

# **POLICY DIRECTIONS FOR TERTIARY EDUCATION**

**SUBMISSION ON THE GOVERNMENT GREEN PAPER  
*A FUTURE TERTIARY EDUCATION POLICY FOR NEW ZEALAND:  
TERTIARY EDUCATION REVIEW***

**EDUCATION FORUM**

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Dr Mark Harrison is a lecturer in the Department of Economics, The Faculties, at the Australian National University, Canberra, where he teaches microeconomics and the economics of education. He previously worked for a number of years at the (then) Industries Assistance Commission. He has published articles on education policy and on student loan programmes in various journals and books. He has an honours degree in economics from the Australian National University and received his Ph.D in Economics from the University of Chicago, where he returned in 1995 as an Olin Visiting Assistant Professor at the George Stigler Centre for the Study of the Economy and the State.

He has written commissioned papers on tertiary education policy for the Industry Taskforce on Leadership and Management Skills (the Karpin Committee), the Review of Higher Education Financing and Policy (West Review), and for the New Zealand Treasury.

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## EXECUTIVE SUMMARY

The Ministry of Education Green Paper, *A Future Tertiary Education Policy for New Zealand: Tertiary Education Review* (1997b), is correct to reject the use of central planning in tertiary education and to endorse a student-focused approach rather than a provider-focused approach.

The key way to improve the higher education system is to provide teaching services in a decentralised competitive market. A market-based system involves students choosing amongst competing self-managing institutions. Allowing students to choose from a range of options on the basis of relative benefits and costs is the best way to solve the 'information problem' (the huge information requirements for efficient central planning) and match course type, quality and cost with students' individual requirements.

Tertiary institutions should be funded primarily by those who benefit directly from their services. When tertiary institutions must attract fee-paying students to survive, they will have a greater incentive to devote the appropriate level of resources to teaching, to identify and meet student preferences, to strive to do better in course design and course delivery, to contain costs and to innovate. Those that supply services of appropriate quality at least cost will prosper.

The goals for increasing participation and quality as set out in the Green Paper are simplistic and could lead to the adoption of unsound policies. No rationale is presented for the proposed distribution of tuition subsidies. Muddled objectives make for poor policy.

A better approach is to judge policies on the fundamental objectives of equity and efficiency. The issue is whether government intervention will improve on market outcomes. Any problems with the market should be identified and intervention targeted at overcoming it. The costs and benefits of intervention need to be evaluated and the government should only intervene if the benefits are likely to be larger than the costs.

The costs of tuition subsidies include the deadweight losses from the taxes needed to finance the subsidies, the crowding out of private expenditure and the fact that students may be less careful with the government's money than with their own. Taxing families in order to give them tuition subsidies will make society better off only if there is some offsetting efficiency or equity gain.

The main arguments for government involvement in financing tertiary education are to increase beneficial externalities, combat capital market imperfections (sometimes called the access or equality of opportunity objective) and help the poor (improve the distribution of income). The first two are about efficiency; the third is about equity. The relevant market failures should be identified, not only to determine the level of government contribution, but also its form and how it should be spent. The interventions should target the relevant problems.

Capital market problems may arise if qualified students are unable to finance tuition and living costs from their own resources and have to borrow against future income. Lenders may find it difficult to assess the creditworthiness of some students in terms of their likely success in their studies and their future income prospects. Students may be unable to offer alternative collateral. Therefore, lenders may be unwilling to extend loans or offer loans only on terms which reflect a high perceived risk. It is unclear how large such capital market problems are. For example, if most students come from middle income families this problem could be solved by having a parent or guardian underwrite a bank loan for them. Whether capital market imperfections justify interventions such as government loans or loan guarantees (perhaps limited to students unable to obtain such backing) depends on an assessment of the relative costs and benefits of such an approach.

The capital market imperfections argument does not give rise to a case for a subsidised loan programme. Nor is there a case for interest subsidies on other grounds. However, with an income-contingent loans scheme it is difficult to avoid some subsidy elements, risks of default and pressures on future governments to write off debt.

As New Zealand has a student loan programme in place, the case for tuition subsidies comes down to externality and equity objectives. Both are weak and may well conflict.

If the rationale for intervention is to promote externalities, then the appropriate response is to target subsidies directly at their production. The externalities should, as far as possible, be made explicit and their production monitored.

The evidence for marginal external benefits associated with tertiary education is extremely weak. The relevant marginal externalities may be positive or negative. If the burden of proof is to be placed on those calling for subsidies, it has not been discharged.

Subsidies to tertiary education are not a good instrument for making the distribution of income more equal. Tuition subsidies should be substantially reduced over a period sufficient to allow students, parents and employers to adjust to a new, much lower level of subsidy.

To give students the correct price signals and an incentive to take cost into account and seek the most efficient provider, the subsidy should not differ according to the cost of programmes as at present. The subsidy should be related to the assessed externality or public good component of programmes in the same way that the government now requires local authorities to identify the elements of their services which confer wider public benefits in determining their charging policies. The present level of subsidy cannot be justified on equity or efficiency grounds and should be reduced. A reduction to an average of 25 percent of course costs is recommended over a period sufficient to allow students, parents and employers to adjust. A period of 10 years is suggested, following which there should be a further review.

Subsidies should be available to students enrolling in qualifying programmes and courses at approved providers. Qualifying programmes and courses would be identified as likely to lead to positive externalities exceeding the costs of the subsidies. The subsidy entitlement would expire at age 30 except in defined circumstances.

The national interest case for government finance of research is to increase production of non-excludable research with external benefits. Funds should be explicitly allocated for that purpose, and research output monitored and rewarded through a performance-based mechanism. Students will be willing to pay for research which benefits teaching through student fees.

If institutions derive significant revenue from student fees, they will have the correct incentives to provide teaching services and to undertake research that benefits teaching. There is no reason why such research will be under-provided in the market.

Research subsidies should specifically target research likely to be under-provided in the global market. Institutions can be left to organise themselves to produce each type of output in the most efficient way.

Minimum research requirements can only guarantee that the minimum is produced, and such requirements do not ensure the most and best research for the money invested. It is simply not feasible for the Ministry of Education to ensure that the correct type and amount of research is done through minimum requirements.

A number of justifications for quality regulation are given in the Green Paper. They do not stand up to analysis.

It should be remembered that information is not free. It is costly to produce information and costly for consumers to acquire it. Comparing the market outcome with a world with full and free information is irrelevant.

Quality is subjective and indefinable and is best left to the individual decisions of users rather than regulated by a costly and intrusive bureaucracy. The interests of consumers would be better protected by the development of a competitive market. Barriers to entry should be removed. The views of existing institutions should not be allowed to influence decisions about whether new institutions and courses should be established.

The proposed quality regulation mechanism is to achieve two purposes:

- to provide information to students and employers – a consumer protection role; and
- to determine which institutions are eligible to receive government subsidies.

The actual mechanism proposed in the Green Paper does not achieve either role particularly well.

If accreditation is to be introduced to protect consumers, it should be voluntary and not tied to subsidies. Voluntary accreditation will place a market test on the value of information produced, give incentives for the quality assurance process to be performed efficiently, and prevent it imposing large costs. The New Zealand Qualifications Authority (NZQA) should be funded by those who choose to use its services.

Provider access to government subsidies provided explicitly on externality or public goods grounds should be dependent on objective criteria (preferably outcomes), allow for diversity, and be competitively neutral between domestic and international and public and private providers. The general consumer protection and anti-fraud laws may be sufficient, particularly if students are given incentives to use government subsidies carefully.

The demand for information in a market system will create incentives for producers and others to generate useful information. Sellers have an incentive to provide accurate information about qualities that can be established before purchase because students can easily check the accuracy of the information. Producer reputation and marketing methods may be used to provide information about the quality of the product when quality cannot be assessed by consumers prior to sale.

The case for government provision of information assumes either provider reputation is not a sufficient indicator of quality and/or specialised information providers will not produce information whose total benefits exceed the costs. On the other hand, it is also the case that the government may very well provide information for which the costs exceed the benefits.

For a government quality assurance mechanism to be justified, four conditions must be met:

- that the quality assurance mechanism does in fact ensure quality;
- that it is the best way to ensure quality;
- that the benefits of ensuring the extra quality exceed the costs; and
- that it would not be undertaken in the market.

Each can be disputed. The key question is the last one: whether the government agency can and will provide valuable information that would not be provided in the market.

It is uncertain how intrusive the quality regulation proposed in the Green Paper will be. If the narrow definition of quality is to be adopted, then the assurance process focuses mainly on objective and verifiable information (search qualities). The benefits are likely to be small, search qualities are likely to be provided in the market, and students are likely to care more about the more intangible or subjective aspects of education.

However, the criteria proposed in the Green Paper would allow a far more intrusive attempt to regulate quality. Then the problem is whether the NZQA has the incentive to set the minimum standard at the efficient level and the capacity to measure more subjective experience and credence qualities. The potential costs are large and the benefits unclear.

If TEIs are to remain in government ownership, a capital charge is needed to achieve competitive neutrality with the private sector, increase equity between students and give incentives for the efficient use of capital.

Governance reforms are required to complement and maximise the benefits from increased competition, and to reduce the resulting fiscal risk to the government from ownership.

Although the proposed governance reforms improve on the current situation, some problems remain, in particular, the clash between political accountability and autonomy. The market provides a mechanism to ensure accountability and maintain autonomy.

The Green Paper does not establish any case for continued government ownership, which may be inconsistent with a competitive market.

The governance reforms proposed in the Green Paper should be adopted as a first step towards privatisation of TEIs. The appropriate ownership form should be allowed to evolve. Decisions should be taken with a view to severing the ownership link to government - not prescribing the longer-term structure. The government should establish competitive neutrality between organisational forms and allow open competition to determine the most efficient arrangements.

## SECTION 1: GOALS AND POLICY DIRECTIONS

### 1.1 Overview of the Green Paper

In the forward to the Green Paper,<sup>251</sup> the minister of education sets out the importance of knowledge, skills and ideas for the social and economic development of New Zealand. He also draws attention to the role tertiary education can play in the intellectual advancement and fulfilment of individuals. The potential benefits from tertiary education are large, and so are the resources devoted to it by both governments and individuals. The government spent around \$2 billion in 1996/97,<sup>252</sup> a figure exceeded by the direct expenditure and forgone wages of students. Tertiary education is a major source of skills and a substantial portion of the economy. It is important, therefore, that the government interventions in the sector are periodically reviewed.

This submission sets out a policy framework to maximise the net benefit that society gets from the tertiary education sector, in line with the minister's exhortation to work towards "solutions to serve the best interests of New Zealanders" (p 4). The recommendations in the Green Paper do not do so.

The Green Paper details problems with the current system, sets goals, lays out a preferred approach and makes specific recommendations. Some key issues are identified, but others are ignored. The report suffers from a number of defects. The goals that are set contradict the preferred approach laid out in the report. The recommendations that emanate are inconsistent with both the approach and the goals, and the rationale for many important policies is not provided. The policy framework that results is confused and may not solve the problems set out in the Green Paper.

The Green Paper lacks a cost-benefit analysis of many policies, or even a recognition that some proposals have both costs and benefits. However, it does correctly identify problems with the current system. The problems include weak incentives for

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<sup>251</sup> Ministry of Education (1997b), *A Future Tertiary Education Policy For New Zealand: Tertiary Education Review, Green Paper*, Wellington, September 1997. Unless otherwise indicated, page references in this submission are to the Green Paper.

<sup>252</sup> Green Paper p 73.

providers to offer courses students want, to contain costs and to innovate. It also correctly diagnoses the root cause of all these problems as the use of central planning – "a complex central process" (p 10) – and the poor incentives that result. Centralised purchase is rejected:

... even if the Government had the most comprehensive information, it could not respond quickly enough to meet the needs of the economy and society. Such decisions are generally better made by employers and students who are closer to the necessary information and are able to adapt faster (p 12).

Moreover, centralised purchase would "decrease institutional autonomy" (p 12).

Instead, the Green Paper endorses a "more student-focused approach, letting resources follow the student more quickly and giving students more flexibility in their choice of an education and provider" (p 12). It supports "reducing barriers to the entry and operation of providers, so that there are incentives for innovation and courses that respond to students' needs" (p 9).

## 1.2 The future direction: a competitive market for tertiary education teaching services

The preferred approach set out in the Green Paper is correct: the key way to improve the tertiary education system is to provide teaching services in a decentralised competitive market. A market-based system involves students choosing amongst competing self-managing institutions and is the system most likely to meet the minister's desire to have a tertiary sector that is more diverse and that can "respond quickly and effectively to a changing world" (p 3).

A market-based approach has a number of advantages. A competitive market overcomes the 'information problem': the huge information requirements for efficient central planning. Competitive markets make use of decentralised knowledge – students know what they want from education and providers know the costs of different methods of provision.

Inherent features of education make central planning difficult. The fact that universities and most other tertiary providers are non-profit organisations producing multiple outputs that are difficult to measure makes it difficult to ensure efficiency. A market-based system addresses many of the challenges raised by the inherent nature of education services. Allowing students to choose from a range of options on the

basis of relative benefits and costs is the best way to match course type, quality and cost with students' individual requirements.

In a market system, price signals provide information to producers on the value students place on different educational packages and the incentive for producers to respond to students' preferences. The market coordinates the subjective judgments of suppliers and demanders. Extra cost for higher quality is tested by consumers' willingness to pay for the higher quality product.

The only way to ensure minimum cost production from non-profit firms is to subject suppliers to competitive market pressures and the imperative of financial survival. Tertiary institutions should be required to attract funds from those who benefit from their services, and they need complete freedom to set fees. When tertiary institutions must attract students to survive, they will have a greater incentive to devote the appropriate level of resources to teaching, to identify and meet student preferences, to strive to do better in course design and delivery, to contain costs and to innovate. Those which supply services of appropriate quality at least cost will prosper. The appropriate mix of subjects and qualities would then be determined by market demands, resulting in a more diverse and responsive system. One advantage of the market is its ability to initiate low cost experiments which are quickly copied if successful.

Competitive pressure will confront providers with incentives to develop effective mechanisms for monitoring and controlling the activities of academics and other staff, to tailor their outputs to the demands of the outside community, and to introduce organisational efficiency, incentive structures and obligations on management to perform.<sup>253</sup>

Reform of the tertiary education sector has been part of a broader effort to make public sector institutions perform more effectively. A widespread belief in New Zealand and other countries was that "public sector bodies were poorly managed, lacked clear objectives and had been captured by their workforces".<sup>254</sup> A common response has been to use increased competition and contestability as mechanisms to improve performance, as well as an increased application of user charges, new mechanisms of accountability, and the application to state agencies of management and governance models developed in the private sector. A reassessment of whether many activities,

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<sup>253</sup> Hogbin (1988) p 30.

<sup>254</sup> Cave, Dodsworth and Thompson (1992) p 79.

such as providing telecommunications and transport services, should be undertaken by government-owned firms has resulted in privatisation.

In a market-based system, government intervention is more transparent and requires explicit justification, making intervention to achieve short-term political objectives less likely.

A competitive system is also better able to respond to, and utilise, new technology, which will affect student access to learning and the marketing, delivery and administration of education services. New technology has the potential to cut costs and increase international pressure on New Zealand providers.<sup>255</sup>

A market system will work better if funding is not used to protect public tertiary education institutions (TEIs) from competition. Funding should be contestable to maximise competition. Competition can be increased by decentralised funding, reduced barriers to entry and competitive neutrality with the private sector.

### **1.3 Goals for tertiary education**

The Green Paper suggests four goals to set "directions and priorities for the next two decades" (p 8):

- improving opportunities for participation;
- improving the participation and achievement of currently under-represented groups "across all types and levels of tertiary education" (p 9);
- improving "incentives for the quality of qualifications, programmes and providers" (p 9); and
- encouraging value for the students and government's financial contributions.

The reason for adopting the first three goals as objectives of government policy is not made clear. Nor does the Green Paper explain its repeated emphasis on higher levels of participation and higher quality.

