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**Organisational Controls And Performance In The
Education Sector**

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ORGANISATIONAL CONTROLS AND PERFORMANCE IN EDUCATION

Introduction

In this paper I want to explore how people's decisions and behaviour are affected by four key controls that operate on all business organisations. These are discussed by Michael Jensen of the Harvard Business School in a 1993 article which has already become a classic in the corporate governance literature.¹ Jensen identifies the four key factors that constrain managers to act in the interests of society as:

- capital markets;
- the legal/political/regulatory system;
- product and factor markets; and
- internal control systems including boards/councils.

In my view, these constraints (which I will discuss in more detail below) are as relevant in thinking about the performance of educational organisations as they are for normal commercial businesses. The different ways they apply to government-owned, private non-profit and private for-profit institutions suggest that there are likely to be systematic differences in the way the different institutions in the tertiary education sector perform. Weaknesses in the controls on 'government-owned' tertiary education institutions (TEIs) are an issue for the sector. Unless stronger incentives for performance are created, under-performance on the part of at least some of the TEIs is likely to be a problem, irrespective of the quality of the people they employ. Recognition of the need to improve the performance of TEIs has motivated the ongoing discussions on governance arrangements between the government and participants in the sector.

Before examining the constraints in more detail, I briefly review the range of ownership forms that currently exist in the education sector in New Zealand and around the world.

Ownership of Tertiary Education Institutions

New Zealand has 39 tertiary education institutions that are Crown entities. These include seven universities, 25 polytechnics, five colleges of education and two wananga (tertiary institutions with a Maori focus). The issue of who can exercise ownership rights over TEIs has been the subject of some debate. Logic and practice suggest to me that the government is the owner of the TEIs and I adopt that assumption in this paper.

¹ See Jensen, M C, "Presidential Address: The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems", *The Journal of Finance*, vol 48, no 3, July 1993, pp. 831-880.

Private tertiary providers (PTEs) have long existed in New Zealand. In 1995, there were over 1,000 PTEs (58 of which received government grants, and around 800 of which were registered with the NZQA).² PTEs have experienced rapid growth over the past few years despite the funding and regulatory regime being heavily biased against them. Many are niche market providers - either to a type of client (such as those providing teacher training) or to a field of study (such as theology, tourism, travel, hairdressing, singing, drama, fashion, interior design, emergency medical planning, crafts, radio, film and television, and electro-technology). Some provide business courses and opportunities for overseas and domestic students to learn English. The PTE sector delivers 20 degree courses.

Ownership arrangements for the PTEs in New Zealand include limited liability private for-profit institutions, sole proprietorships, private non-profit charitable trusts and other non-profit arrangements.

Around the world, non-profit education arrangements predominate with both private and public institutions often coexisting. Private for-profit institutions of higher education are the exception rather than the rule, in large part because governments have heavily favoured non-profits and state institutions through their funding and tax regimes.

The DeVry Institute of Technology which provides for-profit advanced technical education in the United States and Canada illustrates that the for-profit structure deserves serious consideration for some institutions or departments. DeVry has been highly innovative and successful. It is a for-profit company that dates from the 1970s and listed on NASDAQ in 1991. Since going public, the company has been entirely independent of tax subsidies and private donations. Individuals pay tuition that is less than half the price of a degree at many state universities and a third of the cost of a degree at many private colleges. DeVry operates year round to minimise costs and economise on the time it takes for a student to obtain a degree. Approximately 27,000 individuals are now taking DeVry programmes at 13 campuses. The Institute offers a no-frills education oriented towards specific technical skills with high labour market returns. DeVry takes a highly entrepreneurial attitude towards determining what skills are needed in the workplace and training its students in those skills. Ninety percent of DeVry graduates have jobs within six months of finishing.

The Philippines, especially before the early 1980s, provides another model of for-profit tertiary education. Exact figures are difficult to obtain, but in 1970 private colleges and universities were serving 92 percent of the student population at the tertiary level. Of these private institutions, two-thirds were private for-profit corporations. The Filipino tertiary education system had a strong reputation for quantity and quality of output. From the 1980s, a change in government policy led to a decline in the importance of private for-profit institutions.

