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Hostility, Trust, and Maximization:
An Economic View of Higher Education in 1992

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HOSTILITY, TRUST, AND MAXIMIZATION: AN ECONOMIC VIEW OF HIGHER EDUCATION IN 1992

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It's increasingly clear that there is a lot of hostility out there toward US higher education. And it seems that it's not as much higher education in general as that elite part made up of Stanford and Swarthmore and Harvard and Wellesley. It's focused on our tuitions levels, our research practices, our problems with the government on indirect cost recovery, not to mention athletics and political correctness.

And if there's hostility out there, there seems to be an equal measure of bafflement in here, within higher education, about what it's all about. There's a strong sense that we're being misunderstood. In a panel at Williams back in October where the presidents of Amherst, Wesleyan, and Williams discussed the current state of higher education, they were asked "Isn't it possible that there's some real justification for the anger and resentment we're collectively feeling?" Two out of three of their answers were clearly "No" while the third confessed to a worry that maybe humanities faculties have become so caught up in their own battles and have drifted so far into exotic private vocabularies -- that surely sound arcane and very very "academic," in the pejorative sense, to the workers and legislators and businessmen of the outside world -- that what we're seeing is a sense of irritation at that sort of irrelevance. One or two members of the faculty audience suggested other alternatives -- that we've bowed to the pressures of the politically correct or we've eliminated the passion from our studies -- but it's fair to say that the session ended pretty much as it had started, with a recognition that those people out there seem pretty angry at us in here, but without any real sense of *why* they're angry.

Economic Theory -- Markets, Trust, and Maximization

I'd like to try out some ideas that come from what may seem an unlikely place -- from economic theory developed in the past two or three decades -- to suggest that they take us some distance toward understanding what's going on in higher education and the nation's attitudes toward it, and what we can do about it. The message -- though it comes from the dismal science -- has a good measure of optimism in it. However glum it might sound to say that -- in part at least -- we've brought this on ourselves, the implication is that we can likely do something about it. If we turned it on, maybe we can turn it off.

Let me begin with markets, as economists so often do. An apology is due those who find it aesthetically offensive to hear someone talk of a college as a "firm" and our students as the "customers who buy what we sell," but it might be useful to follow Coleridge's advice and willingly suspend disbelief until you see what insights can come from that sort of talk -- from that set of analogies. I think you'll find that seeing higher education as an "industry" with a "market" takes us in useful directions you might not have expected. To those who are comfortable with the analogy -- economists and their fellow travellers -- an apology is also due because what follows may sometimes sound like a paean with a title like "In Praise of Inefficiency and Sloth." That's not, in fact, where it's going so you, too, should be patient and see where it all comes out.

So there's a market for higher education. Colleges and universities produce educational services and sell them to students as our customers.

Economists have spent a lot of time and energy on one very central question to understanding social behavior: "When do markets work and when do they fail to work?"

"They work," means that markets organize transactions between people to give them what they want most -- recognizing that they can't have it all.

You might not guess that economists worry a lot about where markets work and where they fail if you listen to the ideological lyricism about markets we're hearing from politicians and ex-Soviet experts on CNN -- it sounds there like markets are the magic solution to all the world's problems because they work all the time in all circumstances and for all transactions. But luckily, economics is very aware that markets are more complicated than that, that you can't analyze social behavior with an acoustic guitar or a public relations firm.

The relevant piece of economic theory is the theory of asymmetric information. It's pretty simple. It says that free, competitive markets can work very well if everybody knows what they're getting into -- if everyone knows everything relevant about what they're buying and what they're selling; if buyers and sellers are both well informed about "the product." But when information is asymmetric, one side of the market knows what's being traded while the other side doesn't. The Berkeley economist who first articulated this -- George Akerlof -- illustrated it with used cars where the seller knows whether he's selling a lemon, but the buyer doesn't. So it's generally known as "the lemon principle." Akerlof showed that under quite plausible circumstances, asymmetric information can cause a market to break down entirely -- there will be buyers who want to buy a car at a price the seller's willing to accept, but nothing happens. There's no market transaction and neither party gets what he wants.

