

## **Promoting Excellence in Higher education**

### **Tertiary education's contribution to economic and social development**

The New Zealand economy is in a better shape to deliver sustained non-inflationary growth than at any time in at least the past two decades. We could expect real GDP to expand by around 50 percent over the next ten years compared with under 18 percent between 1984 and 1994. This growth would still see us growing more slowly than the dynamic East Asian economies. We should set our sights higher.

The job of restructuring the economy is never finished and it is important that we do not stand still or worse, go backward. If we do, the present expansion and employment growth will run out of steam and will be looked upon as an aberration rather than as a decisive break with the past.

To raise living standards further, we need to produce more goods and services which people value and produce them more efficiently. Sources of growth in real output are improved skills and aptitudes, increased investment in physical capital (such as machinery and equipment), advances in technology, and improved forms of economic organisation.

From this perspective, the education sector's prime purposes are to facilitate skill acquisition, undertake public good research and act as a storehouse of knowledge. The skills required to promote social and economic development are broad, and range from vocational skills to a deeper appreciation of the arts. Skills can be raised in a host of ways - through on-job training, learning by doing, self-managed study, as well as learning in formal contexts provided by state and private institutions. Some economists suggest that over 20 percent of a developed country's resources are devoted to education and training in their broadest sense. If these resources are not put to good use, economic performance and social development will be impeded.

## **A changing environment**

A strategic vision of where tertiary institutions should be heading must take account of the likely changes to the economic and social context in which they exist.

A more flexible labour market, rapidly changing product markets and new technology will create demands for increasingly diverse skills. People will need to change and upgrade their skills throughout their working lives. These factors, together with a changing age structure, are likely to result in mature students becoming an increasingly important segment of the student population.

Students are also likely to be confronted with an increasing range of choices about how they will acquire the skills they need. Already, there is competition among state tertiary institutions and between those institutions and senior secondary schools, on-job training and private training providers. There is also competition between New Zealand and overseas universities, particularly at the post-graduate level. Competition is likely to intensify as remaining divisions between formal and informal education and training, and between tertiary and secondary education are reduced.

For sound policy reasons, per student tertiary subsidies are set to decline progressively over the next few years. This trend will sharpen the incentives for students to demand, and providers to respond with, courses that are value for money and that are tailored to meet student needs.

Higher private contributions to direct tuition costs are likely to increase pressure by students for shorter, but more intense, courses. In the past, the length of courses has been increased with little apparent regard for the interests of students who, as a result, bear substantially higher costs by way of foregone earnings.

Technological advances will also potentially reduce the costs of tuition and facilitate linkages with overseas institutions. This will make it easier for private providers to compete with state institutions, despite the fact that private institutions are discriminated against by funding and regulatory policies.

State tertiary institutions are likely to be subject to increased government scrutiny of their performance for two reasons.

First, the efficiency and responsiveness of formal tertiary education is critical to the achievement of the government's economic and social objectives. Substantial state-funding of providers is likely to continue over the next decade. Accordingly, the influence of fee-paying student clients, while greater than in the past, will continue to be limited. If such an important sector does not use resources efficiently, overall economic performance and social development will be impaired. State institutions therefore need to be encouraged to become as efficient as possible. Productivity improvements would help offset fee increases.

Second, the Crown is exposed to significant risk in respect of the sector. The Crown's interest in state institutions is large, both in absolute terms and in relation to other Crown bodies. The value of the Crown's equity investment in state tertiary institutions was \$3.3 billion at 30 June 1994. By way of comparison, the Crown's equity investment in Crown Health Enterprises was just over \$1 billion and in State-Owned Enterprises \$7.2 billion. Increasing competition from alternative providers, and among state institutions, means that a greater proportion of the revenues of state tertiary institutions is contestable. More institutions are borrowing to finance capital expansion and to upgrade. In the light of these risks, ownership monitoring arrangements for state institutions are likely to be strengthened.