There are many determinants of the participation of students and the quality of courses (including the costs of participating and producing quality). Why are

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<sup>255</sup> See Global Alliance, "Australian Higher Education in the Era of Mass Customisation", Appendix 11 of the Review of Higher Education Financing and Policy (the West Report) (1997) for an informed speculation about the effect of information technology on tertiary education over the next 20 years.

the resulting participation rate and quality of courses perceived to be too low? Do the benefits exceed the costs of higher participation or quality? On what evidence do the authors of the Green Paper base their conclusion?

### *1.3.1 Participation rates*

A student should not participate in tertiary education when the benefits received are less than the costs (where the relevant costs and benefits are all the social costs and benefits flowing from the individual's decision to undertake tertiary education). Why do the authors of the Green Paper assume that many students who choose not to participate in tertiary education are making an incorrect decision? Why do they regard Maori and Pacific Islanders as particularly likely to make an incorrect decision? Such assumptions appear paternalistic.

Many policies can increase participation. But key questions need to be addressed. For example, how do we make sure that the policies introduced only encourage participation by those for whom the benefits are greater than the costs? Participation can obviously be too high as well as too low. How do we know when we have reached the optimal participation level?

The policy to increase participation is inconsistent with the earlier statement that choices are best left up to individual students. Indeed, it was admitted that the government finds it difficult to determine "optimal" levels of participation "either because [it] lacks information or expertise, or is not in the best position to respond. Decisions are made too slowly and result in inaccurate responses" (p 8). Yet apparently it is known that the current level of participation is small, although no evidence is presented that additional students will do better in tertiary education than in the alternative activities they currently choose.

Although it is stated that tertiary education "encompasses a large number and range of formal tertiary settings, the development of skills within the workplace, and self-directed learning" (p 3), the participation objective is only concerned with "education leading to formal qualifications" (p 5) and only it is to be subsidised. How do we know whether tertiary education has a higher rate of return than on-the-job training? The Green Paper simply does not make a case that only tertiary education "leading to formal qualifications" should be favoured by subsidies, nor does it even recognise that a case should be made.

Further, the Green Paper does not explain how it is known that Maori and Pacific Islanders should increase their participation and why the level of participation should be even across all types and levels of tertiary education. If Maori and Pacific Island students are to be singled out as special objects of positive discrimination, why tie aid to participation in tertiary education? If the rate of return is low, the subsidies may be wasted.

If an objective of government policy should be to ensure that rates of participation by Maori and Pacific Islanders are equal to those of other New Zealanders in all courses, race-based policies are implied. The most direct instrument to achieve it would be to mandate racial quotas for each course so that the proportion of Maori and Pacific Island students in each course is equal to their proportion in the relevant population. TEIs could then adjust fees/admission standards between the different racial groups to achieve equal participation at the least cost to their other aims.

The social and educational implications of such a policy would, of course, be disastrous. Admission would no longer be based on merit, reducing the incentive for favoured groups to achieve in high school. Students and courses would be mismatched, with some being forced, others induced, into courses they would not otherwise choose, reducing the social return from education. Different admission standards may create racial disharmony, and students may be admitted into courses for which they are not suited.

As the objective is ensuring participation, the result may not even mean a better outcome for the favoured groups. TEIs have an incentive to get favoured groups to participate in their courses, but participation does not ensure success. Subsidies to encourage students to take courses which they do not desire or are not suited to are unwise. If it is not desirable to achieve the goal directly, then it should not be pursued in an indirect (and more costly) manner.

Government departments often focus on inputs that are easy to measure. The participation objective is no exception. Participation is an input of the students' time. Inputs should not be confused with outcomes and should not be used as an objective. The question is whether participation in tertiary education produces a good outcome for the student and for society. Did the education produce benefits? Was the education provided better suited to the student's needs than the alternatives? For example, a student who undertakes a remedial course at the tertiary level participates in tertiary education. A better policy may be to remedy the problems in schools that allow students to leave without basic literacy skills. That may reduce participation in

tertiary education, but is more desirable as it achieves the same outcome (a literate student) with fewer inputs (fewer years in education).

The participation goals are not good policy objectives. In fact, the policies proposed in the Green Paper do not maximise participation. To maximise participation, subsidies should be targeted at those who would not otherwise attend. Yet the proposed tuition subsidies go to all those in tertiary education. Spending on those from affluent backgrounds who would have attended tertiary education anyway does not maximise participation. Spending large amounts on European and Asian students will not increase participation by Maori and Pacific Islanders. The expense of tuition subsidies for all restricts the number of tertiary education places funded by the government.

The participation objective is silent on the number of years any individual should spend in the tertiary education sector and does not seem to be concerned with course mix. For a given level of funding, participation will be higher the shorter the participation period of each individual and the cheaper the courses offered. If the aim is to maximise participation, subsidies should be targeted at the cheaper courses and be for limited time periods.

Moreover, the participation objective conflicts with the objective of higher quality. Higher quality tends to be more expensive, which reduces the number of people that can attend for a given amount of expenditure. The Green Paper does not indicate to what extent quality should be traded for participation.

One way to target subsidies to increase participation is considered in option G (p 18). Option G proposes targeting tertiary tuition subsidies to those who have achieved the least outside the tertiary system. The Green Paper points out the perverse incentives this creates for school students.

The policies proposed in the Green Paper do not achieve the participation goals it sets out. It is not clear what other criteria are being used in order to come up with these policies, except that "resources must be shared more fairly between students" (p 68). The lack of any rationale for the proposed distribution of tuition subsidies is another defect of the Green Paper. Muddled objectives make for poor policy.

A better approach is to judge policies on the fundamental objectives of equity and efficiency.

### 1.3.2 *Equity and efficiency*

Equity should be concerned with helping the disadvantaged and improving the distribution of income. Education is a key determinant of earnings and a vehicle of social mobility. Thus the willingness to learn and access to tertiary education will have important distributional implications.

Efficiency involves maximising benefits minus costs. The relevant costs and benefits include all social costs and benefits to the community flowing from tertiary education, including non-pecuniary and cultural benefits. Efficiency requires the right type of output to be produced, in the right amount, at minimum social cost.

Producing the 'right type' of output requires a range of services, including qualities of services, that match the needs of students, industry and society in general and that respond to changes in demands. The 'right amount' includes taking account of external benefits. 'At minimum cost' means getting value for money, getting the most output from inputs by using the most productive techniques and the least cost combinations of inputs. It does not mean producing the lowest quality or at least cost to government.<sup>256</sup> Cost efficiency also requires appropriate incentives for innovation in service provision to increase benefit or decrease cost.

A well functioning market will produce an efficient outcome. The government may still wish to intervene to promote equity. If the market does not work well, the government may increase net social benefit by interventions targeted at overcoming the impediments to efficiency. The government may intervene through:

- finance;
- regulation; and
- provision of tertiary education.

All three methods are currently used. In the following sections we will consider the rationale for each, develop the appropriate policy framework and evaluate the policies recommended in the Green Paper.

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<sup>256</sup> Blandy (1988).

## 1.4 Conclusions and recommendations

- Increasing participation rates in the tertiary education sector should not be objectives of government policy. Such a policy appears paternalistic and focuses on an input (of the students' time) rather than outcomes. The Green Paper presents no evidence that additional students will do better in tertiary education than in the alternative activities they currently choose.
- A better approach is to judge policies on the fundamental objectives of equity and efficiency. The issue is whether government intervention will improve on the market outcome. Any problem with the market's operation should be identified and intervention targeted at overcoming it. The costs and benefits of intervention need to be evaluated, and the government should only intervene if the benefits are likely to be larger than the costs.

## SECTION 2: FINANCING TUITION

### 2.1 Introduction

Someone has to pay for tertiary education, and the issue is identifying the best financing arrangement to promote equity and efficiency. Possible sources of funds are the student's family, the student's own savings (eg if of mature age) and earnings from full-time, part-time or vacation work, the student's future income (brought forward by borrowing), endowments, employer contributions and the taxpayer. When taxes are imposed to finance subsidies, the other sources of funds are reduced.

If government subsidisation of tuition is not to impair competitive provision, the subsidies must be given out on a per head basis so that funding follows the student and student choices determine how the funds are spent. The Green Paper supports this student-focused approach to funding.

Direct student support is an alternative way to give out funding in a decentralised system. However, the Green Paper states "The issue of student support will be covered in a separate process" (p 5) and merely states that it is relevant for determining "the appropriate level of [the government's] contribution" (p 15). But the rationale for student support disappears if the government provides a student loan programme. Tuition subsidies and student allowances must be considered together.

A number of disadvantages arise from government subsidisation of education. A major cost of the way we currently finance education that is often ignored is the cost of shuffling the bulk of expenditure on education through the government. Instead of families purchasing their education directly, in the same way they buy food and shelter, billions of dollars of their money are collected in taxes to be cycled through the bureaucracy. The costs of administration and bureaucracy (in both the tax department and the education ministry) are clear.

Another major economic cost of taxes is the deadweight losses they impose. Taxes change behaviour and distort decisions. It has been estimated that in New Zealand the cost of raising an extra dollar from taxes on labour income is 18 cents, and the

equivalent figure for consumption tax is 14 cents.<sup>257</sup> The economic costs of taxes on capital are likely to be substantially higher. The efficiency cost of the *marginal* dollar of revenue is the marginal efficiency cost of the *most inefficient* source. Administration and compliance costs are estimated to be at least an additional 8 cents for every dollar of tax collected. Allowing for all these costs, it probably costs around \$1.30 to raise the last \$1 of tax revenue, so this is an expensive way of providing services that could be provided directly to students with no efficiency loss. Another cost arises from the probability that students will be less careful with the government's money than their own, particularly when the subsidy is not transparent.

To justify these costs, there must be some offsetting benefits. It is not good enough to blandly state that "governments around the world have been unable to establish a consistent rationale for the level of government contribution to tertiary education" (p 14). If allowing students to choose freely amongst providers is the best policy, then why not let students and families purchase tertiary education services out of their own incomes? Taxing families in order to give them tuition subsidies will make society better off only if there is some offsetting efficiency or equity gain.

The main arguments for government involvement in financing tertiary education are to increase beneficial externalities, combat capital market imperfections (sometimes called the access or equality of opportunity objective) and help the poor (improve the distribution of income). The first two are about efficiency; the third is about equity. The relevant market failure should be identified, not only to determine the level of government contribution, but also its form and how it is spent. The intervention should target the relevant problem.

## **2.2 Capital market imperfections**

The special properties of human capital and the operation of the legal system may make it difficult for students to pay for their education by borrowing against future earnings. Capital market problems may arise if qualified students are unable to finance tuition and living costs from their own resources and have to borrow against future income. Lenders may find it difficult to assess the creditworthiness of some students in terms of their likely success in their studies and their future income prospects. Students may be unable to offer alternative collateral. Therefore, lenders may be unwilling to extend loans or only offer loans on terms which reflect a high perceived risk.

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<sup>257</sup> Diewert and Lawrence (1995).

It is, however, important not to overstate the problem of capital market imperfections. Many families could afford to finance an undergraduate degree in, say, the arts or humanities, funding of which costs less than most family cars. Competition is likely to bring down the cost further by removing cross subsidies from teaching to other activities and by improving efficiency. New technology and innovation may result in costs being lowered further (even if teaching methods were to remain unchanged), and much university administration could be automated. Moreover, it should not be forgotten that if subsidies were lower, family incomes could be increased through tax cuts. Private lenders may be willing to lend to those in high cost, high quality courses, as successful outcomes are highly likely. In the case of the majority of students who come from middle income families, the problem of a lack of collateral could be solved by having a parent or guardian underwrite a loan for them.

It is important to note that capital market imperfections are faced by youth for other types of investment. The case for a special loan programme for tertiary education depends on the assumption that the imperfections for tertiary education are worse, or have more serious consequences, than other types of investments.

Whether capital market imperfections justify interventions such as government loans or loan guarantees (perhaps limited to students unable to obtain such backing) depends on an assessment of the relative costs and benefits of such an approach. If the problem is that students cannot borrow, a loan programme provides borrowing opportunities. A loan gives the student the incentive to weigh costs and benefits appropriately. Unlike grants, unsubsidised loans do not impose deadweight losses by requiring an increase in taxes. There is no evidence that the poor have an aversion to loans, especially if the loan is income contingent, thereby protecting them from default due to low income.<sup>258</sup>

On the other hand, there are a number of problems with government-run income-contingent loan schemes. Because the risk of loans cannot be priced accurately they inevitably involve cross subsidies between student borrowers. Taxpayers face the risk of default on loans. There may be political pressures to write off debt, and students have an incentive not to work after completing a qualification. There is little case for providing loans to those who do not expect to earn income (such as 55 year olds undertaking degrees for personal satisfaction). The loan programme may need to be targeted (for example by putting an age limit on those eligible to borrow).

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<sup>258</sup> See Chapman (1997) and Woodhall (1987) quoted in Blandy (1988) p 59.

The capital market imperfections argument does not give rise to a case for a subsidised loan programme. A loan programme should not have to run at a loss. For example, providing borrowing opportunities does not imply that the interest rate should be subsidised. If it is desirable to offer insurance through an income-contingent arrangement, a premium to cover the actuarial cost should be levied.

Nor is there a case for interest subsidies on other grounds. Interest subsidies give the most to those who borrow the most and take the longest to repay and, therefore, are not well targeted to achieve externality or equity aims. If, in the light of the evidence on externalities and competing social priorities, it is decided that students should bear around 25 percent of the cost of their education as at present, why give a further subsidy to those who decide to finance the payment by borrowing? If a further subsidy is desirable and can be afforded, why was the student burden set at 25 percent?

Interest subsidies make it very expensive to raise the limits on borrowing or to extend the repayment period, thus limiting the extent to which capital market imperfections can be overcome. They also encourage students to borrow, even when they have alternative sources of finance, to borrow as much as possible and to use the money for other purposes including arbitraging it into other investments. Subsidies also reduce the incentive to repay and to earn income (if the loan is income contingent).

There is a substantial grant element in the current loan programme. The interest subsidy is estimated to be 8 to 11 percent of the value of the loan.<sup>259</sup> The insurance element of the loan is not charged for, and its actuarial cost is estimated to be 15 to 17 percent.<sup>260</sup>

An alternative to providing a loan programme is to take steps to improve the capital market for private lenders. For example, student borrowers could be allowed to waive bankruptcy protection and the tax office allowed to sell its income measurement and collection services to private lenders (with the borrower's agreement). Under current arrangements the use of the tax office collection mechanism is bundled with the particular terms and conditions of the government programme, a uniform scheme with the same conditions for all borrowers. Borrowers cannot choose between different repayment options and there is no market test on what is preferred by borrowers.

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<sup>259</sup> OECD (1997) p 33.

<sup>260</sup> New Zealand Business Roundtable (1994) p 23.

An advantage in using the private sector is that market forces will give incentives for cost efficiency, diversity, innovation and experimentation in disbursement, collections and conditions, which will vary with each borrower's needs and economic circumstances. For example, lenders could offer fixed or variable interest rate loans. A further advantage is that lenders would be a potential source of information for students, as they have an incentive to gather information to protect their own investments and could play the role of financial adviser specialising in human capital investment.

### **2.3 Externalities**

Provided students are able to borrow if necessary to supplement their other resources, subsidies to tertiary education will be efficient only if they increase the production of beneficial externalities. Externalities occur when the benefits or costs of a good or service also accrue to others. It is possible that some of the benefits of tertiary education are not captured entirely by the student but 'spill over' to the wider society.

If the rationale for intervention is to promote externality production, then the subsidies should be targeted at the beneficial externalities, which should be made as explicit as possible and monitored. For example, if arts degrees produce external benefits and accounting degrees do not, only arts degrees should be subsidised. If only particular types of research are associated with external benefits, then only those types should be subsidised.

The fact that tertiary education is associated with increased income is not enough to justify a subsidy. If all activities that produce income are to be subsidised, we would be left with the problem of what to tax to raise the revenue to pay for the subsidies. Nor is it enough to list the benefits of tertiary education. For the authors of the Green Paper to justify subsidies by the fact that students receive private benefits is paternalistic and inconsistent with their earlier admission that students are the best judges of the private benefits they receive from different types of education. A subsidy will distort student decisions towards the favoured activities and will only increase efficiency if it produces external benefits that outweigh the deadweight loss imposed by the extra taxes needed to finance the subsidy.

