American colleges and universities have been sliding down an increasingly slippery slope over the last two decades. As more people have viewed higher education as offering mainly personal advantages, institutions have been able to charge higher prices to provide those advantages. Thus many public institutions have become less dependent on state appropriations, to the point that they now behave like private ones. At the same time, many private colleges -- especially those that because of small endowments must rely more than ever on tuition and research-grant revenues -- have virtually given up defining themselves in terms of their social and economic contributions to the community, state, or nation.

Much is lost when higher-education institutions are shaped almost exclusively by the desires of students pursuing educational credentials or businesses and government agencies seeking research outcomes. When a college or university is wholly dominated by market interests, it sacrifices much of its capacity to serve its public purposes and sometimes even its fundamental mission.

Yet, at this point, the question we must ask is not whether the growing importance of markets is detrimental to institutions, but whether anything can be done about it. It's clear that there will be no return to a simpler era when market forces played a less dominant role in American higher education. Nor is there any likelihood that colleges will become less costly or complex enterprises. The conversion of institutions into market enterprises will proceed apace, if for no other reason than that market income will continue to substitute for public appropriations.

Given that reality, the key to making the academy more publicly relevant and mission centered lies in making it, ironically, even more market sensitive -- or, to use the term that we have come to favor, more market smart.

Markets have, in fact, been part of the academic scene since the beginning. Clark Kerr, the former president of the University of California, once described the tension between the acropolis, with its focus on values and mission, and the agora, the Greek word for marketplace. Arguing that colleges always have served the market, Kerr went on to observe: "The cherished academic view that higher education started out on the acropolis and was desecrated by descent into the agora led by ungodly commercial interests and scheming public officials and venal academic leaders is just not true. If anything, higher education started in the agora, the market, at the bottom of the hill and ascended to the acropolis at the top of the hill. ... Mostly it has lived in tension, at one and the same time at the bottom of the hill, at the top of the hill, and on the many pathways in between."

To stay safely within the acropolis means losing the financial support and opportunities that the market brings. However, dwelling too much in the market exposes an institution to influences outside its control that may or may not align well with its values or mission. Then again, colleges sometimes have no choice: Public policy or their own lack of resources may force them into the market.
But does embracing the marketplace mean subordinating mission to market? Not necessarily, particularly if an institution uses the proceeds derived from the market to invest in its mission. Being mission centered and market smart is, in fact, shorthand for explaining university behavior from a rigorous model that is firmly rooted in economic theory.

Beginning economics courses teach that businesses try to maximize profit. Other factors may enter the equation, but companies that cannot provide adequate returns on investment will eventually be forced to merge or go out of business. Although no one claims that colleges maximize profits, some of the elements of the for-profit model have counterparts in the higher-education context.

What do colleges and universities try to maximize? The answer, of course, is that they try to maximize mission attainment: They want to produce as much high-quality education, research, and public service as possible given their circumstances. While colleges are not in business to make money, neither can they operate without it. Just like businesses, colleges cannot spend more money than they make over the long haul without having to merge or close.

The money available to colleges and universities comes from fixed revenues -- government appropriations, private donations, and endowments -- or from the variable "profits" of individual programs within each institution. As institutions depend less on fixed revenues, they must focus on obtaining more money from such activities, like the classes and majors that attract students or research that generates grants. But should all the money get plowed back into the programs that generated it? Probably not. Colleges are not allowed to distribute profits to owners as for-profit enterprises do, but they can improve their ability to attain their mission by reinvesting the profits earned in one activity to enhance other worthy activities.

Such "cross-subsidies" are a way of life in nearly every nonprofit college and university and, indeed, in any nonprofit enterprise that operates in multiple markets. To see why, imagine for the moment that you are looking over the shoulder of a provost as she ponders next year's faculty allocations for her college's business and philosophy departments. She knows philosophy lies at the core of the college's value system, but the department scrambles for students and loses money. The business department is not as central to the college's traditional values, but it turns away good students and produces financial surpluses.

Many professors in the philosophy department think the business department's success threatens the college's identity and hence its mission, despite -- or perhaps because of -- its profitability. They want new faculty slots to better cover the full range of specialties that make up the modern discipline of philosophy. However, some provosts, and perhaps most chief financial officers, would expand the business department to make it even more profitable and contract the philosophy department to reflect its smaller revenue base.

That strategy is one of "following the money," in effect letting the market rather than the mission determine department size. Other provosts might reallocate a few faculty slots from business to the philosophy department -- a strategy that would cater to mission but ignore the potential market consequences of larger classes or increased teaching loads in business.
The provost whom you are observing, however, knows that the nonprofit model requires a more complex calculus. Her thinking runs something like this: "Every program produces two goods: mission attainment and revenue from the marketplace. One might say these represent 'love' and 'money.' I'll expand a program if the extra love plus the extra money exceeds the variable cost of expansion, and vice versa; and I'll continue expanding or contracting until the sum of love and money just balances that cost. By doing this I'll produce more value over all than if I considered either love or money alone."

Using that logic leads the provost to expand both business and philosophy. Her decision process speaks volumes. To maximize a college's mission attainment, the provost is saying that she needs to take money as well as love into account. For her, money is no more a dirty word than love is a dreamer's escape. When called to explain why she is allowing business to expand, thus further distorting the college's historic mission, the provost responds: "No, I've not debased the college's values by 'putting money above love.' I'm using the 'profits' obtained by expanding business to boost mission attainment elsewhere, which will leave the college better off over all. Without the extra profits from business, for example, I might have to contract the philosophy department."

