for Europeans to reflect about Europe and to this extent I should apologize for narrowing my focus. But I find it difficult to make claims that I can comfortably view as universal. Also, I should think that the consideration of the European case will hold some lessons of more general appeal.

I. Why competition?

It is not popular in much of the world, including Europe, to view the higher education system as a market. However, a market it is, albeit a very imperfect one. It satisfies the technical requirements. There is a service: advanced training. There are suppliers: institutions such as universities. To some extent, the students, the demanders, can select the institutions from which to acquire the service. There are also prices (registration and other fees), although they are typically far from market clearing prices determined by the intersection of demand and supply. And, again in a limited way, there is competition.

I suppose that the critics of the “higher education as a market” concept would agree with the description I have just made. They would emphasize, however, that what they object to is the consideration of the higher education system as, *mainly*, a market. I concede this point. The

higher education sector satisfies a function that our societies need and that would have to be satisfied in any case. That is, higher education is not an activity that if the market does not provide there is nothing to worry about, since it would only mean that there is no demand for it, and therefore should not be provided. Higher education has to be provided. There is therefore a public responsibility. Yet this does not mean that it may not be convenient for the efficient satisfaction of its mission that the field has significant market features. Today I'll emphasize some of these. However, let me here, at the very beginning of my talk, recognize that in all likelihood the market should be a regulated one, subject to the strictures of modern competition policy, including, perhaps, the existence of public regulatory agencies.

What is the mission of a higher education system? My position on this is, at bottom, very traditional. I believe that its essential role is human capital formation, encompassing in this term the Humanities, the liberal arts education and even the social, relational, capital emphasized by authors such as Henry Hansmann. The position I am adopting has substance. It implies, for example, that other functions of the universities commonly viewed as central, need to be justified in relation to the primary object. This applies to functions such as being a repository of knowledge, transmitting knowledge, advancing knowledge (that is, research) or transferring knowledge (that is, the role of universities as economic engines). I think that what explain that the institutions of higher education, besides training, do all these things, are complementarities: it is much cheaper to do them jointly than separated. A good researcher may often be a good teacher, even an extraordinary one. The skills that go into the preparation of lectures may not be very different than the skills needed for research; those required for industrial innovation are also close to research abilities, etc. It is possible to have quality institutions of undergraduate education that do not place a strong emphasis on research. But I do not think that this is really possible for the post-graduate level of education.

Higher education is a differentiated product. There are varieties of advanced human capital training and there are varieties of initial student abilities. Therefore, efficient production will require some specialization and targeting in the training offered by universities and a good matching with student abilities. All this will be reflected by the degree offered by the institution. Hence, the degree signals quality but it is important to realize that this quality is an entangled composite, a product, more than a sum, of ability and training. The view that higher education could be fundamentally signaling of ability seems to me too extreme. It is true that in the modern economy we are overwhelmed by the availability of rough information and therefore the importance of credentialization increases. But developments in many sciences should make the signaling easier, and make it less crucial to spend years at school, if that was all there was to schooling.

If I were to follow a completely orthodox approach I would now have to enquire about the objectives of the higher education institutions, that for simplicity I will refer to as universities. Obviously, the objective is not, typically, the maximization of profits. The schools for profit are still an exception and I will abstract from them. Most universities are public, or foundation-like, hence non-profit, institutions, or a mixture of both. There is a real issue of what the objectives are then. Maybe the maximization of the expected future social surplus generated (and partly appropriated in the form of own compensation) by the graduates. Most likely there is no a clear cut objective, but a general mission, or aim, imposed by the owners, public or private, or directly by the law. It seems to me, however, that whatever the mission is, it will always include as part of it the duty to be statically and dynamically efficient, that is, to produce a maximum for the resources committed.

It is my claim that this alone imposes that higher education institutions should compete among themselves, at least for students. Indeed, they should strive to attract the students with the best profile for their particular mission and equipment (including faculty). Since, typically, there will be institutions offering similar products the most successful, recall that the interaction of ability and training is multiplicative, will be the one that manages to attract the best suited students.

Let me point out a second, more indirect and more pragmatic, reason for why higher education competition is desirable in the current European context. Look at the official objectives of the European Union, in particular to the Lisbon agenda. Try not to smile, or cry, when Europe sets for itself the objective to be “the most dynamic and competitive, knowledge based, economy in the world by the year 2010”. Acknowledge that this is a noble and worthwhile objective, if not for 2010 for 2025. After all, the real danger for Europe is to slide into permanent decadence. Presumably, this modified Lisbon objective, with its emphasis in knowledge, includes the competitiveness of the European universities, which, to judge from various rankings (Shanghai, Times, etc.), and from casual observation, are behind the American universities. Be then under no illusions. As with competition among firms, the external competitiveness of the European universities can only arise from its internal competitiveness. It is fallacious to think that in order to overwhelm internationally the way to go is the way of cooperative internal planning. As you well know this has been tried, and has failed, in related domains. The virtuous circles that emerge from the “wasteful” process of creative destruction emphasized by Schumpeter in the economic realm do also apply here.