There is clearly a range of feasible ownership options for tertiary institutions including government ownership (normally non-profit), private for-profit and private non-profit ownership. I now consider the impact of the four controls on these three different types (broadly defined) of tertiary education institution.

² New Zealand Official Yearbook 1996, pp. 199, 208.

Capital Market Constraints

The capital market provides a number of mechanisms for aligning management behaviour with society's interests. These include monitoring by existing and potential shareholders, the operation of the sharemarket for listed organisations, the takeover market, and monitoring by other capital providers (debt holders and donors).

Managers of private for-profit institutions face strong constraints in the capital market. Private for-profits are owned by individuals committed to profit maximisation (or to a sum of profit maximisation and their personal goals). Profits are maximised in a competitive market when a firm is better than its competitors at meeting customers' requirements at minimum cost. Because private shareholders have a direct financial interest in the organisation they own, they have strong incentives to monitor management and to take action when they perceive weaknesses in performance.

Where the shares of a company are listed on the sharemarket, professional analysts, institutional investors and others also have strong incentives to monitor management performance carefully since they can profit from superior information about a firm's future earnings. The existing PTEs are unlikely to consider listing on the stock exchange given their current size. However, that might change if funding of public and private institutions were placed on a neutral basis and other barriers were removed.

The threat or reality of takeover provides a powerful constraint on management performance in private for-profit organisations. When management performance is poor or where existing managers are missing important opportunities, another management team may be able to add value by taking over the company. The capital gains achievable provide the motivation and reward for changing control and replacing management. Replacement of the management team may be possible through the concerted actions of existing shareholders or through new shareholders buying into the company. The prospect of takeover ensures closer alignment of managers' and shareholders' interests and helps ensure that organisations produce the goods and services preferred by customers at minimum cost.

These capital market constraints are weak or absent for TEIs. Managers of TEIs do not face the same threat or reality of takeover if their performance is poor. The incentives for taxpayers as owners to monitor management performance are likely to be weak because the monitors cannot profit from their effort. Professional analysts have no reason to monitor organisations that do not have purchasable shares.

If the government maintains control over TEIs, there are a number of options for attempting to proxy the capital market constraints imposed on private for-profit organisations. A capital charging regime may sharpen the incentives for TEIs to optimise the use of the resources they control. Increased transparency and greater information on the performance of institutions can assist monitoring. An improved ownership monitoring regime could provide improved incentives for performance.

The spectacular gains in productivity and performance achieved by the state-owned enterprises which were corporatised in 1987 indicate the potential improvements that can be achieved by adopting proxies for capital market constraints, at least where commercial activities are involved. However, while the government can attempt to provide proxies, none of them replicates the strong incentives provided by private capital markets including the direct financial incentives for monitoring associated with tradeable shares. Moreover, nothing can overcome the ongoing risk of political interference in the affairs of government-owned organisations.

Private non-profit organisations also suffer from weak capital market constraints. In a non-profit trust there are no shares or ownership rights that are traded. Profits cannot be distributed to those who exercise control over it, so that financial incentives to gain control of a non-profit trust and improve performance are absent. Takeover of the organisation is generally precluded or very difficult.

Monitoring of education institutions by lenders may occur if tertiary education institutions are funded by debt. Debt holders and creditors have an interest in ensuring that an organisation does not behave fraudulently or irresponsibly, or take excessive risk, thereby endangering the organisation's ability to meet its debt payments. Lenders have a greater incentive to monitor private (non-profit and for-profit) education institutions than TEIs since the latter inevitably have an implicit or explicit government guarantee.

Private non-profits in some countries rely to a significant extent on donors as a source of capital. The need to attract donors, who are likely to contribute only to wellmanaged organisations, may constrain management behaviour. In the United States, for example, many private non-profit universities and colleges, especially at the upper end of the rankings, are highly dependent upon endowments and voluntary gifts for funding. A for-profit institution is unlikely to attract significant donor funding. Where institutions are not heavily reliant on donor funding, monitoring by donors would not be a significant constraint. Donor funding of tertiary institutions is relatively unimportant in New Zealand at present, but may become more important as funding and other reforms are implemented.