Likely changes to the environment in which tertiary institutions operate mean that competition among state providers and between state and other providers will intensify over the next decade. There is evidence already from reforms to date in the tertiary and other sectors of the economy that a more competitive environment encourages providers:

- to be more responsive to the needs of student clients who can choose among a wider range of competing suppliers;
- to innovate, for example to develop new courses and to modify or delete existing courses and to seek out new ways of delivering education and training. In the presence of weak competition, producers tend to argue that there are not better ways of meeting demand. Greater competition

strengthens incentives to respond to the real wishes of consumers, for otherwise new entrants will;

- to minimise costs. Protected suppliers often argue that they are as efficient as possible and that costs cannot be decreased without reducing the quality of services. This argument has been proved to be without foundation on many occasions;<sup>1</sup> and
- to produce relevant information. Very little information is currently available on the demand for particular courses and on the delivery of education. As a consequence, decisions tend to be taken on the basis of inadequate information. Enhanced competition has (and will) encourage institutions to collect information that is necessary to manage their activities efficiently.

To ensure that the competitive environment stimulates maximum improvements in performance in the sector, reforms on three broad fronts are necessary:

- government funding policies that increase rewards for efficiency and quality;
- a regulatory environment that accommodates diversity; and
- a system of governance that enables state providers to respond effectively to changing requirements.

### **Funding issues**

Tertiary funding is substantially biased in favour of state providers. Aside from TOP courses, few private providers are funded. When funding is granted to private providers (other than for TOP) the actual level of subsidy is substantially less than that which would apply if a similar course were provided by a state institution.

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<sup>1</sup> A detailed study of the benefits from regulatory reform affecting airlines, railroads, trucking, telecommunications, television, banking, security brokerage, petroleum and natural gas concluded that the United States gained amounts equal to a 7-9 percent improvement in the contribution of affected industries to GDP. Some net benefits could not be quantified. Most benefits accrued to consumers and, contrary to some expectations, employees and producers benefited. The facilitation of competition was a central feature of the reforms that were examined. (Winston, Clifford (1993), "Economic Deregulation: Days of Reckoning for Microeconomists", *Journal of Economic Literature*, XXXI (September), pp. 1263-1289.)

PTEs, for instance, receive a lower maximum rate of subsidy for all courses than tertiary institutions receive for their lowest cost courses (extramural courses). One reason for this is that PTEs are not funded for the capital component of courses. There is no valid justification for this practice. Because requests for funding from PTEs exceed available funding, the actual rate of subsidy provided is generally less than the maximum rate provided for PTEs. Student allowances and the loan scheme are also biased against students attending PTEs.

In practice, these differences result in substantial disparities in the funding received by different providers. For example, a private training entity in 1994 would have received a subsidy of \$2,700 per EFTS for a 46 week hairdressing course at trade certificate level. For a comparable course, a polytechnic would have received a subsidy of around \$8,000.

Uncertainty concerning future funding arrangements deters private investment in tertiary education facilities.

The overall effect of existing funding policies is to reduce the ability of PTEs to compete with state institutions. State providers have tended to introduce courses that compete with those initiated by PTEs (such as hairdressing). PTEs are therefore “crowded out” by more heavily subsidised competitors, even though they might provide better value for money.

The bias in favour of state institutions is inequitable because it discriminates against people who pursue courses at private institutions, many of whom are from disadvantaged backgrounds.

Neither public benefit nor equity grounds for subsidising the direct cost of tertiary tuition requires that education be provided by publicly-owned institutions. The question of whether public benefits arise centres on the nature of the education and training provided rather than the ownership structure of the provider. Likewise, equity issues arise in relation to the individual student’s circumstances and not whether the provider is publicly or privately owned.

A more responsive and dynamic sector would be promoted by a programme to phase in neutral funding of tertiary courses offered by state and private providers, including those provided at the senior secondary school level.