What screws things up is the combination of maximization of self-interest and asymmetric information that, together, make the potential buyer of that used car vulnerable. A profit maximizing used car salesman -- and we always assume they are -- not only can be opportunistic when faced with a naive, uninformed buyer, he has to be opportunistic, or he's not actually maximizing his own self-interest.

One solution is obvious. Akerlof showed that if everybody were honest about the product's quality -- if used car salesmen could always be counted on to tell you what's wrong with the car, whether it is a lemon, so used car salesmen could always be trusted -- then the market would work, even where asymmetric information is inherent. People who want to buy cars can buy them and people who want to sell cars can sell them, all at prices both find acceptable. But in place of maximization then, each party to the deal would, instead, be following a rule of honesty that justified *trust.*

So markets with asymmetric information can usefully be called "trust markets". They work best when the participants in those markets temper their desires for maximum personal gain with a measure of a self-denial that will justify the other guy's trust. They substitute a self-restraining ethic for a maximizing ethic.

So maximization -- self-serving behavior -- and trust are in conflict in this sort of market. If you maximize, you exploit weakness; if you respect that weakness, you don't maximize.

Of course honesty isn't the only way to address the problem. Legislators keep hoping that *laws* can be made stringent and specific enough to keep people from exploiting each others' vulnerability in these kinds of markets -- like laws on fraud and malpractice and insider trading. And certainly those laws do have an effect. But, to sound an economists' theme again, that route is a good deal more cumbersome and expensive than honesty is -- surveillance and enforcement are costly -- so even on that simple ground we're better off if there's trust.

Trust Markets

That's enough of abstraction. Are there lots of actual and important markets with asymmetric information? Obviously there are. It's certainly the essence of the market for medical care. You go to the doctor precisely because he knows more about the medical service he's selling you than you do -- otherwise, you wouldn't be there. So -- as an aside -- what we're seeing in US health care is a far deeper revolution than is normally acknowledged as we watch an important trust market be transformed into a market where maximization is the accepted ethic. Technology is driving the transformation and can't be wished away, but that is a reason to be more, not less, nervous about the change of market character in medicine.

Other notable trust markets include nursery schools and day care where the customers aren't competent to understand what's actually being sold to them -- done to and for them. For the same reasons, but at a very different stage of life, nursing homes operate in a trust market.

And, of course, higher education is sold in a trust market. Just like going to a doctor, our students come to colleges and universities in important part <u>because</u> they don't know what they'll get from us. If they knew what they'd learn, they wouldn't have to learn it. Sure they can read College Guides and the piles of literature we all send them and talk to friends and parents and parents' friends, but ultimately, there remains a whole lot of asymmetric information between buyer and seller as inherent in the educational process. We know more than they do. So we operate in a market that has to rely on <u>trust</u>. (It's more often described as "reputation," "status," "prestige" -- what gives the customer assurance that she'll get what she pays for.)

Nonprofit Firms

Before turning to why and how the recent behavior of colleges and universities fits into this, let me note another useful piece of economic theory, due to economists Henry Hansmarm at the Yale Law School and Estelle James at SUNY Stony Brook. It's no accident that when we look at trust markets, we usually see a whole lot of <u>nonprofit</u> firms. The distinguishing feature of non profit firms is NOT that they can't make profits -- which may surprise you as much as it did me when I first realized it. They often make large and handsome profits. But they can't <u>distribute</u> those profits to stockholders or the Board or any other outside <u>owner</u> like a normal business firm would.

They can only use those profits for the purposes of the institution, now and in the future. Hansmann called this "the non-distribution constraint" and argued that because they can't distribute their profits, the managers of nonprofit organizations are more trustworthy. When you send your $50 to WGBH or KPFA, you don't have to worry that it will simply be passed on to the owners of those stations as part of their yearly dividend -- you have more reason to believe that it will be spent the way you want it to be spent, on public radio programming. So nonprofits often dominate trust markets, as they do higher education.