In summary, everything I have said so far has a corollary for public policy: it is highly desirable to dismantle barriers to competition among universities.

II. The nature of competition: Competition for students.

Let me now put forward the assumption you would expect from an economist, namely that students engaged in higher education wish to obtain the best education possible. To the students a quality university environment offers at least three things: good content and good teachers, an effort commitment device and a network of peers and potential employers. In turn, an important factor in the long-run reputation of a school is the ability level of its incoming students. Thus, quality breeds quality and the logic of competition will not fail to generate a cumulative process of quality and reputation building. I submit that this competition for students is the base of the entire competition dynamics for universities, which, of course, will, in a derived way, end up affecting many other dimensions (competition for professors, for research grants, etc.)

It is worthwhile to observe that competition for students and the ability to select students is not exactly the same thing. In principle in a closed university area (the term “closed” is used in the same sense than “closed economy”) with several universities we could apply two extreme assignments methodologies.

The first is free access. The student has the right to attend any school she chooses. As you well know, this is not an exotic possibility. It is the norm in many universities around the world. To my mind this is a disastrous arrangement, completely deleterious to the proper functioning of incentives. What is the stimulus to improve the quality of the degrees if this will lead to an increase in the number of students enrolled, thus degrading the degree? There are, certainly, ways to try to counter this effect, involving, typically, the transformation of the beginning courses of the curricula into cumbersome and costly selection devices. But even then the truly stable arrangement is the offer of low quality degrees.

The second, polar, methodology involves complete freedom by the university to select applicants (perhaps, in the case of public institutions subject to a minimum number) and maybe even with the ability to bid for them.

Leaving aside this bidding possibility the second methodology, free selection, is preferable to the first, free access. It is also the easiest and simplest to implement in a context of an open – across countries - university system, such as the European. But there are intermediate approaches that can be quite satisfactory and that, avoiding the extremes, go a long way towards implementing competition. They are forms of external, or objective, selection. Thus, in many countries the admission to a university is determined by the result of a national exam, by high schools degrees and by the preference rankings of the students. In others, each university sets an

entrance exam, but this is essentially anonymous and admission is automatic if the performance is above an equilibrium threshold. Any of these forms is superior to free access, because they induce quality building competition. If factors such as objectivity and anonymity are important in themselves then they may also be superior to free selection. The assignment in an open context remains a difficulty but even there the role of external forms of accreditation for admission purposes is bound to increase at the same pace as the mobility of students.

At this point I should mention the Bologna process, which actually was initiated here in Paris with the Sorbonne declaration. While the process has marginalized too many important things (research, for example, or doctoral studies, introduced as a sort of afterthought), it is undeniable that it may have a crucial and favorable effect for competitiveness. If in establishing a European Space of Higher Education its makers were aware that they were, without ever uttering the “competition” word, unleashing very strong competitive forces, the precise forces that are needed, then my bow to them.

It is natural to surmise that the biggest competitive shakedown will occur at the postgraduate level. Even in the USA most initial college education takes place close to home (in two years colleges) and, modified perhaps by the increase of Erasmus style programs (that anyway may displace themselves towards the postgraduate level), this is, and will continue to be the case in Europe. It is in the new postgraduate degrees that we may observe an increase of European-wide competition for students. It is already happening at an incipient scale.

III. The nature of competition: competition for professors.

In an almost mechanical way the competition for students should induce, on the part of universities, the wish to acquire the best professors, and therefore the competition for them. What does “best professors” mean? Strictly, it should only mean those with the capability to transmit knowledge in a manner well adjusted to the students present at the university, or, more generally, to those the university desires to attract. In principle, an adequate sort of teaching ability could suffice for this. Yet there is more than one reason why the competition for professors will tend to give value to research accomplishment. One, of course, is that the latter guarantees that there is interesting and up-to-date knowledge to transmit. Another, perhaps more subtle, focuses on signaling. Indeed, how is the suitability of the professors transmitted to the potential student? It is possible that, somehow the school has reputation, for whatever historical reason, and therefore the mere fact of being a faculty member of the school conveys the right information to the student. But it may also happen that the professor may have a standing on its

own right, gained in pure research or even in media presence, and this adds then to the reputation of the school. In other words, that the professor be also a researcher, of one sort or another, may be important not only because it is a guarantee of better knowledge to transmit but also because it is easier to transmit to the students, and I could add to the schools as potential employers, that he has good knowledge to transmit.