Two points are critical in the analysis of externalities and their policy implications. First, the external benefits must be external. It is not enough that others benefit: *those receiving tertiary education must not be rewarded for the benefits accruing to others*. For example, the value to employers from having access to the higher skill level of

graduates – an 'educated workforce' – must not be reflected in the pay rates the graduates receive. Moreover, pecuniary externalities that operate through the price system involve offsetting costs and benefits and do not warrant a subsidy. Secondly, for a subsidy to be justified, the external benefits must be marginal so that a subsidy to tertiary education increases their production. *The question is not only whether tertiary education produces external benefits but whether those benefits are significantly increased with subsidies.* For example, if the private return is high enough to encourage a student to undertake a degree, the external benefits that come from doing the degree will still be produced even if tertiary education is not subsidised.

The Green Paper admits that "While the overall contribution by the government of the day should relate to the public benefits from tertiary education, it is not possible to determine these benefits precisely" (p 15). If it cannot be determined which activities produce external benefits, then finance should be neutral between activities. For example, recent theoretical literature in economics suggests that human capital investment is a driving force behind economic growth.<sup>261</sup> But the theory does not tell us what type of human capital investment has the largest external effects. It is a large step to claim that it is formal public tertiary education that drives growth rather than, say, primary schooling or on-the-job training.

Tertiary education may produce negative externalities. Education may impose external costs on others if it is used as a screening device to identify innate talent.<sup>262</sup> If more education identifies someone as having high ability and raises his or her wage, someone who did not acquire the same level of education may be identified as having lower ability and likely to earn less.<sup>263</sup> Tertiary education requirements are also used to restrict entry into some professions thus imposing negative externalities on those who do not meet the requirements.

The evidence for externalities associated with tertiary education is extremely weak. There are no systematic measures of the size (or even the sign) of externalities, much less whether they are marginal. Many defy objective measurement, and it is almost impossible to empirically test the screening view and to measure the value of the information produced. Even the evidence on the effect of tertiary education on economic growth is limited. (How, for example, are we to measure the human capital produced?) A recent careful review concluded that at best there was tentative

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<sup>261</sup> See Lucas (1988) and (1993).

<sup>262</sup> This point is made in Sowell (1966), Blaug (1983) and Fane (1988).

<sup>263</sup> Even if education merely identifies innate ability, the information produced may be socially valuable, as it can be used to sort workers into appropriate jobs.

evidence (the studies were fairly crude and the data of poor quality) of "very modest" positive growth externalities from tertiary education.<sup>264</sup>

The present 75/25 split between public and private funding of tertiary education in New Zealand would be justified on externality grounds if each extra dollar of expenditure on tertiary education produced 75 cents in external benefits (plus a further 22.5 cents or so to cover the total economic costs associated with the increase in taxes to finance the expenditure). This seems implausible, especially as there is no evidence of such large externalities, and the subsidy is not targeted at activities that produce them. If the burden of proof is to be placed on those calling for subsidies, it has yet to be discharged.

Although there is little research evidence on externalities in tertiary education, the externality rationale can be used to draw conclusions about the recommendations and options posed in the Green Paper.

One possible interpretation of the participation objective is that the more students who participate in tertiary education, the more externalities will be produced. This can be disputed. If the screening view is correct, an expansion in participation will merely result in 'credential inflation', decreasing the significance of educational qualifications, with little social or economic benefit. In fact, costs such as graduate unemployment may result as employers and students adjust to the change in the information conveyed by possession of a university degree. Sowell<sup>265</sup> argues that increasing the proportion of high school students going through college is wasteful because not only does it throw resources at those who do not have the ability to benefit from tertiary education, it also lowers standards and the quality of education, reducing the gains to those with high ability. As a result, externality production may be reduced.

If externalities come from tertiary students, a competitive market should be favoured since it would ensure that tuition subsidies are directed for the students' benefit. Under current arrangements, the TEIs receive a block grant and allocate it according to their own objectives subject to constraints such as their cost structure, the market framework (demand for student places and the institutional budget constraint) and regulation. In the current system it is not clear how much of the subsidy is spent on different TEI activities and whether it is spent on activities generating external benefits. A major problem is that lack of competitive pressure can result in some of

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<sup>264</sup> Gemmell (1997).

<sup>265</sup> In Sowell (1966).

the subsidy being wasted through higher costs and an easy life for staff and management. TEIs are currently protected from competition from overseas providers and private tertiary establishments (PTEs) by more generous subsidy arrangements, and the cap on the number of funded places attenuates competition between TEIs.

The functions of the tertiary education sector include the creation, transmission and storage of knowledge, but these are global attributes which are not in many cases specific to the New Zealand system. Externalities may result from the performance of each function. The policies outlined in the Green Paper involve subsidies to students (promoting the transmission function) and to research (the creation function). Possible externalities from the storage of knowledge function are ignored, yet some consider the existence of this function to be the most plausible reason for government support of universities. Important activities may not be supported if funding is given out on the basis of student numbers.

These activities may survive under current arrangements because a lack of competition permits TEIs to use profitable activities to cross subsidise unprofitable activities. A competitive market will reduce or remove these cross subsidies, and unprofitable activities may survive only if they are directly subsidised.

The movement towards explicit subsidies in a market-based system would be an improvement on current arrangements. The problem with the current system is that a lack of competition allows universities to appropriate subsidies for their own ends, which may or may not include activities that have external benefits. The incentive to produce external benefits is vague and indirect. Explicit targeted subsidies allow the relevant activities to be monitored and rewarded, ensuring that the money is spent to produce the maximum public benefit. The subsidies are more transparent and the recipients more accountable. Further, the government can use subsidies to directly achieve its priorities, which may change over time (for example, if new technology changes the repository of knowledge function).

The Ministry of Education needs to think carefully about which TEI activities provide public benefits, and whether activities currently supported by cross subsidies should be directly subsidised or permitted to fold when competition increases. The danger is that the ministry has not considered all the consequences of the removal of cross subsidies through competition. The outcome may be restrictions on competition to maintain cross subsidies – a costly and poorly targeted way to ensure external benefits are produced.

## **2.4 Equity**

Subsidies to tertiary education are not a good instrument for making the distribution of income more equal. Current subsidies actually redistribute from the poor to the rich, while churning large amounts of tax income between members of the middle class.

In 1996, the average subsidy per equivalent full time student (EFTS) for TEIs was \$7,833. TEIs also receive a further hidden capital subsidy. It is not clear how much students benefit from the subsidy to tertiary education. The funding also covers research. The part of the TEIs' subsidy that is spent on teaching depends on their internal allocation of funds. Incorrect quality decisions and cost inefficiency are likely to mean that much expenditure on teaching does not benefit students.

A movement to a competitive market and per head funding will ensure that subsidies to students will be spent on providing teaching benefits. Even then, the distribution of that part of the subsidy allocated to teaching services between students and suppliers depends on the elasticity of supply and demand curves for teaching services. The more elastic is the student demand curve (ie the more responsive is student demand to changes in tuition fees) and inelastic the supply of teaching services (for example, a quota would make the supply inelastic), the more the benefit goes to the suppliers (or, more accurately, to the factors of production responsible for the supply curve sloping upwards).

To the extent that the subsidy to teaching services increases the supply of graduates, the effects depend on the elasticity of demand and supply for university graduates. For example, if graduates are in elastic supply, or if the demand for graduates is inelastic, graduate wages will be bid down and students do not gain much in terms of pay.

The effects on the distribution of income of a subsidy that benefits suppliers and employers are difficult to determine. However, equity is unlikely to be improved. To the extent that the subsidies do benefit students, it is important not to confuse the cross-sectional and lifetime perspectives. The following facts about tertiary students are relevant:

- on average they come from relatively well off families. Participation in tertiary education is positively correlated with socioeconomic background, whether measured by parents' income, wealth, occupation, education or residential area;
- on average they have relatively high lifetime earnings; and

- at the time the students are undertaking tertiary education they often have very low incomes.

If we take a cross-sectional perspective, students are poor. They are earning little and may have to pay living and tuition costs. But if we take a lifetime income perspective, subsidies to tertiary education go to people who are relatively well off, and therefore subsidies are inequitable. Further, subsidies may substitute for support and gifts from the student's family. Subsidies to these students will benefit their families, who tend to be well off.

Tuition subsidies to all tertiary education students transfer income from the average taxpayer to a privileged group. The result is inequitable. There is no case for subsidising all students in order to help the minority who are truly needy.

Even subsidies targeted at students from poor backgrounds who would not otherwise attend tertiary education may make the distribution of income less equal. The recipients are better off than those from poor backgrounds who do not qualify for further education. The subsidies result in one group moving from the middle of the income distribution to a higher position.

Strategies for raising the income of those at the bottom of the income distribution who often drop out at the end of compulsory schooling should involve measures such as labour market deregulation and the removal of employment barriers such as minimum wage restrictions. Avoiding welfare disincentives and strict work-testing for work-ready beneficiaries are also important. Subsidies and reform efforts targeted earlier in the education process or at human capital investments made by the poor (such as on-the-job training) will be more equitable than subsidies to tertiary education. Cutting education expenditure and expanding other programmes or reducing regressive taxes may result in further improvements.

Even to achieve the narrower aim of increasing the proportion of those from poor backgrounds in tertiary education, efforts should be targeted where they have the highest return, which is almost certainly earlier in the education system. Many disadvantaged students do not go on to tertiary education due to inadequate schooling, poor academic achievement and low aspirations. Those receiving poor secondary schooling are simply unable to benefit from subsidies at the tertiary level. Relevant policies could include giving better incentives to families and to those who provide education to the poor (eg by providing choice and competition at the compulsory level) and redirecting subsidies towards the schooling of the poor.

Tuition subsidies for all are inequitable. If the subsidies are targeted at those from low income backgrounds, there are adverse incentive effects. For example, subsidies based on family income or wealth reduce the incentive for families to accumulate income and wealth and support their children at university. Feldstein estimates that families eligible for college scholarships in the United States face implicit levies on wealth accumulation of between 22 and 47 percent (in addition to income taxes) through the effect of the needs analysis system.<sup>266</sup> Means tested grants also encourage effort to be expended in acquiring the subsidy (such as hiring a good accountant).

While people may differ on the extent to which they wish to trade efficiency for equity, using tertiary education subsidies to achieve equity involves a particularly poor trade-off. There are better ways to help the poor – in particular, private scholarships, income transfers, wage subsidies and broad subsidies to human capital accumulation, and reform efforts targeted at the schooling of the poor (such as increasing competition). Moreover, attempts to use the tertiary education system as a tool of income redistribution will detract from its performance in respect of other aims.

## **2.5 Level and delivery of tuition subsidies**

New Zealand's student loan programme is a response to the problem of capital market imperfections, so the case for tuition subsidies comes down to externality and equity objectives. Both objectives are weak. Also they may well conflict: intervention to promote externality production may benefit a privileged group at the expense of the average taxpayer and decrease equity.

The external benefits from current tuition subsidies are unlikely to cover the costs of the taxes needed to finance them. The subsidies are poorly targeted at externalities and are inequitable. Subsidies should be targeted at activities with demonstrable public benefits that outweigh the proven costs of the associated increase in taxes. Tuition subsidies do not pass this test and are a poor equity instrument: they should be phased down substantially. A reduction to an average level of 25 percent is recommended. Such a level of subsidy almost certainly overestimates externality production. The reduction could be phased in over, say, 10 years after which the level should again be reviewed. The phasing is required so that students and their families have time to adjust their earnings and savings plans, labour market responses in the

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<sup>266</sup> Feldstein (1995).

form of changes in pay rates can occur, and offsetting changes in tax rates faced by students and parents can be made.

Tertiary funding through the EFTS system is currently running at \$1,127 million per annum. The savings from a reduction in subsidies from an average level of 75 percent to 25 percent would be two-thirds of that sum or around \$750 million. If taxation was reduced by that amount and a marginal economic cost of taxation of 30 percent applied to the total, there would be an increase in national income of \$225 million over and above the increase in private income of \$750 million. The average household would be better off to the tune of \$760 in discretionary income per annum.

If tuition subsidies are cut, an increase in competition, more choice, improved incentives to focus on teaching and increased cost efficiency will moderate the impact on students. The resulting expenditure savings can be used to cut taxes or to help the poor in a better targeted way (which should include cutting regressive taxes).

### ***2.5.1 Delivering the subsidy – the Green Paper options***

The Green Paper seeks comment on various options for delivering tuition subsidies. In principle any of them could be used for delivering the much lower level of overall subsidy proposed in this submission.

Option A (p 16) is like the current system, whereby all students receive tuition subsidies for as much study as they choose to do. Those who spend longer in the system, and take longer to complete a course, receive a higher subsidy. However, it appears to envisage a fixed level of total subsidy to be shared among participants ie with the level of subsidy per student rising or falling as total participation falls or rises. Variations in the level of per student subsidy would appear to bear no relation to factors considered relevant here – externality production, equity and efficiency. The management of such a system poses administrative difficulties.

Option B would deliver the subsidy through a student entitlements system which gives each school leaver a fixed lifetime subsidy (a lifelong learning account).<sup>267</sup> The ministry recognises that option B "would encourage students to use their subsidy carefully" (p 16). It asks whether, under such a system, a co-payment from the student should be required. It should not: a fixed learning account makes the subsidy

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<sup>267</sup> The recent Review of Higher Education Financing and Policy (the West Report) (1997) made a similar recommendation, as did Baldwin (1997) from the left of the Labor party in Australia.

equivalent to the student's own money. Requiring a co-payment would not increase the care taken when the student spends the subsidy and would reduce the student's choice over how to allocate the subsidy over his or her lifetime.

Under the current system, and in option A, enrolling in a course always increases an entitlement to a subsidy, reducing the incentive to spend wisely. Enrolling in a course may not reduce entitlements to future subsidies, and not enrolling does not guarantee any entitlement to a future subsidy. The current system gives a subsidy for years spent at university, and so encourages students to substitute inputs of teaching services for their own effort and reduces their incentives to use their time as efficiently as possible and to monitor provider performance. It requires central planning to ration the subsidies.

If option B were adopted, once a student spends the allocated subsidy a further subsidy should not be available after a break in study. The Green Paper acknowledges that access to further subsidies later in life leads to "poorer incentives for students to use their government contribution carefully" (p 19). Additional external benefits from someone who has already been through tertiary education are likely to be low. Mature age students are likely to find on-the-job training a closer substitute for tertiary education, and so the distortion from subsidising tertiary education is likely to be greater. If the investment was expected to be privately profitable students could finance it themselves. Mature age students could be given access to loans, but are more likely to have their own resources and work opportunities than younger students, and greater access to the capital market. Moreover, the equity effects of subsidies for mature age students are unclear.

In the Green Paper it is correctly pointed out that a student entitlements system will also make the link between a student's participation and the resources received by the provider more direct.

Under any delivery system, to give students the correct price signals and an incentive to take cost into account and seek the most efficient provider, the subsidy should not differ according to the cost of programmes. There is no evidence that more expensive programmes produce greater externalities, but if they were found to do so higher subsidies would be justified.

Fees should vary with the cost of a programme, reflecting different costs to society. The Green Paper notes that "Some students from lower socio-economic backgrounds – for example, some Maori and Pacific Island students – may choose not to participate in

more expensive courses or programmes simply because of cost" (p 12). The answer is to provide borrowing opportunities or to target poor students directly. Giving a bigger subsidy to all students doing an expensive course is a poor targeting strategy, especially when most students undertaking such courses are from better-off backgrounds.

Under option B, the subsidy should be a fixed amount rather than for a fixed number of years to be 'mode of delivery' neutral.<sup>268</sup> Current policies are based on inputs of a student's time rather than outcomes. TEIs are paid for delivering education over a specified period of time and are not encouraged to economise on student time by offering shorter, more intense, programmes. In fact, TEIs have an incentive to lengthen programmes to maximise enrolments.

As to whether payment should be on the basis of enrolments or completions, if the payment is debited from students' entitlements, the students and providers can come to an efficient arrangement – whether to pay by enrolment or on completion or in some combination. A centrally imposed formula for all would not allow diversity and would not be efficient.

