Preface

My purpose here is to apply formal economic theory to higher education. The uniquely high cost and quality issues in higher education lead me to a critical evaluation of the academy. I know these criticisms are difficult for members of the academy to accept and I hope my colleagues realize I undertake this project because I am dedicated to what higher education can and should be.

The problems come from the network of incentives within the academy. These incentives are not properly aligned with the public interest. The incentives create the problems. The incentives can make it appear members of the academy are engaged in collusion. Nothing could be further from the truth; there is no conspiracy; people follow where the incentives lead. The vast majority of faculty members, administrators, and board members are sincere in their belief the actions they take are in the public interest.

The misalignment of incentives leads to extravagant increases in cost per student and a secular decline in quality. Because the public is uncertain about value added per individual institution, they choose cost as a proxy for quality; the assumption is, if it cost more, it must be higher quality. The value added uncertainty also explains why reputations are the primary means of competition among higher education institutions. The association of cost with quality creates a perverse incentive for colleges and universities to spend as much as they can per student. The competition has no limit; there are always projects that conceivably could improve "quality." Hence, reputation competition among higher education institutions is a race to spend as much as possible per student.

As they are nonprofit institutions, their ability to spend is capped by available revenues, so any increase in revenues drives costs higher in an unending spiral. Even the richest institutions never have enough money; they are always in fundraising mode in order to lift the cap on expenditures. The wealth accumulated by colleges/universities and the amount they spend per student are barriers to competition from less well regarded institutions. The faster a top tier institution can raise its expenditure per student, the less competitive threat there is from lower tier institutions.

Reputation competition is efficient when consumers make frequent repeat purchases, they can easily evaluate quality after purchasing the product, they immediately abandon producers who cheat on quality, and there are no third parties in the transaction. None of these conditions exist in higher education. Reputation competition in higher education is inefficient, quality uncertainty is a financial advantage for institutions, quality cheating is a constant problem, costs are chronically high, and the institutions are subject to significant principal/agent abuse.

There are few constraints on principal/agent abuse in higher education and agency problems always lead to costs that are higher than necessary. The decades long history of exceptional cost increase is the product of reputation competition and serious unresolved agency problems in higher education.

The importance of academic reputations means administrators and governing boards are narrowly focused on public relations and they scrupulously avoid all controversies. As conditions change, they do not attempt to reallocate resources; instead, they seek to solve all campus problems by raising more money. This public relations mindset adversely selects for lower academic quality. Administrators divert resources from real quality because those programs are slow to develop, the benefits are difficult to measure, and the results are most likely to be realized during the next president's tenure. Instead, administrators prefer projects with immediate public relations value and obvious tangible results, such as facilities competition and media events.

Since attempts to control cost are always controversial and controversies damage reputations, administrators and governing boards will not voluntarily reform. There is a bias against real reform among administrators and governing boards. The college access problem cannot be solved until colleges and universities control their costs. The bias against reform among administrators and governing boards insures that true reform will not come from within higher education.

There is a robust market for senior scholars and no market at all for senior teachers. This is an anomaly because the public values quality teaching and is indifferent to research; economic theory suggests there should be a vigorous market for senior teachers and an indifferent market for senior scholars. There is no market for gifted senior teachers because colleges and universities refuse to measure teaching value added. Maintaining uncertainty about teaching value added is a financial advantage for colleges/universities; quality uncertainty makes the demand for services more price inelastic and it strengthens the institution's negotiating position with respect to teaching faculty. Median faculty members also benefit from quality uncertainty; when teaching productivity is not measured, low productivity faculty are paid a premium and high productivity faculty are paid less than their true contribution. Unfortunately, this adversely selects for poor teaching and people who prefer that rewards are disconnected from productivity. Further, the incentive imbalance between teaching and research creates one-dimensional faculty members who are too intensively focused on research; when you are rewarded only for more research output, you neglect teaching. The neglect of teaching leads to a secular decline in quality.