The capital market constraints on for-profit firms act to encourage managers to produce the outputs that customers value at a minimum cost, since this maximises profits. Lowering the cost of tertiary education has benefits on both access and equity grounds. However, a for-profit will not generally produce outputs unless someone pays for them, so that it may under-produce 'public goods' such as basic research. It is also suggested that a for-profit may skimp on quality where quality is difficult to measure, if by doing so it can increase its profits. Thus, where the quality of outputs is difficult to measure, or where outputs have public good characteristics, a for-profit may not produce the outputs preferred by its customers. Whether the output of education institutions has substantial public good elements, or quality is substantially more difficult to measure than with other complex goods and services produced by for-profit organisations, is debateable. Also debateable is whether other organisational forms could do better than for-profits. A non-profit organisation may, in some circumstances, have stronger incentives to produce the quality and quantity of outputs preferred by customers and society, but it is also likely to have weaker incentives to minimise costs.

The Legal/Political/Regulatory System

Jensen argues that the legal/political/regulatory system is poorly targeted to controlling the problems of wasteful management behaviour. General constraints on the behaviour of the management and boards of private sector companies are provided by the provisions of the Companies Act. Securities law and stock exchange regulations require forms of disclosure, legislation regulates insider trading, and there are laws governing fraudulent behaviour. These constraints act to prevent or control gross management failures in private organisations but are poor instruments for ensuring that managers act in the best interests of society. Many of these constraints do not apply at all to TEIs.

A number of specific regulations apply to institutions in the education sector. None of these seems likely to provide effective constraints on management behaviour.

The regulatory environment in the tertiary sector is governed primarily by procedures for the accreditation of providers and the approval of courses. The main economic rationale for the accreditation of tertiary providers is to protect the interests of consumers and taxpayers. It may be argued that without government action, taxpayer subsidies could be spent poorly. A related argument is that 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.

However, the argument that the regulations are necessary or effective in protecting consumers and taxpayers is not wholly convincing. First, particularly in vocational education, students face a market test of their acquired knowledge at the end of their course, employers have strong incentives to take graduates only from those institutions that are teaching the outputs they require, and various sources of information on the quality of courses are available (opinions of other students, teachers, and specialist monitors of quality). Second, there is little evidence that the accreditation process disciplines poorly performing long-established providers. Third, it provides no information to consumers as to how New Zealand providers compare with top overseas providers. Fourth, providers in a competitive market have adequate incentives to market themselves directly to students, as the US higher education market demonstrates.

The present arrangements amount to mandatory accreditation because of the links between public funding and NZQA accreditation. There is a risk that rather than improve the performance of tertiary institutions in delivering the quality of education that students want, the regulations will:

- encourage excessive conformity, impeding the responsiveness of education providers to changes in demand;
- increase course length because of practitioner capture and because the regulator cannot readily determine whether shorter courses provided by more efficient providers maintain quality;
- reduce the incentives for providers to protect and develop their reputations since the qualifications awarded by poorly performing organisations are

treated by the regulator as equal to similar qualifications conferred by other providers;

- provide little comparative information about quality and value for money since information is costly to obtain and the incentives for the accrediting agency to obtain accurate information are unlikely to be strong; and
- result in direct and indirect compliance costs that may be very high.

In my view, the interests of consumers and taxpayers would be better protected by the development of a more competitive market for tertiary education with responsibility for standards being primarily located with individual providers. An accreditation system may be suitable for setting explicit criteria for more neutral public funding of courses by state and private providers. It should allow for greater diversity and should be based on minimum requirements that are clearly promulgated in legislation or statutory requirements. New institutions should not be required to adopt similar delivery structures to the present large multi-faculty institutions. New entrants and existing institutions should be free to adopt the structures they believe are most efficient.

Competition and Flexibility in Product and Factor Markets

TEIs are protected from competition by a funding regime that is heavily biased in their favour. Apart from TOP courses, few private providers are funded. When funding is granted to private providers (other than for TOP courses) the actual level of subsidy is substantially less than for a similar course at a TEI. The uneven funding substantially reduces the incentives for performance that competition could provide.

With neutral funding, competitors and potential entrants would strongly constrain institutions, whether private or government-owned. When firms compete, their ability to survive and prosper depends on an ability to use resources better than their competitors - to develop a more cost-effective production process, to make use of information about customers' different preferences for quality, to implement streamlined managerial systems, to develop new and desirable products and so forth. Organisations that minimise costs and respond perceptively to customer demands prosper at the expense of those that are less successful in those areas.