Option B is more equitable than option A because it does not give so much to those with higher levels of tertiary education. Option A would be more efficient (but still less equitable) if the meritorious produce more externalities, but, if that were true, better policies could be devised than option A. For example, subsidies could be better targeted rather than an equal amount given to all students. It is likely that the marginal externalities produced decline with the number of years spent in tertiary education and that the screening function of education becomes less important. If so the case for option B is strengthened.

A cap on the number of student places, or learning accounts (p 17), would require the ministry to decide which students receive them. That would still be an improvement on the current system, in which a fixed number of funded places are allocated across institutions by a central planning process. The institutions' admission decisions determine which students receive the subsidy. The advantage of an individual entitlement scheme is that students' decentralised decisions will then determine the allocation across institutions.

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<sup>268</sup> The terminology is from the Review of Higher Education Financing and Policy (the West Report) (1997), which made a similar recommendation.

A further advantage of the option B approach over that of option A is that it requires the allocation of subsidies to be squarely addressed. The subsidies can be allocated according to the government's priorities, rather than the TEIs determining, according to their own priorities, which students receive the subsidies. A problem with a capped individual entitlement scheme is that qualified students with a high willingness to pay may not receive an entitlement. However, such students should be permitted to pay full fees (as in Australia). In the current system the funded places are rationed between qualified students by price, and so the problem does not arise.

### *2.5.2 Delivering the subsidy – a preferred option*

As discussed above, a student entitlements system for tertiary education such as option B offers some improvements on current subsidy arrangements, which are poorly targeted on equity and efficiency grounds. There are, however, substantial difficulties with it; the aim should be to preserve its advantages while diminishing its difficulties.

The first difficulty with option B, as outlined in the Green Paper, is that it poses major administrative problems and hence costs. The number of those with an 'account' would rapidly increase and become a very significant percentage of the total population.<sup>269</sup> The periods over which many accounts would remain open would greatly add to the complexity and costs of administration. Secondly, it would seem imprudent for any government to accept the long-term fiscal risks of such an open-ended scheme. Thirdly, if the entitlement varied between different age cohorts (perhaps being reduced for later cohorts to moderate the fiscal burden and risk) there would be understandable dissension. Indeed because of this, governments would be extremely reluctant to reduce entitlement levels even when this would be the responsible course of action. Fourthly, while the notion of lifetime learning is superficially attractive, the point was made that the present value of any externalities produced will tend to decline with the age of the student. It is hard to see, for example, the justification on externality grounds for subsidising tertiary education during retirement. Finally, and perhaps most importantly, option B does not, as presently formulated, face up to the fundamental issue of the identification of the externalities to be supported.

We consider that the advantages of an 'entitlement' could be achieved in more simple and cheaper ways. For example, a subsidy entitlement could be limited to the

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<sup>269</sup> The complexities and costs associated with the National Qualifications Framework (NQF) are considerable (see Smithers, 1997) but might be small in comparison with what is envisaged here.

completion of a first degree or its equivalent. An age boundary should be included to avoid the problem of diminishing marginal externalities with age. Ending the subsidy entitlement at age 30 would seem likely to cover the great majority of students, though there could be defined exceptions such as the case of a parent who took time out from the paid workforce to bring up children.

The issue of which courses are to be subsidised needs to be addressed explicitly. There would seem to be little value from a public perspective in subsidising vocational courses at any level since they are geared directly to the achievement of private benefits. Public subsidies would thus be largely confined to the humanities and the general sciences. However, the important point is that the government should identify the courses and programmes which it considers are associated with net positive externalities and which it is prepared to justify and support with taxpayers' funds on those grounds.

### *2.5.3 Neutrality between providers*

It is recognised in the Green Paper that, on efficiency and equity grounds, private training establishments (PTEs) should be resourced on an equal basis. There is no case for limiting subsidies to public providers. Externalities depend on the type of education provided, not the ownership of the provider. Indeed if, for example, public universities are cost inefficient fewer external benefits are produced for a given level of expenditure.

The equity effects depend on the outcome for the student and not whether he or she attended a public or private institution. Low income students and Maori and Pacific Islanders are more likely to be in PTEs than TEIs.<sup>270</sup> The only counter-argument put in the Green Paper is that competitive pressure may threaten the viability of some TEI courses. But that represents students taking up more preferred options, at no extra cost to the government, which is one of the gains from increased competition. The argument demonstrates how government ownership, although protecting TEIs, may result in limits on student choice.

Deregulation of demand will not result in the maximum benefits without deregulation of supply, which means allowing students to buy from private as well as public institutions. Competitive pressure is required to give institutions the incentive to meet market demands and become more cost effective. The US tertiary education sector

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<sup>270</sup> Guerin and Baker (1997).

and the Australian schooling sector show that competition from private providers can be salutary.

Allowing students to use their subsidy allocations to purchase teaching services from foreign providers, both in New Zealand and overseas, will increase choice and competitive pressure on domestic providers. It is the most direct way to ensure New Zealand providers meet international standards. If the purpose of the subsidy is to help the person who receives it, then there can be no objection to the policy. If the purpose of the subsidy is to encourage production of external benefits in New Zealand, one concern is that overseas trained students may not return to New Zealand. Yet the current system gives subsidies to students who then go overseas to live. One possible answer would be to make the subsidy repayable upon emigration, although the administrative difficulties would require careful evaluation.

## **2.6 Conclusions and recommendations**

- The loan programme may be justified as a means of overcoming capital market imperfections, but it should not be used to give out subsidies.
- If the rationale for government intervention is to promote externalities, through encouraging additional enrolments of students in particular courses, then the appropriate response is to target subsidies directly at the production of externalities. The externalities should, as far as is possible, be made explicit and monitored.
- Current tuition subsidies do not target externalities and are a poor equity instrument. They should be phased down over 10 years to around 25 percent of average tuition costs, at which point there should be a further review. The resulting expenditure savings can be used to cut taxes or to help the poor in a better targeted way (which should include cutting regressive taxes).
- The Ministry of Education needs to think carefully about which TEI activities provide public benefits, and whether activities currently supported by cross subsidies should be directly subsidised or permitted to fold when competition increases.
- Tuition subsidies would be available for programmes and courses identified as likely to lead to positive externalities exceeding their costs. Therefore, this would not include most vocational education and training.

- The subsidy entitlement would expire at age 30 except in defined circumstances.
- Provider access to government subsidies should be dependent on objective criteria (preferably outcomes), allow for diversity, and be competitively neutral between domestic and international and public and private providers.

## SECTION 3: FINANCING RESEARCH

### 3.1 Introduction

The case for government financing of research rests on the externality argument. Some research may be 'non-excludable', that is, the benefits from the research accrue to people who cannot be 'excluded' and therefore cannot be charged, for example, 'public good' or basic research. The producer of the research cannot capture all of the benefits that result and so may not find it profitable to produce research that is socially valuable. Such research activity produces positive externalities, and too little will be produced unless a subsidy is paid.

On the other hand, research may involve negative externalities where extra research reduces benefits received by others. If researchers are competing for a fixed prize (for example, where only one will receive a grant or be the first to solve a particular problem), then competition can result in excessive resources being devoted to research.

It should be noted that not all research is non-excludable. Some research is sold to private companies. Some may be an essential part of the teaching process. Research may benefit students through improving the quality of teaching or through enhancing the reputation of the institution. Students will be willing to pay for that research through higher fees, and a government subsidy is not needed for its production.

In the Green Paper, the ministry proposes allocating research resources either on the basis of student numbers or on a contestable basis.

### 3.2 Advantages of a performance-based mechanism

If the objective of government intervention is to encourage more research producing external benefits, then funds should be explicitly allocated for that purpose and the research output monitored and rewarded through a performance-based mechanism. The process of developing a performance-based mechanism requires a focus on evaluation and measurement and a clarification of the objectives underlying public

funding. Making the expectations of government more explicit will increase accountability. Transparency is important to minimise the influence of political objectives.

The international evidence is that the effect of direct funding of research is to concentrate research funding.<sup>271</sup> In Australia and the United Kingdom, a small proportion of the universities receive most of the competitive research funding. Research productivity varies greatly across academics. A department's apparent research productivity is heavily influenced by the productivity of a handful of highly productive individuals. Clearly, it is efficient to concentrate funding on those researchers who are productive.

When teaching and research are funded separately, the funding for each can be made contestable and the appropriate organisational form determined by competition. The funds should be contestable by all institutions (public and private – as in the case of the Public Good Science Fund), because there is no presumption that TEIs are the most efficient producers of research. If teaching benefits research, then institutions that teach should have an advantage in the competition for research dollars. Whether specialist research organisations are more effective may differ by discipline and even depend on the project.

A further advantage of unbundling the funding of teaching from research is that the government can use funding to directly influence the balance between the two, and the mix of research activity. With limited funding available, priorities must be set. When the funding is bundled, the allocation of funding and the type of research conducted (public good or teaching oriented) depends on the objectives of the TEIs and the constraints they face. When academics determine research priorities, they may place too much weight on international prestige to further their own careers. An explicit approach can ensure funding is aimed at research likely to produce the greatest external benefits for New Zealand, for example, towards problems of importance to the New Zealand community.

Funding research on the basis of student numbers gives muddled incentives. Student numbers do not reflect performance in producing non-excludable research. Indeed, the incentive is for TEIs to neglect their non-excludable research in order to build up student numbers. In a competitive market for teaching services, competition will eliminate cross subsidies to non-profitable activities such as non-excludable research.

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<sup>271</sup> See Hare and Wyatt (1992).

To the extent that TEIs are protected from competition, the problem is that the subsidy can be used for other ends (such as the easy life) and it still cannot be guaranteed that non-excludable research will be produced.

The Green Paper proposes to ensure that when research is funded according to student numbers it meets minimum requirements. It is unlikely that this approach will ensure the most and best research for the money invested, especially as the Green Paper claims one advantage is that some providers who would not win funding on a contestable basis will receive funding. Minimum requirements can only guarantee that the minimum is produced.

A problem with the minimum requirements is that production of non-excludable research may not be distinguished from research that helps teaching and would be produced anyway. It cannot be guaranteed that the subsidy actually increases the output of non-excludable research. In fact, the objectives of the Green Paper are rather confused on this point. It seems to consider that the government's role is to ensure that research contributes to teaching, but this does not encourage non-excludable research. Not all research benefits teaching, and the ministry cannot ensure research that benefits teaching takes place, much less measure the contribution of research to teaching - certainly the criteria for satisfying minimum research requirements (p 34) do not even attempt to do so.

A better arrangement would be to give institutions the correct incentives to provide teaching services (through having to raise funds from students). The institutions will then have the incentive to undertake research that benefits teaching. There is no reason why such research will be under-provided in the market. Research subsidies will then directly target the non-excludable research that *is* under-provided in the market. Institutions can be left to organise themselves to produce each type of output in the most efficient way.

Indeed, how to allocate staff time and set staff incentives in order to produce the desired amount of teaching services and the appropriate mix of research are exactly the kind of decisions that should be left up to individual institutions facing the correct incentives, rather than be subject to central direction. A central department faces the information problem - it is difficult to measure teaching, research and the relationship between them from above. The optimal mix of time for an academic to spend on research to improve teaching performance no doubt differs by field, level of teaching and the individual academic. It is simply not feasible for a government department to

ensure that the correct type and amount of research is done through setting minimum research requirements.

### **3.3 Should research be compulsory?**

The Green Paper proposes that the current requirement that "all degrees must be taught mainly by teachers engaged in research" (p 30) be kept or that only post-graduate degree providers be required to carry out research "to assure the quality of post-graduate degree-level teaching" (p 30). In contrast, both the West and Dearing inquiries concluded that a major problem was that incentives for academics were skewed towards research and encouraged neglect of teaching.

Then the Green Paper puts the arguments against requiring compulsory research for undergraduate degrees (p 31). First, research may not help teaching (and may actually conflict with it). Research requirements may divert resources from teaching. Secondly, undergraduate degrees are mainly concerned with teaching existing knowledge, and teachers need not be engaged in research to undertake this task. Scholarship may be more important. Thirdly, students can judge the quality of teaching and can choose between programmes with different amounts of research on the basis of costs and benefits.

The only counter-argument presented in the Green Paper is that compulsory research is necessary to provide "assurance that degree teaching is of the highest standard" (p 32) and to protect New Zealand's international reputation.

The arguments for compulsory research requirements are paternalistic. They also conflict with the earlier arguments that students are the best judges of teaching and that the system needs to be diverse. It is arguable whether research is required for good teaching in all degrees (especially some vocationally oriented degrees like law) and whether it can be ensured by minimum research requirements. At most there is a case for releasing information on research performance so that students can make informed judgments.

The Green Paper admits that "[c]urrent arrangements do not assure the quality of research activities. ... Students have no guarantee that where research is taking place it is of sufficient quality or contributes to teaching" (p 33). If the relevant government department and domestic students do not know the quality of research, it is difficult to see how research requirements can be contributing to New Zealand's international

reputation for teaching. New Zealand's international research reputation can be best enhanced through a programme that directly rewards research performance.

It is also difficult to see the case for requiring post-graduate providers to carry out research. A paternalistic attitude towards post-graduate students is even less justifiable as they all have degrees and tend to be smart. Again, at most there is a case for releasing information on research performance, but even then the information collected by the ministry may not inform the student about the contribution research is making to teaching.

A major potential cost from a compulsory research requirement is that it could be used to protect incumbent institutions from the entry of new tertiary providers. There is no evidence that the requirement has been an effective quality discipline on TEIs, or that it has ensured that research benefits teaching. In the study referred to by Blandy, 20 to 25 percent of staff in Australian university economics departments were "non-researchers".<sup>272</sup> Moreover, they are likely to be doing the bulk of the teaching, as productive researchers are rewarded with light teaching loads. The situation is unlikely to be different in New Zealand.

The Green Paper suggests one cost of competitive research funding is that some providers would not receive research funding and so would not meet their minimum research requirements. This argument reveals a degree of confusion about the case for subsidies to research. The purpose of research funding should be to encourage research with external benefits. Research that benefits teaching should be financed by fees on students (who can weigh up the extra costs involved against the benefits from improved teaching). A provider will have an incentive to conduct cost-justified teaching-related research. If a provider can attract students without meeting minimum research requirements, then perhaps the research requirements should go. Certainly they should not be used to prevent research funds being distributed to maximise the value of research output for the money spent. If compulsory research requirements result in institutions being shut down "despite the quality of their research" (p 33), then perhaps the standard is being set too high.

### **3.4 Introducing competition between funding mechanisms**

The problem with rewarding research through a performance-based mechanism is that research performance is difficult to measure, particularly in the absence of market

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<sup>272</sup> Harris (1987), quoted in Blandy (1988).

prices for research output. A poor mechanism will give the wrong incentives. Still, the current mechanism does not measure research output at all and can be improved.

Research can be funded in a number of ways. Individuals, departments or universities can be funded. Research projects can be directly funded according to priorities, or researchers with demonstrated expertise can be funded.

Universities respond to incentives, and research funding has a large effect on the internal organisation and performance of universities. Many institutions use the formula for rewarding research for their own internal allocations.

Measures of research output include publications, citations, ability to secure grants and the subjective assessment of experts. All are currently used in hiring and promotion decisions. Each is an imperfect measure of research performance. For example, the weighting to be given to different publications is controversial, and the rank of different departments is very sensitive to the weights chosen. For example, how many journal articles are equivalent to a book? How should different journals be compared? How should jointly authored papers be counted? Long publication lags mean that the measures are not timely and measure past rather than current performance. When staff transfer between universities, it is difficult to determine which institution should be credited with the publication and citations. Citation analysis may give an indication of quality, but it involves long delays.

Monitoring by audits or expert judgment is subjective, and may reflect the prejudices of the reviewers and encourage the development of cronyism. It is also costly, as both the experts and the researchers must spend much time on the measurement process. In practice, audits do not involve the panel reviewing research output to judge their quality but instead give a professional judgment on the quality of the journals in which the publications appear.

The ability to secure grants is an important component of the index used to distribute the research quantum in Australia. A major problem is that it measures an input rather than output. Grants reward research proposals, although the proposer's track record and past performance are important. The physical sciences, which require large expenditures to conduct research, tend to be favoured over the social sciences in which research is less costly. But the money spent on research does not indicate its value.