Under the EFTS funding system, all state providers receive a set level of funding for each class of course, based on projected enrolments. This encourages institutions to expand their rolls rather than to compete on grounds of costs and quality. Against this, higher fees paid by students (albeit often funded by income-contingent loans) have encouraged them to monitor more closely the services provided by tertiary institutions. Further benefits could be obtained by allocating a larger proportion of EFTS tuition subsidies currently paid to tertiary institutions direct to students. This would encourage institutions to focus on cost and quality considerations as the basis for attracting more students.

Unlike Australia, there is no limit on the number of years for which EFTS subsidies are available in respect of each student. Students are able to undertake multiple degrees or take a considerable period in completing a degree without incurring a penalty, other than the loss of student allowances. It is implausible to believe that extra public benefits from each additional year of tuition do not begin to decline as investment in each individual increases. Students would be encouraged to take more care of their choice of courses and would have greater incentives to perform if:

- a maximum limit were set on the number of years of full-time study which could be funded through EFTS subsidies and income contingent loans. Students studying beyond this period could fund their tuition through competitive scholarships or part-time work; and
- performance standards were introduced to retain EFTS subsidies appropriate to the course.

### **An appropriate regulatory environment**

The regulatory environment in the tertiary sector is primarily governed by procedures for the accreditation of providers and approval of courses.

The Education Act 1989 provides for the establishment or disestablishment of state tertiary institutions. Controls on the establishment and disestablishment

of tertiary institutions are additional to the accreditation of courses and qualifications. The purpose of such regulations are unclear. They appear to be directed at regulating entry into, and exit from, most of the formal tertiary education sector and seem to duplicate, at least to some extent, accreditation requirements. The controls have the potential to restrict competition. Existing institutions are consulted on new entrants. Legislation entrenches the characteristics of tertiary institutions. These factors may restrict the development of more appropriate types of education providers.

The accreditation of providers and approval of courses are related to the government's desire to put in place a national qualifications framework. This will provide a highly structured set of interrelated qualifications that are required to be recognised by all providers. Some of the underlying aims of the qualifications framework are commendable, such as breaking down artificial barriers among different classes of institution. However, the practicability of the NZQA's proposals is unproven and the real cost of the qualifications framework is likely to be substantial.

The main economic argument for the accreditation of tertiary providers is to protect the interests of consumers. It may be argued that, in the absence of government action, consumers would face excessive costs in establishing that courses meet at least prescribed standards and that qualifications awarded indicate that certain levels of attainment have been achieved. The quality of education may, for instance, be more difficult to assess than the quality of some other goods and services. Consumers can also be expected to possess less information on the quality of courses and qualifications than providers.

Accreditation may benefit employers if it provides better information than would otherwise be available about the quality of prospective employees. Existing providers may promote accreditation requirements because some new entrants (perhaps emotively described as fly-by-night operators) might lower standards and diminish the international acceptance of qualifications awarded by existing institutions.

The present rules are akin to mandatory accreditation because public funding reinforces the NZQA's role. A PTE cannot receive funding for courses unless it is accredited by NZQA.

The issue that needs to be addressed is whether the benefits of accreditation outweigh the costs involved. Mandatory accreditation imposes the following costs on the community:

- ***it encourages excessive conformity.*** This impedes the responsiveness of education providers to changes in demand. Providers are required to obtain approval for courses and qualifications from accrediting agencies which tend to support conformity with the industry norm. In the case of universities, approval is required from a body comprising the provider's competitors. There is no valid reason why each provider should be required to aim at a similar quality standard to that of other providers. Most markets provide consumers with choices of goods and services which are characterised by different mixes of quality and price. Consumers and employers can be expected to require different levels of skills which a flexible education and training system should be capable of supplying. The example of the diversity of qualifications and standards among tertiary institutions in the United States illustrates that diversity need not diminish the reputations of individual institutions;
- ***it reduces the incentive for providers to protect and develop their reputations.*** Under the qualifications framework, qualifications awarded by poorly performing organisations are required to be recognised as equal to similar qualifications conferred by other providers. This reduces the incentive for the former providers to maintain standards and impedes the establishment of independent standards by high quality institutions (through, for example, establishing brands and emphasising an institution's longevity and achievements). The fact that producers might be better informed than consumers on their quality is not unique to tertiary education. That is why reputation is important;
- ***it may provide inadequate or misleading information.*** Accreditation systems depend on reliable information about each institution's courses and qualifications which is costly to obtain. There can be no assurance that the incentives on accrediting agencies to obtain reliable information on the quality of particular courses will be strong enough to provide appropriate and accurate information;
- ***it imposes compliance costs on providers including the direct costs of preparing submissions and supplying information.*** Indirect costs may be larger. They include the costs of delays, inappropriate courses and qualifications which satisfy the accrediting entity's requirements rather than the needs of students and employers, and the costs of lobbying the

agency. The compliance and implementation costs of the national qualifications framework are likely to be substantial; and

- ***it encourages lobbying.*** The value to employees of qualifications depends on their scarcity value. Holders of qualifications have an interest in restricting the supply of people with similar qualifications, knowledge, skills and attitudes. This helps to explain attempts by professions, such as the accountancy profession, to control entry and to raise entry standards. Employers will seek qualifications that accurately signal to them that the employee or applicant has the ability, attributes, knowledge and skills required for entry or progression and is suitable for firm-specific training. The interests of employees and employers may differ, however, since employees can be expected to prefer generic qualifications which enable them to move among firms and industries. The interests of employee and employer organisations may also differ from those of their members for similar reasons. These conflicting interests lead to pressure on accrediting authorities aimed at enhancing self-interest at the expense of the community.

The above costs have not been adequately examined in the development of the national qualifications framework and its application to the tertiary sector. The interests of consumers would be better promoted by the development of a more competitive market for tertiary education and training with responsibility for standards firmly placed on individual providers.

If an accreditation system were to be provided it should be voluntary and less intrusive than present arrangements. It should allow for greater diversity and should be based on minimum requirements that are clearly promulgated in legislation or statutory regulations. Institutions should not be subject to compulsory requirements to give credits for qualifications obtained at other institutions and the views of competitors should not be taken into account in establishing new institutions and courses. In addition, new institutions should not be required to be structured on the same basis as the present large scale multi-faculty institutions. New entrants and existing institutions should be free to adopt the most efficient structure, which is likely to change over time.

### **Governance Arrangements**

In an increasingly competitive sector, governance arrangements will either impede or facilitate the ability of state institutions to respond to continuously changing requirements.

Two approaches for the future direction of governance are possible. The first approach would be one that crystallises the current reality, namely that the government is the “in-substance” owner of tertiary institutions. The institutions should therefore be accountable to taxpayers and the electorate for their academic and financial performance. Under this model there is logic in the government looking to have more say through its own appointments to councils.

Under the second model, institutions would evolve over time to a position where they owned all their assets, determined their own governance arrangements and were basically free to make all management, employment, financing and academic decisions. The government would retain a financing role (for tuition subsidies and research) and perhaps some regulatory role. Each governing council would determine its own size.

Under either approach academic freedom and institutional autonomy would be preserved by virtue of section 161 of the Education Act 1989. Arguably they are better safeguarded in the longer term under the second “self-government” model. The self-government model also potentially confers on institutions greater flexibility to respond to changing requirements in a competitive environment.