Colleges, Universities, and Trust

Which brings us to the central question -- what have US colleges and universities been doing to provoke such unfriendliness from the nation? And the general answer appears to be that we've let an unseemly interest in revenues -- in income, making money -- erode the public's trust in higher education.

It would not be entirely inaccurate to call the past twenty years, The Age of Maximization in elite higher education. Or, maybe, The Age of Creeping Maximization. We've seen, over that period, the systematic introduction of "professional" and "rational" management of colleges and universities and while there is clearly much about that to be applauded -- to the extent that we've used our resources more carefully and more self-consciously -- there is also something about it to be feared -- as we may have so enthusiastically accepted the message of careful maximization that we've not noticed its erosion of trust.

Maximization on Campus

"Maximization" means many things to economists in many contexts -- it can mean, simply, getting the most out of your limited resources -- using them efficiently -- or it can mean getting the most out of your customers or your workers or your suppliers. It's a portmanteau word. Being efficient is pretty unambiguously "a good thing." Getting the most out of your customers, in a trust market, is not so clearly "a good thing." With that distinction, let me briefly track the creep of maximization -- the growth of hard, aggressive, rational behavior -- in dealing with our customers.

Colleges like Williams and Amherst and Wesleyan get their yearly income in roughly equal amounts from three sources: about a third comes from wealth, largely in the form of endowment income; about a third comes from student charges; and about a third comes from gifts. In an elite university, a fourth roughly equal source is added in the form of research grants and contracts.

The past twenty years have seen policies of maximization applied, one after the other, to each of these sources of income.

It seems to have begun with the Ford Foundation's campaign in the 1960's to persuade nonprofit institutions to loosen up a little and manage their wealth for "total return." At the time, endowment wealth was invested where it would provide the steadiest flow of interest and dividends so the college could plan on a predictable flow of income from endowment. But that policy denied colleges very lucrative -- and safe -- investment opportunities where the dividends were small but the long run growth -- capital gains -- would be large. So, Ford Foundation said, colleges should invest where the total return -- interest, dividends &capital gains -- were the greatest. They'd have to figure out a way to discipline themselves not to spend all that income -- if they spent all interest and dividends, they weren't in trouble, but if they spent all the total return, their real wealth would be eroded. But if self-discipline could be handled, the schools would get more from their endowment wealth than they'd been getting. Indeed, they'd <u>maximiz</u>e. By the early 80's, most colleges and universities with significant endowments were trying to maximize total return.

Tuition income was next. Admissions offices have become masters of direct mail merchandising techniques, using sophisticated searches of national student data bases -- buying mailing lists -- to find and contact potential customers with an efficiency that would do LandsEnd or J.Crew proud. And our publications -- tested by all the techniques of modern advertising psychology -- have become slicker and more sophisticated, expensive, and, presumably, effective. We've maximized the impact of our admissions spending. And the larger pools of applicants that all that effort generated have let us select measurably better classes of freshmen -- with higher SATs and more diversity and (for some) better football teams. Those applicant pools have also kept our tuition income growing with little fear of "pricing ourselves out of the market."

The transformation of college development offices -- the institutional seekers after gift income -- follows much the same pattern, using, in fact, some of the same aggressive marketing techniques and creating some more of their own. The criterion of efficiency in a development office is that they should push their activities until the last dollar of cost brings in just one last dollar of gifts. That warms the hearts of economics professors since it represents one of the central lessons from Econ 101 -- or any one of the nation's MBA programs -- that a firm should expand any activity until its marginal cost just equals its marginal revenue. That is, significantly, the rule for a profit maximizing firm.

Finally, it's been hard for any of us to avoid the news stories about the universities' maximization of overhead cost recovery from the government. A persuasive argument can be made that Stanford has been unfairly singled out for nationally televised abuse -- with repetitive references to yacht maintenance and the President's new brass bed -- but however much university administrations may have been encouraged in their practices (and there's a plausible case for a measure of entrapment) the fact is that they were pushing to the outer limit sharp accounting practices that might have embarrassed them. Instead, Stanford held seminars for accountants from less aggressive universities to teach them how to get the very last dollar in their indirect costs.