Moreover, time spent in competing for research grants is a significant cost (in both preparing and judging proposals). In Australia, only one in five proposals is successful and the costs involved have been estimated as 75 percent of the value of the grants.<sup>273</sup> A consequence of rewarding success in securing grants has been an enormous increase in grant applications. It is not clear how much this increased competition for research grants increases the quality of the projects that end up being funded. An alternative possibility is that what we observe is rent-seeking competition which dissipates the value of the grant but does not increase the value of research output.

As there are different costs and benefits associated with different methods of measuring and rewarding research output, the best way to subsidise research may be to have a number of mechanisms in competition. For example, a number of bodies using different methods could be set up, and their budgets could be adjusted according to performance on clearly specified criteria based on maximising the value received from dollars spent.<sup>274</sup> The research bodies need to be given incentives to establish appropriate performance measures, to select well and to avoid resort to personal prejudices. Some weight should be placed on the track record of a successful researcher, regardless of the apparent 'relevance' of the proposed research. Success in winning private sector contracts may be a useful indicator of performance.

### **3.5 How much to subsidise research?**

So far the focus has been on how best to subsidise research. The other issue is how much to subsidise research. That depends not only on the amount of output, but also its value to society and by how much a subsidy increases the research produced. Although the value of research output is difficult to estimate, direct research subsidies and measures of research performance give useful information to determine the appropriate level of subsidy. They can at least be used to work out the cost of current research output.

In an Australian study on the research output of university economics departments, Blandy estimates that the average staff cost of a top-ranked published research article in economics in Australia was more than \$26,000 (in 1988).<sup>275</sup> At the moment it is difficult to judge whether the research output justifies its cost because there is little information on what research costs. Even the TEIs have little idea how much they

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<sup>273</sup> Gallagher (1997).

<sup>274</sup> Blandy (1988) p 7.

<sup>275</sup> Blandy (1988) p 43.

spend on research, much less how much teaching-focused research would be produced without research subsidies.

### 3.6 Conclusions and recommendations

- Funding research on the basis of student numbers gives TEIs muddled incentives. Student numbers do not reflect a TEI's performance in producing non-excludable research. Indeed, the incentive is for TEIs to neglect their non-excludable research in order to build up student numbers. If institutions have to raise funds from students, they will have the correct incentives to provide teaching services and to undertake research that benefits teaching. There is no reason why such research will be under-provided in the market and no need for minimum research requirements.
  - Minimum research requirements can only guarantee that the minimum is produced and do not ensure the most and best research for the money invested. It cannot be guaranteed that the subsidy actually increases the output of non-excludable research by TEIs, as production of non-excludable research may not be distinguished from research that helps teaching and would be produced anyway.
- Σ The Green Paper seems to consider that the ministry's role is to ensure that research contributes to teaching. Not all research benefits teaching, and the ministry cannot ensure research that benefits teaching takes place, much less measure the contribution of research to teaching. It is simply not feasible to expect that the ministry can ensure that the correct type and amount of research is done through minimum requirements.
- The case against compulsory research requirements is strong. Research may not be necessary for undergraduate teaching. The arguments for compulsory research requirements are paternalistic and conflict with the earlier arguments in the Green Paper that students are the best judges of teaching and that the system needs to be diverse. Minimum research requirements cannot assure

good teaching or New Zealand's international reputation. It is difficult to justify a paternalistic attitude towards post-graduate students.

- Non-excludable research should be directly subsidised under a performance-based, contestable system. Research subsidies will then target the research that is under-provided in the market. Tertiary providers can organise themselves to produce each type of output in the most efficient way.
- As there are different costs and benefits associated with different methods of measuring and rewarding research output, the best way to subsidise research may be to have a number of mechanisms in competition. For example, a number of bodies using different methods could be set up, and their budgets could be adjusted according to performance on clearly specified criteria, based on maximising the value received from dollars spent. Weight should be placed on the demonstrated research achievements of applicants for research funding, including their success in winning private sector contracts.
- Direct research subsidies and measures of research performance give useful information to determine the appropriate level of subsidy. At the very least, they can be used to work out the cost of current research output.

## SECTION 4: REGULATION

### 4.1 Introduction

In the Green Paper on national qualifications we are told "Quality is the key".<sup>276</sup> The emphasis on quality continues in the Green Paper on tertiary education with the proposal to put in place "regulatory support" (p 35) to ensure "the attainment by qualifications, programmes and providers of a *minimum quality threshold* that is necessary in order to attract government subsidies (regardless of how subsidies are delivered)" (p 36).

The quality regulation mechanism is to achieve two objectives:

- to provide information to students and employers "to reduce information costs incurred by students and employers in verifying the value of tertiary programmes and the quality of suppliers" (p 35) – a consumer protection role; and
- to determine which institutions are eligible to receive government subsidies "to achieve value for the taxpayers' contribution to the resourcing of tertiary education" (p 35).

The actual mechanism proposed in the Green Paper on tertiary education does not achieve either objective particularly well. For the consumer protection role it is desirable to subject the value of the information provided to a market test to ensure that the costs of intervention do not exceed the benefits. This does not happen when eligibility for subsidies is tied to achieving a defined quality standard. The standard becomes *de facto* compulsory and may survive even when it is inefficient.

If the government is to subsidise tuition, decisions must be made about which providers are eligible to receive subsidies. Even if the subsidies are given to students, the government needs to specify where the students can spend their subsidy. The criteria set should be targeted at the relevant problems, such as fraud. A standard that produces the most valuable information for consumers may not be appropriate. On

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<sup>276</sup> Ministry of Education (1997a) p. 10.

the other hand, a suitable minimum standard to determine access to subsidies may not be the most informative for students. There is a conflict between the two objectives.

In the following section the case for quality regulation and provision of information to protect consumers is examined, and the Green Paper proposal for minimum standards is evaluated. Then the proper policy to determine which providers are eligible to receive government funding will be discussed further. Other forms of regulation, such as entry regulation, are also analysed.

## **4.2 The Green Paper case for quality regulation**

A number of justifications for quality regulation are given in the Green Paper. They do not stand up to analysis.

The goal that underlies the quality regulation recommendations is "Improving the incentives for the quality of qualifications, programmes and providers" (p 9), in particular, promoting "incentives for higher quality" (p 13). What is not stated is exactly why participants currently lack incentives to provide quality and why current quality outcomes are considered too low. If some market failure could be identified, that would guide us to the best policies to combat the relevant problem.

The Green Paper asserts "students need assurance that a New Zealand education reaches an acceptable national and world class standard" (p 9). Acceptable to whom? Presumably the students. But in advancing a student-centred approach it was accepted that students are the best judge of whether a course meets their requirements and provides value for money.

There may be a case for the government to provide information so that students can make an informed choice, but instead the Green Paper presents quality as an absolute, and student preferences do not enter into it. For example, "[a]ll policies must encourage tertiary providers to strive continually for quality that is internationally recognised" (p 9) and, in the Green Paper's Overview, "[t]he Government wants a tertiary sector with a high international reputation. New Zealand's qualifications must meet the highest international standards. ... Teaching must be of top quality".<sup>277</sup> Such statements could be dismissed as wishful thinking, but presumably are meant to be taken seriously. It is not clear why every tertiary qualification, whether domestically oriented or not, must meet some arbitrary world benchmark or whether

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<sup>277</sup> Ministry of Education (1997c) p. 3.

central regulation can ensure it does. For some tertiary courses, international standards are going to be difficult to define.

Merely asserting that higher quality is good is not enough. Policies to promote higher quality have costs. Higher quality is more expensive, and we have seen that a trade-off with the participation objective is implied. Again, what is missing is a cost-benefit analysis. What are the benefits of higher quality, and do they exceed the costs? There is no point in a TEI having a mathematics programme to rival the Massachusetts Institute of Technology programme if only a handful of students are competent to take it.

The Green Paper gives some other justifications for quality regulation. Current regulatory requirements are criticised on the grounds that "a range of different accreditation requirements operates across the sector ... some [providers] face higher compliance costs because of regulations specific to them. In some areas, current regulation is no longer serving a useful purpose" (p 36). The "various uneven quality standards and assurance practices" (p 36) are said to create the problems of "limited information by which students and employers can judge quality, uncertainty about the value of programmes to students, [and] inconsistency in the regulatory requirements to different providers" (p 37).

Diversity of assurance mechanisms may match diversity in provision of quality. Institutions have diverse outputs and missions, and a range of qualities is optimal. A range of quality standards and assurance practices does not automatically mean limited information and uncertainty, but instead may provide a lot of information. The problems arise because the standards are mandatory, not because they are diverse. There is no case for a uniform quality assurance mechanism. The correct policy implication to draw from the Green Paper's criticisms of current arrangements is that quality assurance mechanisms should not be compulsory.

In any case, the Green Paper proposes a minimum standard, and emphasises the right for institutions to opt for higher standards and the need for different bodies to accredit different institutions. There will still be a range of accreditation arrangements and compliance costs. It is true that the proposal aims at equalising mandatory compliance costs, but is not clear whether they are to be equalised at the highest or lowest level.

The Green Paper states "it can be especially difficult or costly for students and employers to independently assess the value of tertiary education programmes"

(p 35). The authors imply that the quality assurance mechanism will reduce these costs. Yet the intervention only applies minimum standards and is not to "cut across providers' efforts to enhance their own brands and reputations" (p 35). Therefore most students will still have to bear the costs of independently assessing tertiary programmes to find the cost-quality combination most suitable for them.

The Green Paper emphasises the need to maintain "international credibility" (p 37). It also claims that "[a]t present, however, the various standards in use ... are not widely understood by the public, leading to perceptions that some tertiary programmes are of inferior quality" (p 37). If the New Zealand public does not understand current standards, it is not clear how foreigners form an opinion about credibility.

A better approach than merely asserting that there is a need for higher quality is to examine how the market would operate and what problems arise. It then needs to be established whether the government can do better. Is there a government role because of lack of information about the quality of providers? It should be remembered that information is not free. It is costly to produce information and costly for consumers to acquire it. Comparing the market outcome with a world with full and free information is irrelevant. The issue is whether government intervention will improve on the market outcome. Intervention should then be targeted at the relevant problem and should only proceed if the benefits that result are greater than the cost.

### **4.3 Provision of quality information in the market**

Education is a professional service, and it is certain that producers will have more information on product quality than consumers. Asymmetric information is an inevitable consequence of the division of labour. Will a market system produce sufficient information about quality for students to make efficient choices?

If there were full information on the quality of tertiary education services offered by different institutions, the lower quality services would sell for a lower price. At the other extreme, if consumers have no information on quality and cannot distinguish high from low quality programmes, both would sell at the same price. As high quality programmes are more costly to produce, they would be less profitable. The result would be to lower the average quality of programmes. It is possible that high quality programmes would be driven out of business.

### 4.3.1 *Information provision by producers*

As the consequences of a lack of information are so great, buyers and sellers will put effort into overcoming these information problems. Students can predict their participation in tertiary education and can spend time acquiring information and seeking advice. Employers will demand information on the value of the qualifications possessed by potential employees. The demand for information in a market system will create incentives for producers and others to generate useful information. The brand name and reputation of providers will become an important source of quality assurance.

The economics literature distinguishes three types of qualities associated with a good or service:<sup>278</sup>

- *search qualities* can be established before purchase, for example, the style of clothing. Sellers have an incentive to provide accurate information about search qualities (for example, through advertising) because consumers can easily check the accuracy of the information provided before purchase;
- *experience qualities* can only be determined after the product is consumed, for example, the taste of processed foods; and
- *credence qualities* are difficult to ascertain even after consumption, but are important nonetheless. Many repair services (including medical care) involve credence qualities. The consumer must rely on the provider's assurances that the repairs were necessary and carried out properly.

Tertiary education services involve all three types of qualities. The qualifications of the teachers and the location and state of the physical facilities can be easily observed. The quality of teaching can only be determined through experience. It can be difficult for the student to judge the quality of the curriculum, even after graduating.

Experience and credence qualities give rise to a moral hazard problem. The producer has an incentive to 'cheat' and gain profits by claiming to be high quality (so as to receive a high price) but provide a low quality service (and reduce costs). Producer reputation constrains a firm from deliberately misrepresenting the quality of the product it is selling when quality cannot be assessed by consumers prior to sale.<sup>279</sup> A

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<sup>278</sup> Nelson (1970) and Darby and Karni (1973).

<sup>279</sup> See Klein and Leffler (1981). A good textbook treatment is Pashigan (1995) at chapter 14.

firm will have an incentive to produce a high quality product if the possible loss of future profits discourages the firm from cheating consumers today.

The high quality product must receive a price commensurate with its higher costs. If a firm claims high quality but produces a low quality product, it will gain current profits but will lose repeat sales. If the loss of future profits is greater than the once-only increase in profits from promising a high quality product but delivering a cheaper, low quality one, the firm will have an incentive to sell its product at an honest price.

Firms will attract consumers and compete profits away through non-price means, for example by making sunk investments. They will invest in ways valuable to consumers (in order to attract them). The sunk investments make the firm a hostage to the industry and send a signal to consumers that it will suffer a large loss if it cheats and does not get repeat custom. Sunk investments reduce the risk that the price offered does not represent value for money.

The more important repeat business is to the institution and the more certain consumers are about the necessary price premium for quality, the better the signalling method to provide information on quality will work. For example, it may work well for cans of tuna, but not for heart surgery. Tertiary education is intermediate between these two cases. When consumers rarely buy the item more than once in their life, the effect on future demand depends on the extent to which dissatisfied consumers can relay their experience to potential future customers, for example by word of mouth.

The issue is to what extent cheating will damage future profits. Although most students only undertake one tertiary qualification in their lifetime, and switching institutions is costly, universities can expect some decrease in future demand if they offer lower than expected quality to current students. For example, current students will be more likely to transfer to other institutions during their programme, drop out or pursue their studies elsewhere. Institutions may rely on repeat custom from particular high schools, families and employers. Fund raising through alumni donations may provide institutions with the incentive not to cheat and a way to signal that they have satisfied customers. Employers may be able to inform future students about the quality of education received by past graduates. Certainly whether employers hire the graduates of an institution is an important part of an institution's reputation.

The threat of losing repeat custom will be more effective for experience qualities, such as the effectiveness of teaching. The loss in custom will be less for credence qualities that are slowly, if ever, revealed.

In summary, producers will have an incentive to provide accurate information about search qualities. Producer reputation and marketing methods may be used to provide information about experience and credence qualities.

A number of features of tertiary education affect the provision of information by producers. One problem in the current system is the lack of clear property rights to reputation in TEIs. Managers are not monitored by those with a direct ownership interest, reducing their incentive to protect the institution's reputation. An important complement to market reform is governance reform to give TEIs management incentives to maximise long-term value.

A warranty – the usual remedy for uncertainty about quality – will not work in education because the student's own effort is an important input in the education process and the success of the education experience.

On the other hand, the student's ability and the ability of student peers are both important inputs into the education process. An important indicator of the quality of education offered is the quality of students entering an institution, which can be measured. Although the value added by a university may be difficult to determine, the quality of the students may provide useful information on the quality of education.

The problems arising with credence qualities are less severe in education than in repair industries. For example, experts can independently judge the curriculum. Providers can form their own quality assurance process, for example, through accreditation and strategic alliances. Accreditation is a system where some body of experts certifies that a programme meets some standard of quality. Quality assurance relies on the reputation of the certifying agency.

#### ***4.3.2 Information provision by others***

Producers are not the only ones who can supply information in a market setting. It is very expensive for each individual to independently seek out information each time it is needed. It may pay for some specialised body to produce information likely to be required by many individuals. Organisations can set up to advise students and pass

on information about the experiences of past students, for example, through university guides. Experts can give advice on credence qualities.

Specialised agencies may produce too little information due to the public good nature of information. Non-excludability is a problem (for example students can pass their university guide on to their friends). The producer of the information cannot capture all of the benefits that result and so may not find it profitable to produce information that is socially valuable. That is, production of information confers external benefits.

Another problem is the non-rival aspect of information – once information is produced it can be supplied to others at very little extra cost. To cover the fixed costs of producing the information, consumers have to be charged. The charge to a consumer for using the information may be above the marginal cost of providing that consumer with the information. Even if exclusion were possible, it may be that too few consumers are informed, and it may not be profitable to provide information when socially desirable to do so.