The competition for professors is not as intense in Europe as in the USA. It is remarkable how many of the European universities have substantial fractions of its senior faculty with doctorate degrees from the own university. There are many reasons for this lack of mobility. The cultural and linguistic diversity of Europe is a factor, the bureaucratic difficulties (normally related to the public character of higher education institutions) that affects salary scales and the possibility of competitive offers is another. But I believe that, historically, the main one has been the lack of incentives to compete.

Let me add that there is, of course, a tendency of quality professors to cluster together. A force in this direction exists because, typically, a good scholar prefers the best company he may get (although, sadly, we all have seen exceptions). If the appointment system is not entirely perverse (note: entirely perverse systems do exist) then its operation will be biased towards some quality concentration. But this is not competition; it is a sort of drift. Competition is a dynamic force that seeks actively the best professors. It is this force that, I believe, will emerge, may be with some lags, once the competition for students is well established. Not all institutions will practice it, the routines from the past can be strong and protectionism is hard to dislodge. Yet, it is enough that some do. Those will be the ones that prosper and that will be increasingly imitated. A margin of mediocrity may remain in the corners of the system, but the harm will then be small.

IV. The Nature of Competition: competition for reputation

I have already referred several times to reputation, an intangible that would not fail to appear if one was pressed to state an objective that could realistically be associated with the behavior of higher education institutions.

There can be no doubt of its importance as a factor in higher education. Spectacularly so in the USA, but also in Europe and in the world at large. The best known ranking of universities originates in China. Incidentally, the passion, perhaps the fad, for rankings is also a manifestation of the significance of reputation. To my mind, a surprising aspect of the rankings

is its one-dimensionality. We do not find unnatural to question if school A has more or less reputation than school B, even if one could ask: reputation about what? I suppose that while the interest in rankings will not go away they will become much more refined and multidimensional.

At any rate, reputation is extremely helpful for competitiveness. It cannot be acquired with just smoke and mirrors; it has to base on genuine quality content. But it is possible for short periods to have more reputation that one deserves and a good builder of reputation will know how to open these small gaps in order to close them, in a relatively easy manner, upwards. Reputation bootstraps itself. It cannot be built effortlessly but it is resilient. I do not agree with the dictum that reputation is fragile. This may be true for the concept of “credibility”, but reputation is not just credibility, it is also a trust-inducing stock that, as any stock, deteriorates without jumps. Have you noticed the staying power of institutions that have been great? In my own field if a Department was very good 20 years ago but not so much now chances are that it will recover its distinction sooner or latter.

Competition for students, for professors, for reputation. We could go on to competition for grants, for donations, etc. To repeat my general theme: all this is at bottom a consequence of the competition for students.

Up to now, I have not referred to size. What about it? Should the search for competitive advantage lead to the increase of the student body? There is a limit to this. The mere fact that none of the 20 largest universities of Europe are in the top 50 European universities according to the Shanghai ranking indicates that large size does not make for quality. After some point (20.000 -30.000 students of all kinds?) decreasing returns set in. Why? Probably because of the coordination and management costs of running the institutions. This brings me to a new topic.

V. The Agents of Competition

To compete means that somebody designs plans of competition, that somebody looks out for opportunities, that somebody with weight makes decisions. In this respect I believe that, as compared with the US, in Europe we are at disadvantage, but that not all is bleak.

Generally speaking, in our university system decision centers are diffuse. In these environments the development of strategic plans cannot always be realized at the appropriate level, nor there a tight correspondence between the competitive opportunities and the decision agents. Often,

whoever sees the opportunities (competition is strategic planning plus opportunism and agility) does not have the capacity to act, and who has the latter does not see the opportunities, perhaps because it is already distracted enough with the daily struggle for normal functioning. I have little doubt that the institutions that will benefit the most from the emerging competition will be among those that dispose of sharp decisions structures. The US example, in this respect, is striking. Threat points to the competitiveness of the institutions are identified quickly and acted upon by accountable authorities that have this as their duty.