Clearly, this description has oversimplified a number of complicated activities and it probably sounds sour about the devoted work of a lot of highly dedicated and imaginative people who have intended to serve their colleges well and in important ways have succeeded in doing it. One thing that makes it hard to see this maximizing pattern as worrisome is that it's been done with the best of intentions by the most devoted of employees.

Too, my description of maximization risks leaving the impression that these things shouldn't have been done -- that we should have stayed with the nice, comfy Mom-and-Pop management style that dominated colleges and universities in the 50s and 60s, that it was a mistake to be thoughtful and aggressive in our management and try to think carefully about what we should do rather than grind on, dominated by tradition and habit. It would be an error to say that, either.

The mistake, I'm suggesting, came not in moving toward more thoughtful management of higher education, but in paying too little attention to -- not being thoughtful enough about -- the cumulative effect these separate and individual steps were likely to have on how much people would trust us. Each move toward maximization made sense in itself, but each move toward maximization also sent a message to the world about how we viewed ourselves. And those messages were, increasingly, that we saw ourselves as pretty much the same as any other business, using the same techniques and taking advantage of the same opportunities. Caveat emntor -- let the buyer beware.

It appears to be no accident that the focus of the hostility toward higher education -- from the Dingle Committee to Saturday Night Live -- has been on our sharp dealing and maximization. So the amount of money given back to the government by Stanford and MIT and Cornell -- all with the implication that it had been got by shady practices -- makes bold headlines. So do tales of scientific fraud, made more damaging by the aggressively outraged innocence of a Nobel scientist who turned out to be dead wrong. We can't trust scholars, it seems, to be scholars, such are the pressures on them for worldly and academic success. Even there, trust is eroded by money.

It's worth noting here, that there's not only an outside audience that has been reading significance into our maximizing behavior. There's also an important internal audience -- faculty, administration, workers -- to whom our institutions have been speaking. And while evidence of sharp practices may leave the outsiders suspicious and less trusting, it seems destined to induce in many insiders more complex reactions. We will worry, too, about unseemly signals of institutional maximization. But also we don't want to miss out on the goodies that are being passed around and the new message is that it's OK for all of us to hold out for a piece of the action. So, increasingly, we'll prepare new courses if we get extra money over the summer and we'll take on thesis students if we get partial course credit and we'll avoid committees because they take too much time from research and that's where our grants and mobility and professional respect will come from. Anyone over fifty is to be distrusted in such an observation as this -- such is the nostalgic lure of when we were Assistant Professors -- but it's easy to see a connection between our institutional maximization and a decline in the sense of community.

More to Come?

I want to pose two final questions. First, "We've been through a lot of very public embarrassment, is more likely to come?" Second, the valuable old classic, "So what?" If there's some truth in all this, what's the implication? What do we do about it?

Take the question of continued vulnerability. Is there another shoe to drop, another place where colleges and universities, despite the fact that they've been playing it strictly according to the law, are close enough to the edge that a Dingle Committee can make us look real bad? Are we, in other words, vulnerable to yet another "expose" that will further erode the public's trust?

Unfortunately, I think we are. There are, I suspect, two shoes that might yet drop -- however much that fact messes up my image of "waiting for the other shoe to drop." One has to do with how honest we're actually being; the other with the appearance of our honesty and loyalty to our own values.