Informed consumers also provide externalities for other consumers by raising average quality. That could mean that not enough is invested by consumers, as they do not take account of the externalities accruing to others. On the other hand, those consumers facing a private incentive to acquire information provide benefits to other consumers which may result in the market working quite well. Efficient outcomes in markets do not require all consumers (in this case students) to be well informed; a small proportion of knowledgeable students can have a large influence.

#### **4.4 The role of government: costs and benefits of intervention**

When producers have reputations, they will internalise the benefits of the information they produce. A case for the government to provide information may arise where reputation may not provide sufficient information about quality, and specialised information providers may not produce information for which the benefit exceeds the cost. On the other hand, the government may very well provide information for which the cost exceeds the benefit. Again, the question is whether actual government intervention improves on the market outcome. The costs of government action need to be weighed against the benefits.

Should the government introduce accreditation?<sup>280</sup> The benefits from accreditation are that it:

- provides information on programme quality;
- promotes inter-institutional communication;
- enhances the prestige and credibility of the programme; and
- promotes programme quality through the process of external review.

The last three benefits from accreditation would accrue to the provider, and therefore do not justify government intervention. If they are important, we would expect providers to voluntarily set up an accreditation agency, as colleges in the United States have done. Certainly it does not seem to be appropriate for the government to force accreditation on providers on the grounds that it is for their own good. Institutions are the best judges of their own interests and the value of inter-institutional communication and prestige, and they can weigh up the benefits against the costs.

Only the information provision role of accreditation can provide a case for government intervention. But even here, if the benefits are large enough, providers may voluntarily set up an accreditation process, as they capture some of the benefits from providing information.

For a government quality assurance mechanism to be justified, all four of the following conditions must be met:

- that the quality assurance mechanism does ensure quality;
- that it is the best way to ensure quality;
- that the benefits of ensuring the extra quality exceed the costs; and
- that it would not be done in the market.

Each can be disputed as discussed below.

#### ***4.4.1 Does the quality assurance mechanism assure quality?***

A key question is whether the government agency can and will provide valuable information that cannot be provided in the market. Ideally the government would provide information that would help students determine which provider was best for

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<sup>280</sup> Defined in the Green Paper (p 93) as a "process which ensures, in advance, that providers have the capability to deliver programmes leading to approved qualifications".

their needs and capacities. It is not clear whether a government agency will have the inclination or the capacity to do so.

First, there is the issue of whether quality can be measured from above, especially the quality that matters to students. Providing information on quality would have beneficial results only if the accreditation or ranking agency produced information that the employers and students demand. But it may not be possible to produce this information. The central agency faces the information problem.

Quality in tertiary education is difficult to define and measure from above. Many qualities can only be measured at the institutional level, or slowly over time. Many tertiary education inputs and outputs involve intangible qualities which are inherently difficult to measure in an objective, quantifiable way. The intangible features are as important as the measurable ones. Tertiary education outcomes are difficult to specify and measure in a timely fashion. We know little about the production process, and it is hard to control for the relative contributions of different inputs and for the influence of outside factors. It is difficult to measure value added. Subjective judgments are inevitable.

The policy suggestion in the Green Paper assumes that the provider's ability to meet a quality standard can be objectively determined. In fact, quality is very much a subjective matter. There is a diversity of preferences among students and a diversity in opinion about how education works (is it through teaching cognitive skills, socialisation or screening for innate ability?), about what should be taught and how it should be taught. People will differ about the value of all the determinants of educational quality and on the trade-offs between them.

Even the experts disagree on issues of quality, the majority opinion changes over time, and innovation will change available options. Nor is it clear that there is one correct answer. A wide range of abilities and needs means that different types of education are suited to different students. There is simply not one best education for everyone. For example, not all students will have the ability to benefit from attending the university with the highest standards and most rigorous programme.

Tertiary education services cannot be ranked on a single dimension. Tertiary providers have diverse missions and clienteles and produce multiple outputs. It cannot be said that a particular bundle of attributes is relevant for all employers and students, nor that they would weight them in the same way. Different groups have

different values, and a single set of criteria used for accreditation cannot satisfy them all.

Diversity in demand for quality means people will rank courses and institutions differently. It is impossible to establish a single hierarchy of quality which everyone will accept. The appropriate quality is often dependent on the individual's skills, need and tastes, and the individual student has the best information on those factors.

Further, even if the quality of a particular tertiary education service had only one dimension, so that any two students could agree which product is better, the students might disagree on how much the extra quality is worth. It is difficult to compare tertiary education costing different amounts. The more expensive education may be better, but whether the higher quality is worth the extra cost depends on an individual student's preferences.

In practice, information provision and accreditation focus on inputs, such as the qualifications of staff. Although measuring inputs is easier, evidence shows that it is not very useful. Input requirements may be over-prescriptive. Nor do they ensure student attainment or specify or verify outcomes.

Process (standard of practice) can be easily specified, modified and monitored. However, many accepted practices have a weak basis. There are no data demonstrating a relationship between accreditation standards and educational outcomes. It is well established in the economics of education literature that once student family background is controlled for, there is no clear relationship between student performance and expenditure, economic resources (class sizes and so on) or the academic qualifications of teachers.<sup>281</sup>

Provision of poor quality information is of little benefit to anyone. In fact, the provision of misleading information may be harmful, especially if it is tied to government funding. Excessive focus on the attributes that can be measured may distort incentives and result in a different product mix than would be chosen by customers evaluating all the attributes. This may divert attention away from what really matters, such as good teaching, which depends on enthusiasm and creativity and is difficult to measure from above (it is an experience attribute). By focusing on one dimension of performance, others may be neglected.

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<sup>281</sup> See, for example, the survey in Hanushek (1996).

There is some question as to whether accreditation can produce valuable information on quality. Moreover, when it is difficult to measure quality, it is also difficult to monitor whether a government body has performed the accreditation function satisfactorily.

#### ***4.4.2 Is the quality assurance mechanism the best way to ensure quality?***

Even if the relevant government agency can provide valuable information, will it in fact do so?

A government agency is controlled by the political process and subject to special interest pressures. A government agency does not have same incentive to maintain reputation as a private firm, because no one has an ownership stake. The result may be little incentive to behave efficiently, to provide information that students want and to minimise costs. Political motives, empire building and other objectives will play a role. For example, regulators have an incentive to be conservative, as the costs of a wrong approval are visible while the costs of rejecting a suitable applicant are often hidden. The use of industry norms reinforces the conservative bias. Innovation can be stifled.

The result may be producer protection rather than consumer protection. For example, minimum standards may be used by producer interests to restrict entry, reduce competition and drive up prices. Existing producers may be favoured over new entrants.

When a government accreditation agency does not have to meet a market test, there is a danger that it will become overly bureaucratic, impervious to criticism and focus on empire building. When bureaucratic empires are built, they are usually difficult to wind up, notwithstanding their poor performance.

#### ***4.4.3 Do the benefits of extra quality exceed the costs?***

The regulation of quality involves both costs and benefits, and should proceed only if the benefits are expected to be larger than the costs. Although this may seem obvious, the Green Paper focuses only on the benefits and ignores associated costs. Given the incentives that face a central regulator, the costs may be large.

One cost is the chance that accreditation will be used to restrict entry and innovation, curb competition, and restrict choice. It may encourage excessive homogeneity.

Quality regulation may result in detailed regulation of course content and loss of autonomy for the provider.

Another cost is the expenditure on compliance that accreditation imposes on providers. Compliance costs include the direct administrative burden (such as the costs of preparing submissions and supplying information) and the indirect costs of delays. Both will increase the price paid by students. The Association of Polytechnics in New Zealand estimated the cost to polytechnics of implementing the National Qualifications Framework (NQF) at between \$12 million and \$20 million.<sup>282</sup> Unnecessary compliance costs are imposed on those institutions which already enjoy a high international reputation.

The provision of information by the government may crowd out private endeavour. It might reduce the incentive for providers to protect and develop their reputations and for students to choose a provider or course with care. Compulsory accreditation may lull students into a false sense of security. If quality cannot be guaranteed by accreditation, there is a cost imposed on those who accept the government's stamp of approval but who receive a course of indifferent quality. The costs imposed by a low quality course on others may be greater if it is an accredited course (and so affects the standing of all other accredited institutions) than if there were no accreditation.

Other costs include the excess burdens on taxpayers from the taxes needed to finance the government agency and the cost of any lobbying activity (for example by existing producers to prevent or restrict new entrants) encouraged by a regulatory system.

The benefits from quality regulation have to be weighed against these costs.

If the government assurance agency focuses on search qualities (which can be objectively measured), then there is not much gained from government intervention. Institutions have an incentive to provide information on search qualities through their own quality assurance (which can include a voluntary accreditation process).

The Green Paper proposes to set a uniform minimum quality standard. A minimum standard will only create incentives for higher quality for those below the minimum. It has not been established that such a group of providers exists. How large is the problem, and is it worth the compliance costs? There is not much gain from imposing a standard that all providers would meet anyway.

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<sup>282</sup> Association of Polytechnics in New Zealand (1997) p 5.

Setting minimum standards requires the provision of information that producers meet some minimum level of quality. That is only useful if this information would not be provided in the market. Are there many low quality providers which would not be identified as such in the market? The fact that there are low quality courses is not enough to justify imposing minimum standards. There must be a lack of information about which are low and which are high quality courses.

Minimum standards do not solve the problem of providing information for those courses above the minimum.

To set the appropriate minimum quality level, the government agency must weigh up the costs and benefits of an increase in quality. The costs and benefits depend on the marginal cost of extra quality, the value placed on the low quality service and the value placed on extra quality. Again, it is questionable whether a government body has the motive or capacity to set the threshold at an efficient level.

Quality is not some absolute standard. Higher quality is not costless, and individuals will differ on whether extra quality is worth the costs. The benefits from raising the quality level depend on an individual's preferences and will be difficult to measure; a central department simply does not have the relevant information on students' preferences. It is an economic problem, not a technical one.

It is important to have a diverse tertiary education sector that responds to changing demands. An accreditation process applies a particular set of standards. These standards may not be appropriate for all students and all employers. There is not unanimous agreement on what should be taught in courses, what is high quality and what is a minimum standard. It would be costly to impose one particular orthodoxy on everyone. Making accreditation mandatory involves an interference with internal university affairs and academic freedom.

The market may fail to provide information that is of net benefit when the information provider cannot capture all the benefits. But the market may not set up an accreditation arrangement because the costs are greater than the benefits. There may be a case for the government to provide information, but not to mandate standards or ban courses. If accreditation is made a prerequisite for funding, unaccredited courses will find it difficult to stay in business. The result will be similar to, but not as extreme as, making accreditation compulsory. There is no market test on whether the assurance mechanism is of net benefit. An inefficient scheme could survive so long as its net costs were less than the accompanying subsidy.

An alternative is to make accreditation voluntary. Students should be able to choose non-accredited providers if they desire so that the market can judge the value of the accreditation and whether it is worth the extra cost. Accreditation is a costly process, and for some providers the costs may not be worth the benefits of being accredited. Institutions that would not seek accreditation might include those which already have good reputations. Those institutions which consider their reputations to be secure without the need for accreditation could avoid the time and financial costs involved. Others may use alternative accreditation procedures, which may be more or less stringent. Which path an institution takes depends on its weighing up of the costs against the benefits.

Producers have better knowledge of compliance costs (including loss of autonomy) than regulators and can balance costs against benefits. Students have better knowledge of their own preferences.

Allowing institutions to choose not to participate in a particular accreditation process will give incentives for the accreditation process to be performed economically, setting standards to maximise benefits less costs to institutions. The right to opt out is particularly important if the accreditation process is government-run. The option of using non-accredited services imposes some market test on the value of information produced by accreditation and provides some check on the misuse of accreditation powers.

The accreditation process applies a particular set of standards, which may not be appropriate for all students and all employers. Students and employers should be free to form their own judgments about the value of accreditation and choose non-accredited courses if they desire. It is one thing to provide information, but it is another to force a particular set of standards on everyone. The right to operate outside the accreditation process also facilitates innovation.

Moreover, the accreditation process should only be subsidised if there are externalities to information provision. As the providers are able to internalise most of the benefits, the costs of the accreditation process should be financed by those providers who use it.

#### **4.5 Evaluation of the Green Paper proposal for minimum standards**

The Green Paper proposes a comprehensive quality threshold for qualifications, programmes and providers to be administered by the New Zealand Qualifications

Authority (NZQA). In the Green Paper on national qualifications the authors emphasise that registration on the NQF is voluntary. But the writers of the Green Paper on tertiary education propose that registration will be a prerequisite to receiving government funding. "Only those qualifications that had been judged to meet NQF quality requirements ... would be eligible to receive government subsidies" (p 40).

The proposed quality standard involves registration, accreditation and audit. There are 16 attributes required for registration of qualifications on the NQF<sup>283</sup> and a further 23 for providers and programmes (p 77). None overlap, although the quality of the provider and qualification are related.

Trade-offs between different qualities are ignored by such a checklist, as is the trade-off between cost and quality. Some of the criteria are subjective, for example whether the qualification is "structurally sound". Indeed the whole notion of quality is subjective. Other criteria like "all interested parties have been consulted and had input into the design of programmes" (p 77) seem to permit arbitrary rejection.

It is claimed in the Green Paper that the proposed quality regulation involves "light government control" (p 37). The Green Paper on the qualifications framework states that "[t]here is no intention that the quality assurance process will intrude on the content of courses or teaching programmes, or compromise the autonomy of providers to decide what and how to teach".<sup>284</sup> If this is true, then the whole discussion of quality in the Green Paper on tertiary education is disingenuous. When the failings of the current system are discussed, the need for regulation is advocated, the aim of "high quality" is set out, and quality is given a broad definition. The aim of regulation is to verify the "value of tertiary programmes and the quality of providers" (p 34). For example, the authors of the Green Paper criticise current arrangements because "there is no guarantee that a particular qualification will in fact lead to employment" (p 35).

Yet the proposed quality regulation does not guarantee a successful employment outcome, nor is it concerned with measuring employment outcomes. It is concerned only about quality in a very narrow sense – that of the quality assurance process. It does not create certainty about the value of programmes to students, as quality that students care about also depends on content. The value for students and New Zealand's international reputation of the information produced is not at all clear.

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<sup>283</sup> See Ministry of Education (1997a) p 20.

<sup>284</sup> Ministry of Education (1997a) p 29.

On the other hand, it is uncertain how intrusive the regulation will be. In the Green Paper on tertiary education the quality standard is to address "the value of the qualifications, the suitability of the teaching and programmes leading to qualifications and the ability of providers to deliver those programmes" (p 38). The criteria for quality standards include that programmes must be "well designed, professionally delivered and validly assessed". Providers must be "well organised" (p 77). It is unclear how these criteria can be determined and measured against without intrusion into course content, notwithstanding the assurance in the Green Paper on national qualifications that this is not intended.

If the narrow definition of quality is to be adopted, then the assurance process focuses mainly on objective and verifiable information (search qualities). The benefits are likely to be small because search qualities are likely to be provided in the market (if it is efficient to do so), and students are likely to care more about the intangible or subjective aspects of education.

However, the criteria in the Green Paper do leave open the possibility of a much more intrusive attempt to regulate quality. The problem then is whether the NZQA has the incentive to set the minimum standard at the efficient level and the capacity to measure more subjective experience and credence qualities. The potential costs are large and the benefits unclear. These qualities are very difficult to measure.

The NZQA is to have overall responsibility for quality regulation. The uncertainty about the degree of regulation that will result from the Green Paper gives the NZQA a wide latitude to determine how to implement regulation in practice. The Green Paper admits that in the past the NZQA has used a "strong government control" (p 38) assurance process. Although we are assured that the NZQA is "currently shifting its emphasis" (p 38), there is a danger that both habit and motive will lead the NZQA to 'heavier' government control when quality regulation is implemented.

