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# Sources of funds and quality effects in higher education

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## Abstract

Economists have suggested that the quality of higher education is not independent of the sources of funds used to fund that education. This paper examines the relationship between student measures of teaching quality and institutional revenue sources. The results indicate that a greater reliance on private subsidies is associated with higher measures of teacher quality. A greater reliance on public subsidies, however, leads to lower teacher quality ratings. The importance of these results for shaping public policy decisions is also discussed. © 2001 Elsevier Science Ltd. All rights reserved.

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“The endowments of schools and colleges have necessarily diminished more or less the necessity of application in the teachers. Their subsistence, so far as it arises from their salaries, is evidently derived from a fund altogether independent of their success and reputation in their particular professions.” (Adam Smith, *An Inquiry into the Causes and Consequences of the Wealth of Nations*, 1993 World Classics Edition, p. 421)

## 1. Introduction

More than two hundred years have passed since Adam Smith argued that the performance of institutions of higher education is influenced by the sources of their operating revenue. Economists and public policy-makers continue to debate the merits of private and public subsidies to higher education. However, there has been little research that examines the empirical relationship between the teaching performance of institutions of

higher education and the sources of funds. This paper makes use of teaching quality ratings based on student surveys as a measure of performance.

While student satisfaction is only one of many possible measures of academic performance, it is still an important measurement of educational performance. Students purchase education for many reasons. Higher education can be thought of as both a pure consumption good and as an investment in human capital. Students expect to obtain satisfaction from the consumption of the good and/or higher future earnings as a result of the consumption of the good. It is important to measure both the consumer satisfaction and consumer investment returns from the consumption of the good. The data in this paper focus on student satisfaction and not investment returns. The results confirm that the source of educational funds is related to students' perception of educational quality in an important manner.

## 2. University performance, behavior and the source of funds

### 2.1. Tuition vs. private subsidies

Smith's observations were based on a comparison of the educational system of Scotland, where masters'

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incomes were highly dependent on the number of students they could attract, with that of England, where schools were supported primarily by large endowments. Smith believed the latter system destroyed both the incentives to teach well and to teach useful subjects.<sup>1</sup> A related argument is that private donations are used to produce attributes desired by donors but not by students.<sup>2</sup> In some cases private donors or foundations may require that universities conduct certain activities or make specific changes that reduce educational quality.

Modern arguments concerning educational funding have been more accepting of private subsidies as a substitute for tuition. A university's ability to use endowment funds to ignore market demands is reduced if the institution requires expansion or if educational costs are rising. The competition for new donations forces the school to compete on those margins that attract additional donations. If donations are related to teaching quality, then a greater reliance on private donations may increase teaching quality (Friedman & Friedman, 1979). If the increased spending is devoted to those attributes that improve educational quality, then it should also lead to improved performance.

## 2.2. Tuition vs. public subsidies

The modern version of Smith's argument against endowments has been refocused on the influence of public subsidies to higher education. Friedman and Friedman (1979), Alchian (1968) and West (1995) argue that government funding has a negative effect on educational quality for reasons similar to Smith's opposition to private endowments. However, supporters of government subsidies to public education argue that the subsidies increase the quantity and quality of education provided. In addition to insulating faculty and administrators from the forces of the market, public subsidies may have effects on educational quality (e.g. Stubblebine, 1965; Peltzman, 1973; Lindsay, 1976).

The ultimate impact of government funds is dependent on the political environment in which they are determined. State government funds for higher education come primarily through direct appropriations to state institutions. The subsidy allows these institutions to set tuition levels below the average cost of providing the education. In order to satisfy the preferences of the median voter, state legislators have an incentive to make education available to as many of their constituents as poss-

ible.<sup>3</sup> While the subsidies may successfully increase educational access, they are likely to decrease the average quality of education. Local government funding is predicted to have similar effects because the nature of the funding and the incentives of local politicians are similar. It is important to note that a decrease in teaching quality does not mean that these subsidies do not achieve their purpose. Public subsidies may also increase the quality of education on other margins even if they result in lower teaching quality.

Federal government funds to higher education are normally in the form of grants from government agencies and not direct federal appropriations. Therefore, the pressures to increase the number of students and provide the education desired by the median voter are likely to be less intense. However, an increased reliance on federal funds will reduce the reliance of student based revenue sources. The most common criticism of federal funding is that teaching quality is lowered as the increased research activity diverts attention away from undergraduate teaching (e.g. Anderson, 1992). An alternative argument in favor of increased federal funding for research is that teaching and research activities are complements. If less than the optimal level of research would take place in the absence of such subsidies, then subsidizing research may increase teaching quality. Again, even if these subsidies decrease teaching quality, they may promote other valuable social goals or increase educational quality on other margins.

There are three potential effects of private and public subsidies to higher education. The subsidies will likely increase the total resources devoted to education, which may improve teaching quality. However, if these subsidies allow administrators and teachers to be less responsive to student desires, then the quality of teaching may decrease as a result of higher subsidies. Finally, if these subsidies are designed to satisfy the goals of private donors or politicians and not educational goals, then there is no reason to expect them to improve teaching quality. If fact, these alternative goals may not be consistent with increased teaching quality.

## 3. The data

The Princeton Review produces an annual *Student Advantage Guide to the Best 310 Colleges* that rates colleges on many attributes. Two of the ratings given for

<sup>1</sup> Smith's view was not universal among the classical economists. See West (1964) for further discussion.

<sup>2</sup> See Lindsay (1976) and the discussion later in this paper for a similar argument with regard to public subsidies.

<sup>3</sup> In related works Sisk (1981) and Sav (1987) find that state supported schools are more successful at enrolling but not graduating minority students. Lower graduation rates are a more likely outcome than lower graduation standards because the faculty retains control over graduation standards and they have little incentive to reduce the standards.

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