But not all is negative in the comparison Europe- USA, or at least I hope so. Let me argue that, paradoxically, one of the characteristics usually perceived as problematical in Europe, the strength of the States (and for this purposes we could add any sub state government), may be here an advantage. The reason is that they provide a level of competitive decision instances that could be key. Let me put it in a more personal way. When I consider the future of the European universities in the world the rational part of my brain anticipates that in fifteen, twenty years the world race will have generated, or maintained, some European world class universities, yet they may all be British and, perhaps, Swiss. None in the Continental part of the EU. When I look at the matter a bit more emotionally I cannot fail to hope that the European States, and the regional units with political power, will contemplate this perspective – not because others are in, but because they are out – with much concern and apprehension and will react in the only manner possible: designing the institutions, removing the impediments and, perhaps, committing the resources necessary for their own countries not to be left out from the world competitive race among universities.

VI. Funding aspects

The desirable perspective of an increase in the level of competition of the European university field has clear financial implications: European higher education will need to mobilize more resources. On this issue let me briefly make a number of points:

- i) The possibility that the bulk of the required additional funding comes from the public sector is limited. If you are European put to yourself the following thought experiment: suppose that Europe were to receive a sudden windfall of resources that had to be applied either to improvements to the health systems, to alleviate the hardships of dependence in old age, or to higher education (which direct beneficiaries are independent, vigorous young people); what would be your opinion about the proper use?. If we add that we are not talking about windfalls but about,

essentially, increasing taxes and/or sacrificing other uses of our resources it seems to me that I can rest my case. I'm afraid that the implication of all this is clear: the funding increase of universities will have to come from private sources. That is, from its own students, from business, or from altruistic contributions. I will address these sources one at a time.

- ii) But first an observation directed towards public authorities. It is very important that the rules for public funding be clear, predictable and, of course, non-penalizing of the fund-raising activities of the universities distinct from lobbying the public authorities. If there are no such rules and public funding is responsive to lobbying then no alternative source of funding may be developed by universities because the most productive use of effort may be lobbying. It is better for the public authority, and in fact for everyone, that the public authority fixes the level of subsidies at a, hopefully generous level (and, yes, let's carry out a last, powerful lobbying campaign to insure this) and then becomes, credibly, completely unresponsive to lobbying efforts. Establishing this framework of stable rules is to my mind the first measure to be taken in any program of reform of higher education in Europe.

- iii) As for the contributions from students it is the turn for an unpopular conclusion: a policy of liberalization of fees for university degrees (especially at the postgraduate level) is inevitable, and it is convenient, as the alignment of fees with costs is favorable to the development of the competition field. It would also have a clarifying effect on mobility matters. For example, if the higher education system of one country is sustained by the taxpayers of that country, does it make sense that the universities strive to get students from other countries? Will they? Will they be allowed to without limit?, and what about if the graduate emigrates?. Undoubtedly, some accounts may balance out in the aggregate but by no means all. Charging fee, however, presents a very major difficulty: if not done well it can discriminate by social class and thus be in conflict with the equal opportunity principle, a main pillar of the self-image of European societies. This is why I will not say that this is the second measure in a reform program. I assert, however, that it is the third and that it should come about some years (not few, not many) after the second reform measure, which should consist in setting up an Australian - and from this year English - style Graduate Contribution Scheme. The doctrinal basis for the Scheme were conceived almost twenty years ago by Nicholas Barr, then at the LSE. It consists, in essence, of a delayed, and contingent, payment mechanism for fees

(and, perhaps, living expenses). Depending on the interest rate applied it could be considered, or not, a loan. Payment takes place after graduation, as a multi-period supplement to the income tax, and only if income goes above a certain threshold (average income, for example). It seems to me that this is a system full of desirable properties (including treating university students as adults). The system represents a kind of intergenerational solidarity pact: current students are being helped by the previous generations of students, and they, in turn, will help the next generations (incidentally, these flows of funds may appear in the statistics as of public origin). I should add that in Britain what I'm calling the second and the third measure have been set up (strictly speaking only in England) simultaneously. This seems to me politically risky. My advice is to do it sequentially. Even more, and to play it safe with the equal opportunity principle, when the liberalization of fees comes it would be appropriate to establish, by regulation, that a significant fraction of additional revenues should be devoted to scholarships. Of course, this is not an original proposal. In France I have heard it made by Elie Cohen, for example.