In the Green Paper on national qualifications, the authors emphasise that "the NZQA must act impartially" (p 29). Yet the authors admit that the NZQA has "strongly promoted new qualifications based on unit standards, and methods of assessment using these standards" (p 29). The NZQA may be more concerned about its main task, to build up a comprehensive qualifications framework, than to ensure valuable information is provided to students or to determine whether it is appropriate to subsidise the provider. The NZQA has been described by one participant in the NQF as "a bureaucratic juggernaut determined to implement a rigid ideology of

competency-based learning ... bogged down in its own paperwork. Its communications and data-handling systems being unable to cope with the monster it had created".<sup>285</sup>

As undergoing and passing the quality assurance process are conditions for receiving subsidies, there is no market test on the value of the information provided. If an accreditation bureaucracy backed by government funding (*de facto* compulsion) is set up, experience suggests it will continue to exist even if it does not perform. Worse still, there is no check on possible excesses by the NZQA.

Tying the quality requirement to funding does not meet the Green Paper's intent to "reduce unwarranted barriers to entry of new providers" (p 36). When the power to accredit entrants is delegated to a body representing incumbent providers, such as the New Zealand Vice-Chancellors' Committee (NZVCC), there is a clear conflict of interest, and the chance that regulation will be used to restrict entry is increased. It is claimed that "transparent processes and periodic audit by the NZQA" (p 81) will ensure the agencies are not biased against entrants. But it is not clear why the NZQA would have and advance that objective.

The NZQA does not have the expertise to accredit the full range of tertiary institutions, and it is proposed that it authorise external qualification validation agencies to do so. But then the responsibility becomes muddled. Who is ultimately responsible and whose reputation is at stake? The criteria for accreditation involve judgment and opinion. How can the NZQA be sure that the same standards are being applied without duplicating much work? If it does not have the expertise to make all the decisions, can it keep them consistent?

We conclude that if the purpose of quality regulation is consumer protection, accreditation should be voluntary and not tied to subsidies so that there is a market test on the value of the information provided. We now turn to how the government should determine which providers are eligible for government funding.

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<sup>285</sup> Coolbear (1997).

## 4.6 Determining eligibility for government funding

Under student-centred funding, the subsidy is attached to the student so that providers receive subsidies by attracting students. Student choice determines where subsidies flow. If the government desires to limit which providers are eligible for government funding, then student choice must be restricted. The government should set out what the problems with unfettered choice are, and the restrictions should be targeted at the relevant problem. Tying subsidies to consumer protection measures may not be appropriate.

The Green Paper proposal assumes that students may be ill-informed. Although that may warrant provision of information, it is not clear why it is relevant to determine which providers receive subsidies. If the case for a subsidy depends on production of public benefits, surely whether the institution receives a subsidy should depend on whether it meets the criteria for producing public benefits. Instead, who gets subsidies is to be determined by the NZQA on other grounds.

Two problems that may justify restrictions on the provision of subsidies are the lack of incentive for students to spend the government subsidy wisely and the possibility of fraud. It should be noted that these costs associated with subsidies are another reason for reducing subsidies.

One way to directly target the problem is to introduce a student entitlement system to increase the students' incentive to spend the subsidy carefully. Such a subsidy is more like the students' own money, in contrast with current arrangements. Lower subsidies would provide the same incentive.

The question then is whether there is any need for specific regulation of tertiary education, or whether the general consumer protection and anti-fraud laws are sufficient. If existing general protections are insufficient, intervention should be targeted at the relevant problem, such as criminal sanctions to combat fraud and prudential regulation to combat problems with financial stability.<sup>286</sup> Eligibility should be determined on the basis of objective criteria – preferably outcomes – which allow for diversity and are competitively neutral. Criteria could include the employment rate of graduates, starting salaries and the default rate on student loans.

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<sup>286</sup> As the Review of Higher Education Financing and Policy (the West Report) (1997) proposed.

## 4.7 Entry regulation

The Green Paper proposes that access to protected terms, including 'university' and 'degree', remain restricted. Providers must obtain permission to award degrees and to use the term 'university'. The Green Paper states that "the main trade-off in determining criteria for universities is between maintaining international credibility and encouraging greater competition" (p 82). It suggests the criteria for claiming 'university' status – that a university should act as "critic and conscience of society" – could be tightened, or relaxed and a wider range of disciplines accepted. Relaxing these requirements is supported. It is difficult to see how performance of the first criterion can be objectively determined, or why it is necessary to perform teaching and research roles, or what it has to do with establishing an international reputation. Relaxing the range of disciplines requirement will permit specialisation of providers and customisation of courses at the university level.

Institutions should be allowed to adopt the most efficient structure, which may change over time, rather than be locked into one particular model. Open competition between different organisational forms is the best way to determine the most desirable degree of specialisation.

If there is a trade-off between international credibility and greater competition, as the Green Paper suggests, then that supports reducing restrictions on institutions calling themselves universities. The gains from increased competition are clear and recognised in the Green Paper. The effects on international credibility and reputation are not so apparent. It could be argued that reputation, to the extent New Zealand institutions do have an international reputation, is based on institutional reputations. The issue is whether a low quality New Zealand institution calling itself a university would damage the reputation of, say, the University of Auckland. It is difficult to believe that it would. Foreigners are likely to judge any university's performance directly. If the government is worried about universities free riding to attract foreign students, that can be directly regulated by restrictions on which providers can enrol foreign students.

It may be that if a foreign company employs an inferior New Zealand university graduate, the company may reduce its opinion of graduates from other universities. But it is not clear how important this effect is. Do foreigners judge all New Zealand universities to be of the same standard? Should they?

Employers know that not all universities and graduates are equal and, where considered relevant, will tend to make judgments based on the reputation of the institution in question. Nor is it clear that the specified criteria are very relevant to foreign employers. For example, they may care about the educational broadness of the particular employee, rather than whether the particular institution he or she attended offered a broad range of courses. Also it is difficult to believe that accreditation has a large impact on the international reputation of New Zealand universities when, as the Green Paper reveals, most New Zealanders have little idea about the effect of current accreditation.

The international reputation argument does not justify reducing competition to the cost of the vast majority of New Zealand graduates who do not go overseas. In any case, international reputation can be protected by certification. If a New Zealand government seal of approval carries no weight, then neither will current arrangements.

Further, if an institution wants to maintain its reputation, it can enter quality assurance arrangements and strategic alliances with other institutions. As the Green Paper states, "nothing would prevent groups of providers from co-operatively developing their own branding under a distinct trademark as part of their marketing approach. ... such privately-determined branding may reflect providers' characteristics and quality better than a set of government-defined protected terms" (p 42).

Universities can enter international quality assurance arrangements, such as Universitas 12, to ensure their international reputation. Evidence "that it is the performance of an individual institution, rather than the title of a class of institutions, which establishes an international reputation" (p 42) comes from Australia. In 1987 colleges of advanced education were permitted to call themselves universities. Universities have developed their own reputations and quality assurance relationships, such as the Group of Eight, the Australian Technology Network and the Regional Universities. There is no confusion between the top universities and the others. Some new universities have carved out a reputation and niche for themselves, winning large numbers of first preferences from university applicants. There has been a boom in foreign students, with some new universities attracting large numbers. Foreign students often deal with specialised recruiters who are well informed and have incentives to protect their own reputation.

The fact that existing institutions are consulted on new entrants in the tertiary education sector makes it more likely that the protected terms are used to restrict entry and protect incumbents from competition. The NZVCC has sometimes been accused of acting as a cartel in this regard. It is not clear whether existing universities are monitored to ensure they maintain the specified criteria. In fact, rather than new entrants destroying the reputation of existing institutions, a bigger problem may be the barrier to entry that reputation creates and which reduces competitive pressure on existing institutions.

The Green Paper also seeks comment on whether the number and type of providers should be centrally regulated. It points out the significant costs that would be involved, such as making the system less responsive to changes in demand and restricting competition between different organisational forms. Central regulation completely contradicts the preferred directions for change set out earlier in the report, including the intent to "move towards student focused funding and encourage the entry of providers" (p 13).

It is not clear why the Green Paper even considers a proposal that would completely undermine the thrust of the rest of the report. The proposal "would ensure that a wide range of education continues to be available" (p 41), but only by forcing students into less valued options. If the demand for a type of education is not there, why would it continue to be provided? If there is some reason (such as regional objectives), then such education should be explicitly subsidised, rather than be given a hidden subsidy through restrictions on competition. The other suggested benefit to regulating provider numbers is that it "might limit the extent to which certain providers were perceived to be 'elite' and others 'second class' " (p 41). It is not clear how the proposal would achieve this, or why the status of providers should be an object of public policy.

The preferred policy is one which encourages providers to meet the educational needs of students and so supports the alternative of "allowing providers to decide for themselves the type of education they will offer, the names under which they will operate, and the quality characteristics they will seek to establish" (p 41). A variety of qualities is optimal – for some providers it will be an international standard, for others the focus will be national or even regional reputation. Diversity in quality and standards need not diminish the reputation of any one institution. With diversity and a continuum of qualities, it is pointless to strictly define what is, and what isn't, a university. The idea that all institutions of a particular type or which fall into the same category are equal is a polite myth, and it is better to recognise the fact and encourage

students to seek information and motivate institutions to be concerned about their reputations.

#### **4.8 Conclusions and recommendations**

- The justifications for quality regulation presented in the Green Paper do not stand up to analysis. A better approach than merely asserting that there is a need for higher quality is to examine how the market would operate and what problems might arise, and to target intervention at the relevant problem. Both the costs and benefits of quality regulation need to be evaluated, and the government should only intervene if the benefits are likely to be larger than the costs.
- Quality is subjective and indefinable and is best left to the individual decisions of the students and employers, rather than made the responsibility of a costly and intrusive bureaucracy. The interests of consumers would be better protected by the development of a competitive market. Barriers to the entry of new providers in the tertiary education sector should be removed. The views of competitors should not be taken into account on whether new institutions and courses should be established.
- If accreditation is to be introduced to protect consumers, it should be voluntary and not tied to subsidies. Voluntary accreditation will place a market test on the value of information produced and whether it is worth the extra cost, give incentives for the quality assurance process to be performed efficiently, and prevent it imposing large costs. The accrediting role of the NZQA should be funded by those who choose to use its services.
- Provider access to government subsidies should be dependent on objective criteria (preferably outcomes), allow for diversity, be competitively neutral and directly target any perceived shortcomings of the market. The general consumer protection and anti-fraud laws may be sufficient, particularly if students are given incentives to use government subsidies carefully.
- The case for government provision of information is based on the fact that provider reputation may not give sufficient information about quality and specialised information providers may not produce information for which the benefit exceeds the cost. On the other hand, the government may very well provide information for which the cost exceeds the benefit.

- For a government quality assurance mechanism to be justified, all four of the following conditions (each of which can be disputed) must be met:
  - that the quality assurance mechanism does ensure quality;
  - that it is the best way to ensure quality;
  - that the benefits of ensuring the extra quality exceed the costs; and
  - that it would not be done in the market.
  
- Does the NZQA have the capacity or incentive to provide valuable information that cannot be provided in the market and to set the minimum standard at the efficient level? The potential costs from intervention are large and the benefits unclear.
  
- It is uncertain how intrusive the quality regulation proposed in the Green Paper would be. If the narrow definition of quality is to be adopted, then the assurance process focuses mainly on objective and verifiable information (search qualities). The benefits are likely to be small: search qualities are likely to be provided in the market (if it is efficient to do so) and students are likely to care more about the intangible or subjective aspects of education.
  
- Protection of the descriptions 'university' and 'degree' is not justified by the need to maintain New Zealand's international credibility. Removing the naming restrictions would have the beneficial effect of encouraging competition on the basis of the reputation of individual institutions. Membership of the NZVCC by a university should not be compulsory.
  
- The Green Paper's proposal to regulate the number and type of providers should be rejected.

## SECTION 5: PROVISION

### 5.1 Improving the accountability of public institutions

This submission strongly supports the government's ownership strategy for reforming TEI governance and strengthening accountability. The Green Paper identifies the relevant problems and sets out appropriate objectives, roles and responsibilities and accountability arrangements. Other government-owned entities have been reformed in similar ways with dramatic improvements in performance. Reforms to public sector governance can simulate private sector agency control mechanisms to monitor performance, and reward or take corrective action to improve performance.

Governance reforms are required to complement and maximise the benefits from increased competition, and to reduce the resulting fiscal risk to the government from ownership. Competition, including the threat of bankruptcy, improves incentives for cost efficiency and better performance. Effective governance is required to allow institutions to respond to competition and avoid bankruptcy, and to give managements the appropriate incentive to protect and develop their institution's reputation. In order to allow the necessary managerial autonomy, such as freedom to manage assets, financial accountability must be strengthened.

The Green Paper poses the alternatives of either all TEI council members being appointed or a majority being appointed and the minority being elected by stakeholder groups. A majority of all TEI council members should be ministerial appointees selected for their skills and competence with the balance co-opted, rather than having a minority elected by stakeholder groups (p 57). Co-opting additional members is a better way to guarantee an appropriate balance of skills and high levels of expertise and to replace members with inadequate performance (increasing the incentive to perform). The responsibility of an appointed board is clearer and accountability greater. Elected representatives politicise councils, intrude constituency politics into decision making and make insider capture and conflicts of interest more likely. Management can still place strong emphasis on consultation, participation and collegiality. Councils should be reduced significantly in size to permit more in-depth

discussion of management proposals and more efficient decision making. There should be proper remuneration of council members.

## **5.2 Capital charge**

If TEIs are to remain in government ownership, this submission supports the suggested capital charge and the Green Paper's proposal that "each TEI would provide the resources for capital projects, expansion, or changes in strategic direction, from its operating revenue or from within its balance sheet. Such activities would be funded through asset sales and (mainly) private sector borrowing" (p 89).

Introducing a capital charge will remove the hidden subsidy that TEIs currently receive. There are three reasons for doing so:

- to achieve competitive neutrality with the private sector by removing the advantage that hidden subsidies give and the disadvantage of input controls;
- equity between students – the implicit subsidy from free capital varies widely across the system; and
- to give incentives for the efficient use of capital – to free up under-utilised capital and facilitate access to private capital.

Nevertheless, there are problems and risks with any capital charging regime. It is a poor surrogate for the disciplines of private ownership.

## **5.3 Privatisation**

In other sectors of the economy, the justification for government ownership has been scrutinised and often found untenable, resulting in privatisation. The Green Paper does not give any justification for continued state ownership. A substantial portion of the Green Paper is devoted to dealing with the costs and risks that result from government ownership and how to protect the government's ownership interest. Yet there is no mention of the benefits of government ownership that offset these costs. How state ownership fits in with the other objectives is not considered.

Nor is the case for ownership specified. It is blandly stated:

The reasons for public ownership of TEIs are mainly historical. Typically, the key reason advanced is a judgment that public ownership is necessary to safeguard the Crown's resourcing interest in tertiary education. Without ownership, the Government might find it difficult to ensure that tertiary

education services are directed towards its overall education strategy and goals (p 49).

The choice between state or private ownership of TEIs should depend on the costs and benefits of privatisation in the light of current circumstances, not historical accident. The government does not own TEIs as an investment. The efficiency case for public ownership must be a transactions costs one: that it is cheaper for the government to achieve its aims by direct ownership than by other means (such as purchasing from private providers or directly subsidising individuals).

The idea that public ownership is needed to safeguard the Crown's resourcing interest is inconsistent with the proposals to make student-based funding neutral between the public and private sectors (it is considered that regulation of private providers is enough to protect the government's interest). The reality is that public ownership often creates pressure to raise expenditure, and it increases the fiscal risk borne by the government when the demand side is deregulated.

It is ironic that the authors of the Green Paper argue that ownership is needed to safeguard the resourcing interest when, on the following page (p 50), they list all the problems with government ownership arrangements, such as low accountability, weak incentives and inefficiency. It seems that public ownership wastes rather than protects resources.

Does public ownership help ensure the government's tertiary goals are met? The goals stated in the Green Paper do not justify state ownership, nor do the more fundamental goals of equity and efficiency discussed in this submission. Indeed, it can be argued that incentives to meet student requirements are likely to be sharper under private ownership. The cost inefficiency of public provision means that spending is less rather than more likely to achieve the government's goals.

In fact, public ownership is likely to hinder rather than help achieve the goal of moving to a competitive market. The potential conflict between government ownership and the establishment of a competitive market is not dealt with in the Green Paper. State ownership may be inconsistent with a competitive market.