In the tertiary sector, competition would encourage TEIs to be more responsive to the needs of student clients. It would provide incentives to develop new courses, modify or delete existing courses, and seek out new ways of delivering education and training. Competition would encourage institutions to tailor the length, timing and range of courses in line with student preferences rather than the preferences of tutors, lecturers or administrators. Experience in industries which have been exposed to competition suggests that there may be substantial scope to reduce costs and better meet consumer preferences. Professor Gary Becker has expressed the view that:

The system of higher education in the United States is the world's best, mainly because competition between private colleges and tuition-charging public colleges has improved the performance of both.³

Competition between TEIs for overseas and local students already provides some constraints on these institutions. Competition between local and offshore providers also provides some constraints, particularly at the post-graduate level. However, I believe that strengthening competition between TEIs, PTEs and overseas institutions is one of the most easily achievable and potentially potent ways of improving the organisational performance of TEIs.

To achieve this, the government must implement a funding regime that is neutral between PTEs and TEIs whether in New Zealand or overseas and is equally available to for-profit and non-profit organisations. The government must also ensure that its funding regime does not disadvantage those institutions that can deliver a study course over a shorter period than their competitors.

In respect of factor markets, a lack of flexibility in employment and pay arrangements in TEIs clearly affects performance.

Increasing the flexibility of pay rates in TEIs is a critical aspect of improving performance. It is not sensible to pay tutors in, say, hairdressing the same salary as tutors in, say, accounting. The salary that will attract excellent hairdressers will not attract excellent accountants since the labour market environment for individuals in the different professions is vastly different. The lack of pay differentiation accounts for the great difficulty some organisations have in attracting excellent staff, and the resultant poor performance of some departments.

Many TEIs are not making use of the flexibility that they have to pay differential amounts to attract excellent people in higher-paying disciplines. There are overhangs from the past, and continuing union resistance to this fundamental reform. Managements have few incentives to tackle difficult employment issues. Restrictive interpretations of employment law by the courts further hinder the ability of government-owned (and other) institutions to shed poorly performing staff. While rigidities remain, the TEIs' performance will be constrained.

If funding is freed up, private institutions will be able to compete not only for students but also for staff. Unless TEIs adopt more flexible labour arrangements, they will lose market share and their best staff to competing private institutions.

Internal Control Systems

Internal controls provide a number of constraints on management performance.

The board or council is the most important mechanism for aligning management performance with the interests of owners and society. The board's primary role is to appoint, monitor, reward or sanction the CEO, set the strategic direction of the organisation, and provide high level advice and support.

³ Becker, G, *Business Week*, 27 November 1993.

Recruiting excellent board members is an obvious first step in improving internal control of government institutions. There are special difficulties when the government appoints board members. Experience suggests that there are significant risks that political considerations may adversely affect the quality of appointments. In addition, board members of public tertiary institutions have dual and sometimes conflicting responsibilities. Board members are supposed to represent the interests of the tertiary institution while at the same time serving as representatives of the public's interest in the tertiary institution. Board members of private institutions do not face similar problems of conflicting loyalties.

Keeping boards small can help performance. Jensen finds that once boards get beyond seven or eight individuals, they are less likely to function effectively and can be more easily controlled by the CEO. As a group gets larger, the coordination and process costs outweigh the benefits of drawing on the skills of a more diverse group. Although there is scope to reduce the numbers of council members of most TEIs below current levels, a change to the Education Act 1989 would be required to go below 12 members.

Generally 'insiders' (i.e. managers and staff) are not represented, or have limited representation, on the boards of non-profit organisations. This separation of control from monitoring is one response to the special difficulties of controlling agency costs in a non-profit - difficulties that apply with equal force to government ownership. For example, there are no residual claimants with an incentive to monitor the terms and conditions of management and staff, and management is not exposed to the constraints imposed by the threat of takeover. Thus the role of the council or board in monitoring and controlling management performance is particularly important. Excluding management and staff from the board provides a strong signal that the board is independent from management and that any surpluses generated will be directed at increasing output rather than being captured by staff in higher remuneration and perks. As long as staff and management continue to be represented on the boards of government institutions, there remains a risk that board decisions will be unduly influenced by their interests.