As discussed previously, the government could be expected to seek improved accountability arrangements if the first model is adopted. Improved accountability arrangements are likely to include:

- ***a capital charging regime.*** This would sharpen the incentives for institutions to optimise the use of the resources they control. The absence of a capital charge could be expected to produce excessive operating costs. It is likely to have led to unjustified investment in land, buildings and equipment because the opportunity cost of capital is not required to be taken into account. Some of these costs will have been borne by students through their contribution to tuition revenues. The absence of a capital charge also confers a competitive advantage on state providers;

- ***a strengthened ownership monitoring regime.*** Monitoring procedures, such as the preparation of strategic outlooks, statements of intent and business plans, are far more developed for other crown-owned entities (such as CHEs, CRIs and SOEs) than they are for state tertiary institutions; and
- ***stronger and clearer duties and obligations of governing councils.*** The legislative obligations on councils concerning efficiency and accountability are less well specified than those regarding charters, educational objectives, staff and community involvement, and academic freedom.

If clearer and more robust parameters that define accountability are put in place, institutions might be offered more freedom to operate within them. This might include greater discretion over the use of inputs, including the ability to borrow, lease or sell assets. However, evidence from the capital charging debate and the regular tug of war over annual funding suggests that the path to a stronger monitoring regime might be a rocky one. Difficult issues arise, such as whether third parties have sufficient information and strong enough incentives to do an adequate job of monitoring performance. Unique aspects of state tertiary institutions mean that they fit uncomfortably within standard corporate governance and accountability regimes for crown entities. Determining residual stakeholders (i.e., the persons or entities that receive any surplus after all other claims have been met) in state institutions is often difficult. This is particularly difficult where the local community or other benefactors have been significant contributors to an institution.

In contrast, self-governing institutions operating in a competitive sector might be more flexible and responsive to changing requirements. The potential benefits and feasibility of self-governing tertiary institutions should be examined. Central issues would be who the stakeholders in self governing institutions might be and how the institutions might be set up. Stakeholders might include members of faculty, alumni, the local community or Iwi. Institutions could be set up as trusts or as companies. Much more work would need to be done to examine these and other options. However, the fact that several state institutions already manage substantial funding from non-state sources suggests that moving towards self-government could be feasible.

If an appropriate model for self-government could be devised, it raises exciting possibilities for a strong and dynamic tertiary sector. Such a long-term strategic goal may also make more immediate reforms easier to contemplate. Any new monitoring and accountability regimes could be seen as intermediate steps toward the self-government model by providing greater latitude to tertiary institutions in the short term. Demonstrable improvements in governance and management would assure the government that tertiary institutions were capable of handling self-government responsibility. Likewise, a more neutral funding and regulatory environment could be seen as a prerequisite for establishing self-governing institutions. Enhanced competition would ensure that independent institutions remained responsive to the changing needs for skill acquisition and research.

Moving in the direction of self-management raises many of the same difficulties that will be faced under continued crown ownership, such as determining residual stakeholders. However, the potential benefits of self-government could make the effort to resolve these difficulties worth the hard work.

## **Conclusion**

A well organised and dynamic formal tertiary sector has an important role to play in contributing towards the goal of a growing and responsive economy and the enrichment of diverse cultural values. Continuous evaluation of the performance of the sector is vital to seek new and better ways of performing its key teaching, research and guardianship roles.

Competitive pressures on state institutions to perform can be expected to increase due to the demands of a fast growing, outward looking economy and more diverse society. An increasingly competitive environment in the sector has several implications. First, the government is likely to seek improved accountability arrangements to safeguard its substantial stake in state institutions. Second, a more competitive environment increases the need to provide sufficient flexibility to state institutions to enable them to respond to changing requirements. Greater flexibility could be achieved by according greater autonomy to state institutions.

Before moves towards greater autonomy could be contemplated, however, tuition and research funding and regulatory policies would need to be changed to treat state and other providers in a more even-handed manner. These changes would increase the incentives for state institutions to respond to the needs of their student clients and to public good research priorities.

Clarifying and strengthening the obligations and duties of institutions and their councils would also enable institutions to exercise greater autonomy within those boundaries. The experience gained would lay the groundwork for potentially greater institutional autonomy in the future.