The first is the fact that the "budget deficits" we tell our communities and alumni and the press about -- the deficits that are assumed to show how hard the times are getting to be for colleges and universities -- are not at all what they seem to be. They seem, reasonably, to describe the economic fortunes of a college for the year -- a deficit seems to show that the college spent more than it took in and a surplus seems to show the opposite. That's what you and I and the press and the public are led to believe. That's the way our family budgets and our checkbooks work. But in fact, "the budget" includes only a small part -- about two thirds -- of the total economic activity of the school. So whether that part shows a deficit or a surplus is arbitrary -- money is regularly "transferred," moved in or out of the budget, making it show red ink or black ink at will with no relation to how the college actually performed economically. A college can, and often does, show a big budget deficit at the same time that a whole lot of savings are being generated that increase its wealth. Or vice versa. Some colleges -- like Swarthmore and Kalamazoo, and Harvard and MIT for a while -- routinely move dollars around after the fact so they'll always show that they've operated with a balanced budget. Or a potentially embarrassing budget surplus of three quarters of a million dollars -- that would seem to contradict an administration's protestations of hard times -- can, with the stroke of a computer key, be turned into a politically comfortable deficit of $150,000. You want a $10,000 deficit, or a $300,000 surplus as a signal of prudent management? We'll give you one. All this is not even a dirty little secret, but an openly acknowledged fact among those who work with college finances -- they rarely bother to wink or look conspiratorial when acknowledging it. But it appears to be a fact that's not always well understood by either the top administrators outside the financial area or by the Boards that have ultimate responsibility for the college.

When the uninformative nature of those deficits and surpluses was first pointed out nearly twenty years ago by Harold Bierman and Thomas Hofstedt, a couple of Cornell accounting professors, it induced an Andy Rooney segment on CBS, a page one feature in the *Wall Street Journal* with the title, "Ten Eastern Colleges Accused of Crying

Wolf In Reporting Deficits," and a set of heated denials from Comptrollers and a couple of Ivy League Presidents. Bierman and Hofstedt showed that when MIT reported a $5 million deficit, they actually saved $100 million; Princeton's reported $1.5 million deficit went with $151 million in saving; and Harvard's $1.4 million deficit coincided with an $314 million in saving.[1] Yet the practice remains today, just as it was in 1973. It takes no vivid imagination to worry about what hay could be made if this deception were to be understood by Representative Dingle before it was eliminated by us. Those numbers are entirely legal -- indeed they're the result of long established college accounting practices -- but they're still deceptive and they're used deceptively.

The other shoe that might fall tells less of deception than of our vulnerability, in elite and well endowed schools, to charges of ripping off unsuspecting taxpayers to enhance our own already considerable wealth. It has to do with our widespread practice of *interest arbitrage.* It works like this: State and Federal legislators -- who apparently want to support elite higher education with taxpayers dollars without making that fact too apparent to their constituents -- have made it possible for colleges like ours to sell tax-exempt bonds, just as if we were the government. Because the people buying our bonds don't have to pay tax on the interest they earn, they're willing to let us pay them a lower interest rate. So, the college pays less to borrow money. But the flip side of that arrangement is that the state takes in less in taxes. Or, putting it the right way around, the taxpayers are paying part of our interest bill on the money we borrow, the difference between the (taxable) market rate and what we actually have to pay. We borrow, say, at a 5% interest rate when the market rate is 10% and the taxpayers of the US and the Commonwealth pay the rest.

"Arbitrage" is a word that's been added to our general vocabulary in the 80's and

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1 These figures apparently weren't adjusted to reflect the erosion of wealth from the year's inflation. If that had been done, real saving would still have been $83 million at MIT, $132 million at Princeton, and $265 million at Harvard.

made into a dirty word by the likes of Ivan Boesky, the ultimate “arb.” It describes making money on price differences -- simultaneously buying and selling the same thing and doing nothing else in the process. What makes us guilty of interest arbitrage is that wealthy colleges simultaneously loan money to some people (our financial assets, the endowment, largely) and borrow from others. Dollar for dollar. But -- and here’s the magic of arbitrage -- each dollar we lend pays us more interest than we pay out on the dollar we borrow. If we earn 10% on our assets and pay 5% on our borrowing, each dollar of simultaneous lending-and-borrowing earns us a nickel a year of arbitrage profits. $20 million of lending-and-borrowing earns us $1 million in arbitrage income each year. And that $1 million of profit is paid for by the taxpayers, available to us because we’re allowed to borrow tax-free.