- iv) My next observation is related to scholarships. Roughly speaking, those come in two flavors: need and merit. The first is a tool for making effective the equal opportunity principle. The second can be a priority scheme for rationing need scholarships. But it is also a competitive tool. Clearly, the drive for universities to get good students may generate bidding wars. This is disturbing. It is worth mentioning that even in the very competitive USA there is an agreement (which is not deemed illegal) by universities not to engage in competitive wars based in merit scholarships. In theory (I'm sure there are doubtful cases, especially in the sports domain) all scholarships are for need. Probably a similar regulation would be appropriate in Europe.
- v) The universities have not been traditionally very good protectors of their intellectual property. A case in point are the academic journals, full of knowledge generated at universities but often appropriated, at a large cost to the universities, by private business. This attitude is changing and will keep changing. The wish, and the right, to have and to capitalize intellectual property will be a side effect of increased competition. Yet, it is also important to realize that this will not, and, certainly, not of a sudden, become a miraculous solution to the funding needs of the universities. On average these sources of money will not go beyond the category of helpful, but small, additions. This is, incidentally, also true of the USA. A note of warning: while the entrepreneurial university may only be a limited improving factor to the

finances of the universities (globally considered) this does not mean that it is not socially useful or that public authorities should not worry about it. To shake the university tree of knowledge so as to gather succulent fruits may be very good for society, even if the tree itself does not get much of a share of it.

- vi) The generosity of Americans citizens towards its universities is the envy of the world. The numbers are staggering. The financial endowment of Harvard, for example, equals 25.000 millions dollars! This is not the place to analyze why. It is certain that cultural traditions play a role, as do the lower levels of taxation, or fiscal incentives. But be as it may, note that even in the US the level of generosity towards the private universities is higher than towards the public. A cynic could argue that this is because people, alumni say, value highly what they pay dearly for (fees in private schools are much higher). But I think it is more likely that the difficulty to generate donations for public institutions – which are the norm in Europe – is related to the fear of the donor that his action may merely substitute existing or forthcoming public support, that is, the fear that his donation not be truly additional. This is, incidentally, another reason that militates in favor of reform measure number one: the most certain are the public financing rules the more confidence universities will have that its fund-raising efforts will not be penalized (this I already discussed) and (this is new) the more confidence will the potential donors have that their contribution makes a difference in its entirety.

- vii) In a context where universities need to be competitive agents its autonomy, or simply its ability to make its own decisions, is crucial. Universities have to be managed – in all its aspects: long-run or short-run – from the universities themselves. The micro or even macro management from a ministry is poison for the stimulus of the competitive spirit. Ideally, therefore, I would recommend the legal form of a foundation, or similar entity, for a university. Of course, the charter of the foundation will have to guarantee its accountability, especially if the institution is a substantial recipient of public funding. It would be also very nice if the institution had an endowment. Nothing guarantees more the independence and the ability to have a strategy of one's own that financial self sufficiency. This is obviously a pipe dream but it is important that when European countries define new legal frameworks for their universities set conditions that, as a minimum, make possible and do not discourage the gradual constitution of endowments.

VII. The role of Europe

Which role could the institutions of Europe play in stimulating a competitive European field of higher education? To the extent that the EU endorses the Bologna process it is already indirectly fostering it. But it is a great pity that the EU has not been more explicit about the desirability of competition and that it has not displayed an activist attitude in promoting it, especially at the postgraduate level and in research. The tradition of the Framework programs, with its single minded insistence on networks and its bias towards industry related research has not been very satisfactory. It is to be hoped that the recently constituted European Research Council, with funding from the VII Framework program, can be more effective. In principle, the ERC is committed to supporting projects (mostly individuals and with no network requirements) on the basis of scientific excellence and nothing else. If this is so, and the evaluation structure that is put in place is first rate, then the initiative may have a very strong effect, even if by itself it is financially quite small when compared with the research budgets of the large countries.

It could be argued - I'm sure that it has been argued - that the EU should not get into the business of choosing projects in individual countries without a network structure because this lacks "European content", that is, the individual country could do it by itself and therefore, in application of the subsidiarity principle, the EU should not do it. I think that the prevalence of this line of argument in the Framework programs rest on a too mechanical application of the notion of "European content". A more sophisticated notion is needed, one that recognizes that if something could be done at the State level but it is not done then maybe it cannot be done after all once we take into account incentives, informational and political constraints. Large research projects are a case in point. States are too close to the recipients to be able to exercise an extreme degree of selection. The EU is more removed and therefore, on this account, it is not limited. In summary, this is the kind of help that the EU could give: through its grants policies it could provide good scoreboards that can serve as reference points in the competition field. Of course, this can also be done without committing resources to it, but it would be very strange that with one hand the EU established rankings and with the other did not follow them for its distribution of resources. The effect would be definitely weak. I repeat: the hope at this point is the ERC. Beyond it, it would be desirable, but on this we have probably to be thinking in the VIII Framework program, that a fund based on similar principles could be developed for educational programs, especially at the postgraduate level.

Thank you very much for listening to me and a happy anniversary to Sciences Po.