We have been using the term "profit" loosely to describe what the accountants would calculate as "margin." Margin is simply the difference between the revenue a unit generates and the direct cost it incurs. Positive margins provide sources of funds for cross-subsidies, and negative ones represent the cross-subsidies themselves. Unlike in the corporate world, where the rule is usually that marginal revenue equals marginal cost -- that programs should expanded only if the revenue from the market exceeds the cost of expansion -- the nonprofit rule holds that marginal mission attainment per dollar spent plus marginal revenue equal marginal cost.

Calculating margins need not be a precursor to decentralizing the budget process. In fact, information about margins is as important in centralized as in decentralized budget systems. To see why, suppose the provost you are observing has, in fact, maximized mission attainment as she and her colleagues see it. Suppose also that the accountants calculate margins of +$35,000 per faculty member for the business department and -$70,000 for the philosophy department. Business professors make money on average while philosophy professors lose it, so the former are more valuable in market terms. However, the college does not expand the business department to produce even more margin because that would detract from efforts to attain the institution's broader mission. Nonprofit theory shows that when an institution is perfectly balanced, its programs' incremental contributions to mission attainment are inversely proportional to their margins.

Also important in the example is the provost's acquisition of the necessary data and willingness to share them with the leaders of both the business and the philosophy departments. To make the mission-centered/market-smart strategy succeed, an institution must commit itself to transparency -- and such transparency requires more than revealing the president's salary or the athletics department's deficit. Transparency means, as a minimum, an agreed-upon set of rules and the necessary data to calculate margins -- even if, in the process of making those calculations, it becomes obvious that some departments, for example, have lower teaching loads or higher average salaries.
The payment of cross-subsidies distinguishes the non-profit from the for-profit enterprise. For-profit enterprises do not subsidize programs or product lines over the long run because they use their discretionary funds to provide payouts to shareholders. Colleges, however, have no shareholders to insist on market rates of profitability or corporate raiders waiting to step in if such profitability is not forthcoming. Nonprofit enterprises use their discretionary money -- assuming they have it -- to subsidize activities they believe will help them attain their mission. In principle, however, the nonprofit calculus is no different from a for-profit company's effort to boost shareholder value.

But what happens when a college or university is barely making it financially? It must behave just like a business. No money is available for subsidies because every dollar of incremental margin and fixed revenue must go to cover fixed cost. Without the ability to subsidize programs, the institution has no way to assert its mission. The institution must remain market smart to survive, but it can no longer be mission centered. The noble purpose of the nonprofit -- that is, its mission -- can be achieved only if it has discretionary funds.

The president of a midlevel private university once described what happened when the University of Phoenix opened a campus down the street from her institution. "In a few years," she said, "the new competition had squeezed all the profit from my M.B.A. program." It was obvious that losing that cash cow had curtailed her ability to provide cross-subsidies for other programs and attain mission in the same way she had before.

Yet does the potential for destructive competition mean that markets are something to be avoided altogether -- or, at best, a necessary evil? Stanford University, for example, charged no tuition during its early years. All support came from endowment and so was, in the present context, discretionary. But Stanford soon realized that it could do more, much more, if it tapped the tuition its students would pay for the quality of instruction that the university wanted to provide. Stanford made the same kind of decision a half-century later when it chose to expand faculty research by pursuing the newly lucrative sponsored-research market. Both revenue streams enabled the university to make substantial gains in serving its mission.

The lesson is that markets confer great benefits when the needs and wants of the marketplace and its inhabitants are well aligned with the university and its value system. Markets also make institutions more responsive to user needs and wants. While academic traditions are important, so are the demands of today's world. Few people would wish to restore the classical education in Latin and Greek, for example. Although missions can change as the result of conversations within the institution, there is nothing like an external stimulus with an economic edge to drive the conversations forward.

In addition, markets provide incentives for institutions to be more productive. The nonprofit model shows that a dollar saved in production cost is a dollar freed up for cross-subsidies, other things being equal. Such pressures can trigger productivity improvements that would not have been feasible otherwise.

Market forces drive institutions to evaluate what they do as well as how they do it. Colleges and universities trim subsidies to their least-valued programs in times of financial stringency. Sometimes such evaluations unearth more low-priority programs than are needed to balance the budget, in which case colleges may shift subsidies toward
higher-priority programs. Such substitutions might have occurred anyhow, but the marketplace often provides the impetus.

A similar process occurs when corporations, in response to competition from others, mount cost-cutting drives to rescue their profits. Less-necessary functions that grew up during good times get excised when times are tough. Shedding unproductive lines of business is an example of the same phenomenon, one that we have suggested might apply to colleges, as well. The anonymous and decentralized market forces tend to override arguments against change from inside the institution, no matter how powerful the proponents. While institutions may not always want to adapt, change is a necessary condition for efficiency in a dynamic environment.

The bottom line, then, is that markets can help institutions attain their missions and perform important public purposes. The challenge for the academy is to make sure that market success remains the means, not the end. Institutions can exploit opportunities to gain revenue, but those opportunities must be reasonably in sync with its mission. If not, the activities required to get the revenue will hurt the institution more than the extra money helps it.

Colleges and universities must avoid getting caught in that trap, no matter how enticing the additional revenue may appear. Their goal should be to remain mission centered by spending wisely and productively the margins generated by being market smart.

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http://chronicle.com
Section: The Chronicle Review
Volume 51, Issue 45, Page B6