It’s legal. The amounts aren’t unlimited -- the cap for any school is $150 million -- and building projects must be nominally involved, but for wealthy schools, it’s inescapably arbitrage. And, equally inescapably, it transfers money -- resources, spending power -- from the average taxpayer to Williams and Amherst and Harvard and the rest.

The concern boils down, really, to whether wealthy colleges may not have so much to lose by being publicly accused of being party to fast financial games played at the expense of the average citizen that they should voluntarily withdraw from these arrangements -- pay off their tax-exempt debts and eliminate their vulnerability to another erosion of public trust. For a school like Williams with $50 million in such debt, it would cost about $2.5 million a year to give up arbitrage income. One thing we’d get out of it is the ability to dissociate ourselves -- clearly and as a matter of principle -- from a practice that got a deservedly bad name in the 80’s -- to dissociate ourselves from Ivan Boesky’s celebrated battle cry of the '80s “Greed is good!” (a call, incidentally, that he issued in a speech at UC Berkeley). It’s not clear that it is worth $2.5 million a year to avoid the taint of arbitrage and taxpayer exploitation -- one’s opinion on that would depend in part about how one feels about the average taxpayer -- but it is clear that it’s a question that should be given serious thought on campuses before, not after, we’re called to public account for it.

The Implications

Which brings me to the significance of all this. I should say, one last time, that the message is NOT that we should shun careful, thoughtful management of resources in wealthy colleges and universities either because we're so rich that we don't have to or because we're so timid and fearful of looking like grungy businessmen. That'd be a pretty silly conclusion. We're rich but we're also trying to do a whole lot and in order to protect some of our most cherished values -- like need-blind admissions and need-based aid -- we have to keep on, indeed increase, our efforts to spend our money wisely. Our money is far more limited than our ambitions and will surely stay that way.

In fact, the first message I read in all this is that we need to increase and redirect our institutional attention toward efficiency, paying less of that attention to getting more income and more of it to how we spend the income we're already getting in ways that best serve our purposes. There's no doubt that it's politically -- administratively -- a whole lot more appealing to get more money than it is to be more careful and more purposeful about how it's spent. And it appears to be a basic American characteristic to feel, always, that the problem is that we don't have enough money to do what we have to do and if we only had a little more... It's as true for colleges as for individuals and as true for income as for the length of your sailboat. But it's probably been a real mistake for colleges and universities to pay so much attention to getting -- it's not at all clear that the hours and days and weeks of Presidential time on our campuses spent in gift-getting might not be better devoted to leading the community to think about how the money should be used, about our purposes and objectives and how our spending supports those.

The second message I hear is consistent with that. It is that we need, as institutions, to be much more protective of the public's sense of trust in us. We need, I think, to hear what's being said to us now -- in the hostility to higher education -- as a warning that our customers think we're drifting off course. It's far too early for us to be sure they're wrong, so we should fight the temptation to circle the wagons and dismiss their worries as wrongheaded. In a way, in the matter of trust, they can't be wrong -- if they're telling us they don't trust us as much as they used to, we can't very well tell them they do And it probably doesn't help to tell ourselves they should -- that we're just being misunderstood.

Is there a practical implication of this? I think there is. It suggests that if we recognize the central role that trust plays in a market like ours, we will want to be far more self-conscious about judging our own behavior in those terms -- more systematic about asking whether something that makes perfectly good, pragmatic sense might be seen by those outside of academe as another reason for erosion of trust. Practically, we need to rebuild old, and devise new, institutions and occasions to remind ourselves -- awkward and embarrassing though it may sometimes be -- of our pm-noses. We need to find ways to help new members of the community to understand those purposes -- their socialization isn't automatic. We need to pay less attention to the legality of what we do and a good deal more attention to the appropriateness of what we do and we need, more often, to decide that some activities -- especially when they are well funded -- simply aren't appropriate to our purposes. We need, in short, to protect and rebuild the sense of public trust in a market where our customers have got to trust us or we don't have much to sell.