COMPETITIVE NATURE

Can traditional economic theory of competition help lower tuition?

by Daniel L. Bennett

Each year, colleges and universities ramp up their recruitment efforts to attract as many qualified applicants as possible, while students compete for admissions offers. In the United States, more than 20 million students are enrolled at nearly 4,500 postsecondary institutions. Economic theory suggests that competition generates lower prices. With an apparent abundance of competition among schools for students and students for admission, why then have tuition fees grown at an average annual nominal rate of more than 6 percent, more than double the annual rate of inflation, over the past three decades? There are at least three reasons.

First, key assumptions of the theory of competition leading to lower prices are violated in the current structure of the higher education marketplace. The theory supposes that full information is available, yet there are gaping informational asymmetries in higher education. As an example, consumers (students and

their parents) provide nearly full information concerning their academic qualifications and ability to pay when applying for college and financial aid. This provides institutions with sufficient information to evaluate the merits of all prospective students, as well as the opportunity to engage in price discrimination by extracting as much tuition from a given student as possible. Consumers, on the other hand, receive very little information they can use to evaluate the relative quality of the various institutions to which they consider applying, as student outcomes such as learning assessments and career placements are seldom measured, much less made available. Therefore, shopping for value in a college education is nearly impossible.

The second reason, which is related to the first, is that colleges compete for students on institutional reputation rather than value or price. Since information pertaining to the value of an institution is not available, students instead rely on a signaling mechanism in an attempt to evaluate the quality of schools that they are considering. Colleges signal their level of quality by doing things that enhance their reputation and cost loads of money, such as building lavish facilities, fostering nationally competitive athletics teams and emphasizing research over teaching. Colleges are also adept at allocating resources to areas that are measured by the various college ranking publications in an attempt to increase their relative standing. It would be difficult to argue that many signaling activities add educational value, but it is certain that they are all cost drivers.

The competition for prestige combined with the disparity of information in the higher education marketplace suggests that colleges more closely resemble monopolistically competitive institutions than perfectly competitive ones, meaning that they offer similar products that are seemingly differentiated enough that institutions can exhibit a degree of pricing power over students. In economic jargon, colleges act as price setters while students are relegated to being price takers, hindering price competition.

Finally, competition in the higher education market is severely distorted by the presence of exorbitant amounts of third-party revenues. The main culprit is government subsidies, which include both direct institutional transfers and student aid programs. In the case of the former, only public colleges receive direct subsidization, giving them a competitive advantage in terms of pricing over non-subsidized institutions. Financial aid programs distort the decision making of consumers as these

In economic jargon, colleges act as price setters while students are relegated to being price takers, hindering price competition.

third-party payments tend to obfuscate the final price that students pay. It is much easier to agree to buy something when you can forego payment or when someone else is footing the bill than when you have to come out of pocket. As a result of both types of subsidies, competitive pricing forces are lessened.

Given the continual rise of the price of college, one might be tempted to discredit the applicability of economic theory to higher education. This would be an incorrect supposition, as several of the assumptions underlying the theory of competition leading to lower prices are violated in the higher education marketplace. In order to harness the power of markets to generate lower prices for college education, we need to transition from reputation-based competition to value-based competition. This can only be achieved if information on student outcomes is made available to alleviate the current informational asymmetries and give consumers of higher education an opportunity to shop for value. In turn, institutions would then face pressure to allocate resources to areas that improve educational value, which will reduce some of the profligacy of higher education. In addition, the higher education marketplace would be more competitive if all government subsidization permitted educational choice so that institutions compete for students and their revenue rather than currying a competitive favor to one type of institution.

Daniel L. Bennett is a Ph.D. student in economics at Florida State University and a Research Fellow at The Center for College Affordability and Productivity. He may be reached by email at dbennett2@fsu.edu