Jensen has a comment that is particularly relevant to suggestions that the councils of tertiary institutions should be comprised of representatives of stakeholders. He says:

Suggestions to model the board process after a democratic political model in which various constituencies are represented are likely to make the [governance] process even weaker. To see this we need look no farther than the inefficiency of representative political democracies (whether at the local, state, or federal level), or at their management of quasi-business organizations such as the Post Office, schools, or power generation entities such as the TVA.⁴

The problems with such a model include the difficulties of obtaining the desirable level and mix of expertise on the council, conflicts of interest between the institution and its stakeholder constituencies, the intrusion of constituency politics into decision

⁴ Jensen, *op. cit.*, p. 865.

making, and the weakness of accountability mechanisms given the lack of an ownership stake by many of the constituencies.

The case for excluding staff members from the board or council is weaker in the case of private for-profit institutions, since other mechanisms such as the takeover market assist in controlling possible inefficiency. Management representation on the boards of open for-profit corporations is relatively common. However, even with for-profit organisations there is evidence, albeit limited, that better performance is linked with a higher percentage of independent directors.

If the proposed improvements to the boards of TEIs were implemented, along with proposed accountability and performance monitoring arrangements, TEIs could be given more operating freedom. This might include greater discretion over the use of inputs including the ability to borrow, lease or sell assets.

However, even with the improvements suggested, the internal control systems of TEIs may be weaker than those applying to private organisations. Some of the incentive mechanisms that operate in private for-profit corporations are not available to government and non-profit institutions because of the non-tradeability of equity. For example, it is not possible to require that CEOs and board members have substantial investments in the organisation.

Controls imposed by active investors are also absent for TEIs. Active investors, such as investment funds, are an important aspect of well-functioning internal control mechanisms in privately owned for-profit organisations. They have the financial interest and independence to take an unbiased view of management performance. Representation on the boards of companies by major investors can provide a powerful means of monitoring management performance. Representation of major donors on the board of private non-profits provides a similarly independent monitor. Monitoring by government agencies provides only a weak substitute for these private mechanisms in TEIs.

Summary

In this paper, I have examined the impact of four important controls on 'government-owned' and other tertiary education providers in terms of Jensen's framework. Constraints are imposed on managerial and organisational performance by capital markets; the legal/political/regulatory system; product and factor markets; and internal control systems including councils/boards. In high-performing organisations, these controls are mutually reinforcing.

Where all the constraints operate effectively, an organisation will produce the services most valued by consumers at the lowest possible costs, and adapt as circumstances change. Where the forces are weak, performance will fall short of potential levels, change will be precipitated by crisis, and customers' interests are unlikely to be met. If any of the control mechanisms is shut down, an added burden is thrown on the others.

The constraints operate only weakly on TEIs. Government ownership prevents most of the capital market constraints from operating. The legal, political and regulatory system is a blunt instrument for dealing with wasteful management behaviour.

Nonneutralities in funding and other barriers prevent full competition between tertiary institutions. Rigidities in employment arrangements slow down adjustment to change. Internal control systems have many weaknesses.

Harnessing the powerful capital market constraints would be possible if TEIs were privatised to a for-profit organisational form. Whether a for-profit role would undermine the academic mission of the institution and/or be inconsistent with its public goods functions are questions that require further analysis. Privatising to a nonprofit form would increase the constraints somewhat. Proxies for these capital market constraints are weak at best.

If the institutions remain in government ownership, the competition and internal governance constraints will assume greater importance. Improvements in respect of one of these alone are unlikely to be sufficient to turn around the performance of TEIs. Competition in the product and factor markets should be maximised by the implementation of a neutral funding regime. This is likely to be the most important control force of all in driving efficiency and responsiveness in TEIs. TEIs should implement more flexible employment arrangements so that, where necessary, they can pay more to attract high quality staff.

Options for improving governance are more complex. If the 'high powered' incentives faced by the members of a for-profit board acting as agents for shareholder principals are ruled out, exaggerated hopes should not be held about the performance of boards under other models, no matter what configuration is adopted. However, raising the quality of board appointments, reducing the size of boards and removing or limiting staff, student and other 'constituency' representation on boards are three obvious possible improvements.