One issue is how the government will deal with failing TEIs. If taxpayers underwrite failing TEIs, the playing field is not level. Institutions with a government guarantee, even if only an implicit one, will have an advantage. Entry into the tertiary education sector by private providers may be discouraged and loss-making TEIs may drive more

efficient private providers out of business. The report is silent on whether TEIs will be permitted to fail.

If the government guarantees borrowing by TEIs, lenders have little incentive to monitor the loans. The government should codify and charge for any guarantee.

Even with improved governance arrangements, the regulation of public TEIs needed to control fiscal risk may prevent TEIs from competing effectively and inhibit supply side deregulation. Either the public TEIs will be driven out of business or the government will prevent competition to stop this happening. Moreover, there is a conflict of interest if the government owns TEIs and regulates the market they are competing in. It could be that agency costs cannot be satisfactorily controlled for a government-owned institution and that privatisation is necessary.

Although the proposed governance forms improve on the current situation, some problems remain. The incentives for council members are weaker than in private non-profit or for-profit organisations. There are few rewards for a good job (remuneration is minimal and council members cannot own stock as in a for-profit firm). The main incentive for council members to perform is to protect their reputations. If it is not clear whether the poor performance of the firm is due to managerial decisions or government interference, reputation in the managerial labour market will not be effective. But when the government does not reappoint council members it is often not clear whether it is for political or other reasons.

When the government appoints board members, political considerations may adversely affect the quality of the appointments. The only protection against political appointments is transparency. Ministerial appointees may have conflicting loyalties: should they serve the institution (as required under the Education Act 1989) or the government? Unsatisfactory performance by a public TEI tends to reflect unfavourably on the relevant minister, yet the minister has few opportunities to intervene other than to disestablish the institution. The incentive to gather and release information that may be unfavourable is reduced. Government ownership suffers from more layers of the principal/agent problem than private ownership.

Another problem is the clash between political accountability and autonomy. The Green Paper does not pay enough attention to issues of autonomy. Government intrusion is an inevitable part of government ownership. Government ownership involves the government determining TEI objectives, and it also risks politicisation. For example, system objectives are specified by the party in power (and they are not

always clear). Government objectives are inevitably political, they change with changing administrations and what may arise from the electoral system may conflict with scholarly values.

Another advantage of privatisation is increased autonomy for the TEI. Autonomy is important for TEI performance and the basic values of scholarship and academic freedom. Independent funding increases autonomy and the ability to pursue fundamental academic values free of government interference. The market is a better safeguard of academic freedom.

Privatised institutions would evolve to a position where they owned their own assets, determined their own governance arrangements and were basically free to make all management, employment, financing and academic decisions. The institutions would be answerable to stakeholders by the need to attract funding to survive, whether through research or teaching. The government would retain a financing role (for tuition subsidies and research) and perhaps some regulatory role.

The Green Paper correctly stresses that TEIs should be more accountable. But the accountability should lie as close to the institution as possible. The ministry runs a system rather than individual institutions. Accountability should lie within the institution, to a body governing it in line with agreed objectives, not to a body governing a system.

The governance reforms proposed in the Green Paper should be adopted as a first step towards privatisation of TEIs.

It is noted that wananga are to be given the option of being removed from Crown ownership, transferring Crown equity to the proprietors (apparently for free) and becoming a private training establishment (PTE). This special treatment seems to be because of the unique characteristics of wananga. Yet the rest of the tertiary sector is not homogeneous and may require diverse policies. Privatisation should be considered for all TEIs.

The appropriate ownership form should be considered on a case-by-case basis. As institutions' goals differ, the best governance structure for institutions may differ too. The objectives for the individual organisation should be identified and governance arrangements set up to achieve them. Current proposals will result in one general governance structure for TEIs, with only minor scope for variations according to the needs of particular institutions.

A non-profit form may be desirable when research is involved – so the institution can raise charitable contributions. But the non-profit form has costs. Capital market pressures are attenuated, for example, because takeover is difficult, thus reducing pressure for efficiency (although the need to attract donor income also places constraints on an institution). Certainly the for-profit form should not be ruled out. There is rapid growth in the for-profit tertiary education sector in the United States. For-profit providers include well capitalised medium-size companies (such as DeVry, Apollo and CBT Inc). They tend to be specialised and flexible and cater to mature-age students and firms.<sup>287</sup> The for-profit role is consistent with public good functions so long as the government funds them. If they are not, then public good outputs will not be supplied in a competitive market whether firms are for-profit or not. Competition will reduce or remove cross subsidies.

The Green Paper does not consider competitive neutrality in access to subsidies. Nor does it fully address other competitive neutrality issues, such as equal tax treatment, equal access to the student support system and equal capital funding. All providers, profit and non-profit, government and private, should be treated on an equal basis so they can compete on their merits.

The government should establish competitive neutrality between organisational forms and let the market decide. The result will be more diversity and specialisation, rather than the current system of one favoured form trying to do everything.

#### **5.4 Conclusions and recommendations**

- Governance reforms are required to complement and maximise the benefits from increased competition in the tertiary education sector, and to reduce the resulting fiscal risk to the government from ownership of TEIs.
- While TEIs remain in Crown ownership the proposed ownership strategy for reforming TEI governance and strengthening accountability should be adopted. TEI council members should be predominantly ministerial appointees selected for their skills and competence, with the balance co-opted rather than elected by stakeholder groups.

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<sup>287</sup> Global Alliance, "Australian Higher Education in the Era of Mass Customisation", Appendix 11 of the Review of Higher Education Financing and Policy (1997) (the West Report).

- The proposed capital charge should be implemented if TEIs remain government-owned, and access to private capital should be freed-up.
- The government should make explicit how it will deal with failing TEIs. It should codify and charge for any guarantee.
- The Green Paper does not establish any case for continued government ownership.
- Although the proposed governance reforms improve on the current situation, some problems remain. State ownership may be inconsistent with a competitive market. There is a clash between political accountability and TEI autonomy, with the risk of intrusion of political objectives. Incentives for efficient operation are weaker in a public organisation.
- The governance reforms proposed in the Green Paper should be adopted as a first step towards the privatisation of TEIs. The appropriate ownership form for TEIs should be considered on a case-by-case basis. The government should establish competitive neutrality between organisational forms.

## SECTION 6: CONCLUSIONS AND RECOMMENDATIONS

### *From section 1: Goals and Policy Directions*

- Increasing participation rates in the tertiary education sector should not be objectives of government policy. Such a policy appears paternalistic and focuses on an input (of the students' time) rather than outcomes. The Green Paper presents no evidence that additional students will do better in tertiary education than in the alternative activities they currently choose.
- A better approach is to judge policies on the fundamental objectives of equity and efficiency. The issue is whether government intervention will improve on the market outcome. Any problem with the market's operation should be identified and intervention targeted at overcoming it. The costs and benefits of intervention need to be evaluated, and the government should only intervene if the benefits are likely to be larger than the costs.

### *From section 2: Financing Tuition*

- The loan programme may be justified as a means of overcoming capital market imperfections, but it should not be used to give out subsidies.
- If the rationale for government intervention is to promote externalities, through encouraging additional enrolments of students in particular courses, then the appropriate response is to target subsidies directly at the production of externalities. The externalities should, as far as is possible, be made explicit and monitored.
- Current tuition subsidies do not target externalities and are a poor equity instrument. They should be phased down over 10 years to around 25 percent of average tuition costs, at which point there should be a further review. The resulting expenditure savings can be used to cut taxes or to help the poor in a better targeted way (which should include cutting regressive taxes).

- The Ministry of Education needs to think carefully about which tertiary education institution (TEI) activities provide public benefits, and whether activities currently supported by cross subsidies should be directly subsidised or permitted to fold when competition increases.
- Tuition subsidies would be available for programmes and courses identified as likely to lead to positive externalities exceeding their costs. Therefore, this would not include most vocational education and training.
- The subsidy entitlement would expire at age 30 except in defined circumstances.
- Provider access to government subsidies should be dependent on objective criteria (preferably outcomes), allow for diversity, and be competitively neutral between domestic and international and public and private providers.

*From section 3: Financing Research*

- Funding research on the basis of student numbers gives TEIs muddled incentives. Student numbers do not reflect a TEI's performance in producing non-excludable research. Indeed, the incentive is for TEIs to neglect their non-excludable research in order to build up student numbers. If institutions have to raise funds from students, they will have the correct incentives to provide teaching services and to undertake research that benefits teaching. There is no reason why such research will be under-provided in the market and no need for minimum research requirements.
- Minimum research requirements can only guarantee that the minimum is produced and do not ensure the most and best research for the money invested. It cannot be guaranteed that the subsidy actually increases the output of non-excludable research by TEIs, as production of non-excludable research may not be distinguished from research that helps teaching and would be produced anyway.

Σ The Green Paper seems to consider that the ministry's role is to ensure that research contributes to teaching. Not all research benefits teaching, and the ministry cannot ensure research that benefits teaching takes place, much less measure the contribution of research to teaching. It is simply not feasible to expect that the ministry can ensure that the correct type and amount of research is done through minimum requirements.

- The case against compulsory research requirements is strong. Research may not be necessary for undergraduate teaching. The arguments for compulsory research requirements are paternalistic and conflict with the earlier arguments in the Green Paper that students are the best judges of teaching and that the system needs to be diverse. Minimum research requirements cannot assure good teaching or New Zealand's international reputation. It is difficult to justify a paternalistic attitude towards post-graduate students.
- Non-excludable research should be directly subsidised under a performance-based, contestable system. Research subsidies will then target the research that is under-provided in the market. TElS can organise themselves to produce each type of output in the most efficient way.
- As there are different costs and benefits associated with different methods of measuring and rewarding research output, the best way to subsidise research may be to have a number of mechanisms in competition. For example, a number of bodies using different methods could be set up, and their budgets could be adjusted according to performance on clearly specified criteria, based on maximising the value received from dollars spent. Weight should be placed on the demonstrated research achievements of applicants for research funding, including their success in winning private sector contracts.
- Direct research subsidies and measures of research performance give useful information to determine the appropriate level of subsidy. At the very least, they can be used to work out the cost of current research output.

#### *From section 4: Regulation*

- The justifications for quality regulation presented in the Green Paper do not stand up to analysis. A better approach than merely asserting that there is a need for higher quality is to examine how the market would operate and what

problems might arise, and to target intervention at the relevant problem. Both the costs and benefits of quality regulation need to be evaluated, and the government should only intervene if the benefits are likely to be larger than the costs.

- Quality is subjective and indefinable and is best left to the individual decisions of the students and employers, rather than made the responsibility of a costly and intrusive bureaucracy. The interests of consumers would be better protected by the development of a competitive market. Barriers to the entry of new providers in the tertiary education sector should be removed. The views of competitors should not be taken into account on whether new institutions and courses should be established.
- If accreditation is to be introduced to protect consumers, it should be voluntary and not tied to subsidies. Voluntary accreditation will place a market test on the value of information produced and whether it is worth the extra cost, give incentives for the quality assurance process to be performed efficiently, and prevent it imposing large costs. The accrediting role of the New Zealand Qualifications Authority (NZQA) should be funded by those who choose to use its services.
- Provider access to government subsidies should be dependent on objective criteria (preferably outcomes), allow for diversity, be competitively neutral and directly target any perceived shortcomings of the market. The general consumer protection and anti-fraud laws may be sufficient, particularly if students are given incentives to use government subsidies carefully.
- The case for government provision of information is based on the fact that provider reputation may not give sufficient information about quality and specialised information providers may not produce information for which the benefit exceeds the cost. On the other hand, the government may very well provide information for which the cost exceeds the benefit.
- For a government quality assurance mechanism to be justified, all four of the following conditions (each of which can be disputed) must be met:
  - that the quality assurance mechanism does ensure quality;
  - that it is the best way to ensure quality;
  - that the benefits of ensuring the extra quality exceed the costs; and

- that it would not be done in the market.
- Does the NZQA have the capacity or incentive to provide valuable information that cannot be provided in the market and to set the minimum standard at the efficient level? The potential costs from intervention are large and the benefits unclear.
- It is uncertain how intrusive the quality regulation proposed in the Green Paper would be. If the narrow definition of quality is to be adopted, then the assurance process focuses mainly on objective and verifiable information (search qualities). The benefits are likely to be small: search qualities are likely to be provided in the market (if it is efficient to do so) and students are likely to care more about the intangible or subjective aspects of education.
- Protection of the descriptions 'university' and 'degree' is not justified by the need to maintain New Zealand's international credibility. Removing the naming restrictions would have the beneficial effect of encouraging competition on the basis of the reputation of individual institutions. Membership of the New Zealand Vice-Chancellors Committee (NZVCC) by a university should not be compulsory.
- The Green Paper's proposal to regulate the number and type of providers should be rejected.

*From section 5: Provision*

- Governance reforms are required to complement and maximise the benefits from increased competition in the tertiary education sector, and to reduce the resulting fiscal risk to the government from ownership of TEIs.
- While TEIs remain in Crown ownership the proposed ownership strategy for reforming TEI governance and strengthening accountability should be adopted. TEI council members should be predominantly ministerial appointees selected for their skills and competence, with the balance co-opted rather than elected by stakeholder groups.
- The proposed capital charge should be implemented if TEIs remain government-owned, and access to private capital should be freed-up.

- The government should make explicit how it will deal with failing TEIs. It should codify and charge for any guarantee.
- The Green Paper does not establish any case for continued government ownership.
- Although the proposed governance reforms improve on the current situation, some problems remain. State ownership may be inconsistent with a competitive market. There is a clash between political accountability and TEI autonomy, with the risk of intrusion of political objectives. Incentives for efficient operation are weaker in a public organisation.
- The governance reforms proposed in the Green Paper should be adopted as a first step towards the privatisation of TEIs. The appropriate ownership form for TEIs should be considered on a case-by-case basis. The government should establish competitive neutrality between organisational forms.

## **APPENDIX A: EDUCATION FORUM**

The Education Forum has been formed to contribute to education policy through research and debate on the current issues, structures and expectations at all levels of New Zealand education.

The Forum believes that New Zealand education requires an approach to learning and achieving which encourages all individuals to reach their full potential, and which will take New Zealand to the leading edge of international performance and achievement.

The Forum is an association of individuals who have a common concern for the future direction of New Zealand education. The membership is drawn from primary, secondary and tertiary sectors of education, together with leaders of industry and commerce.

The principles incorporated in the above statements include the following:

- a commitment to excellence and high expectation in all human endeavour, based on a lifelong desire for learning;
- the belief that the community and government should ensure that all young New Zealanders have access to quality education;
- the teaching of values and life skills which will preserve the dignity of the individual and the integrity of the family;
- the acceptance of healthy competition for both individuals and the education sector;
- the encouragement of cooperation, creativity, adaptability and enterprise;
- the encouragement and recognition of personal responsibility, goal setting and achievement in all endeavours, through self discipline and hard work;
- the acceptance of a compulsory core curriculum in primary and secondary schools;
- the necessity for high standards of assessment of student performance and of accountability of teachers and institutions;
- the promotion of a New Zealand cultural identity;
- the key involvement and responsibility of parents in their children's education;
- the emphasis on the value of parental choice and the self-management of education institutions; and
- the development of closer links between education institutions and industry.

**PO Box 38-218, Auckland 1730  
Telephone: 09-273-1860 Facsimile: 09-273-1861**

## APPENDIX B: MEMBERS OF THE EDUCATION FORUM

Mr Simon Arnold  
Chief Executive Officer  
New Zealand Manufacturers Federation

Mr John Boyens  
Principal  
Meadowbank School

Mr John Fleming  
Principal  
Pt Chevalier School

Mrs Alison Gernhoefer  
Principal  
Westlake Girls' High School

Professor Peter Gluckman  
School of Medicine  
University of Auckland

Dr John Hinchcliff  
President  
Auckland Institute of Technology

Ms Jan Kerr  
Executive Director  
Independent Schools Council

Mr Roger Kerr  
Executive Director  
New Zealand Business Roundtable

Brother Pat Lynch  
Executive Director  
New Zealand Catholic Education Office

Mr John Morris  
Headmaster  
Auckland Grammar School

Mr Phil Raffills  
Principal  
Avondale College

Mr John Taylor  
Headmaster  
King's College  
Auckland

Ms Claudia Wysocki  
Headmistress  
St Margaret's College  
Christchurch

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