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How America's Universities Became Hedge Funds

In August 2009, just one month after the state of California cut over a billion dollars from its higher education budget, the University of California (UC) turned around and lent the state $200 million. When journalists asked the UC president, Mark Yudof, how the university could lend millions of dollars to the state, while the school was raising student fees (tuition), furloughing employees, canceling classes, and laying off teachers, Yudof responded that when the university lends money to the state, it turns a profit, but when it spends money on salaries for teachers, the money is lost.

Welcome to the university as hedge fund world. In this strange new world, institutions of higher learning care more about interest rates than educational quality. In fact, Harvard cared so much about reducing the cost of borrowing money that it made several expensive credit default swaps, which resulted in a loss of hundreds of millions of dollars and the halting of an ambitious expansion plan. Not only did Harvard gamble on interest rates to support future construction plans, but it moved much of its endowment into high risk investments, and the result is that the world's wealthiest education institution is now claiming poverty.

Risky Businesses

Like Harvard, the University of California was seduced by the Yale endowment manager, David Swenson, who inspired universities throughout the country to shift their investments from secure bonds and treasury notes to volatile equities and commodities. At first, schools were showing high rates of return in their investment and pension portfolios, but when these investments turned south, the universities lost billions of dollars of savings. In fact, the UC lost over $23 billion dollars in its combined pension and endowment funds, and this loss will take years to recover.

Of course, universities will say that everyone lost money in the global financial meltdown, but schools like Harvard, Yale, and the University California lost so much more than everyone else because they followed Swensen's model of shifting funds into supposedly low-risk, high-yield assets. Moreover, these schools were pushed to gamble big in their investments in order to keep up with their expensive spending habits. For the fact of the matter is that when these universities were getting double-digit returns on their investments, they continued to jack up tuition, borrow more money, and increase compensation to the top earners, but now that bottom has fallen out of their investments, they are left with no choice but to eliminate the non-tenured faculty who currently teach a majority of the students. Since it is very difficult to lay off tenured faculty, and administrators are resistant to get rid of other administrators, the only thing left to cut is the instructors without tenure, and this means courses will be cancelled and class sizes will be expanded. In short, students will be paying more and getting less because big bets did not pay off.

To understand how both public and private research universities have gotten themselves into this mess, one needs to understand five inter-related factors: the state de-funding of public education, the emphasis on research over instruction, the move to high-risk investments, the development of a free market academic labor system, and the marketing of college admissions. These different forces have combined to turn universities into corporations centered on pleasing bond raters in order to get lower interest rates so that they can borrow more money to fund their unending expansion and escalating expenses.

The Defunding of Higher Ed

Starting in 1980, as part of the Reagan revolution and the desire to cut the taxes of the wealthiest Americans, states began to reduce their funding for public universities. In order to counter this loss of funds, public research universities had to look for other revenue streams, and not only did they raise tuition to make up for the reduction of state support, but they also expanded the research parts of their budget.

This move to find new revenue through research activities was enabled in 1980 by the passage of the Bayh-Dole Act, which allowed universities for the first time to buy and sell research produced at federally funded labs. Not only did this law push universities to seek profits by selling the results of their research, but the move to increase research triggered a major expansion of administration and staff. It turns out that in order to perform high-level research, schools need to hire an army of lawyers, accountants, regulators, and staff. After all, they have to have administrators and staff to run compliance offices, regulate research centers, oversee venture capital enterprises, and to administer fund-raising activities. They also need administrators to watch over the other administrators, and then they need staff to collect the information so that administrators can watch over other administrators, and of course, these institutions need computer staff to compile the data to give to the staff so they can give it to the administrator who gives it to another administrator, and once one gets to this level of complication, one needs a whole set of other people to see if everyone is following the state and federal guidelines, and the expansion continues to infinity.

A result then of the growing emphasis on research is that the number of administrators has expanded, while the number of faculty has remained flat. For instance, during the last decade, the number of administrators in the UC system has doubled, while the number of faculty has increased 25%; in fact, nationally, there is now one higher ed administrator for every faculty member. Moreover, many administrators pull in huge salaries, and they often bring with them a purely corporate mentality that is in conflict with the stated missions of educational institutions.

Pleasing the Bond Raters

To support the expansion of research and the increased cost of bureaucracy, universities have to borrow huge sums of money. For example, during its recent financial crisis, the University of California applied for over a billion dollars for construction bonds, and almost all of this debt will go to build new research facilities. In response to these bond applications, Moody's gave the UC system a high bond rating, which will result in low interest rates, further fueling more borrowing. Moreover, as UC Santa Cruz Professor Bob Meister has revealed, the UC is using student fees and tuition as collateral for its construction bonds. In this modified credit swap, students are forced to take out subprime students loans, often charging 6% interest, so that the university can borrow money at a reduced rate.

Not only do the bond raters help to determine the cost of borrowing, but they also tell universities what they should do in order to attain a clean bill of fiscal health. For instance, Moody's slipped into its bond rating for the UC system, the need for the institution to restrain labor costs, increase tuition, diversify revenue streams, feed the money-making sectors, and resist the further unionization of its employees. Like the IMF or World Bank, the bond raters tie access to credit to the dismantling of the public sector and the adoption of free market fundamentalism.

In the case of the UC system, it appears that the President Yudof is taking his marching orders from the bond raters and is doing everything in his expanded powers to feed money into the privatized profitable sectors, while starving the non-revenue generating public areas, like instruction. Yudof's core values were revealed when he described the fiscal status of the UC system on the PBS News Hour: "Many of our, if I can put it this way, businesses are in good shape. We're doing very well there. Our hospitals are full, our medical business, our medical research, the patient care?-so we have this core problem, who's gonna pay the salary of the English Department? We have to have it. Who's gonna pay it, and Sociology, and the humanities, and that's where we're running into trouble." For many people inside and outside of higher education, Yudof's statement may seem jarring, but for bond raters, his argument makes perfect sense. From a purely financial perspective, there are profitable ventures and unprofitable ones, and only the areas bringing in money should be nourished.

Of course, lately, bond raters have been proven to be questionable experts when it comes to predicting the financial health of institutions, and in the case of judging universities, not only do the raters seem to have the wrong values, but they also have the wrong numbers. In contrast to Yudof's statement, the reality is that it is the humanities and the social sciences that actually subsidize the research centers and not the other way around. Studies have shown that humanities' programs often educate most of the undergraduate students, and they do this with relatively inexpensive teachers and low overhead. In fact, most humanities' departments turn a huge profit that is then distributed to support the supposedly profit-making sectors. Since federal and corporate-sponsored grants often fail to cover the full cost of buildings, administration, labs, staff, maintenance, and utilities, money has to be taken from undergraduates and humanities programs to subsidize the research sectors.

Marketing Academic Labor

The twin engines of increased debt and an emphasis on research have fueled a third new market force, which is the academic free agent system. In order for universities to remain highly ranked, they feel that they must compete for the best faculty, and the best faculty are often defined by how much other schools are wiling to pay them. In the UC system, for example, there is an official salary scale, but over 85% of the faculty are now off the scale, and this means that many of them have negotiated private deals with a dean. Not only does this system turn everyone into competitive individualists, but it also circumvents the peer review process that is supposed to be at the heart of the modern democratic university.

In elite private and public universities, many faculty members search for outside offers from competing institutions every year so that professors can renegotiate their deals, and these deals not only include higher compensation but also less time in the classroom. One of the results of this system is that the more universities pay star professors, the less teaching they do, and the less loyal they are to the institution. In turn, star faculty, administrators, and coaches hold universities hostage by threatening to go to a competitor. This compensation system has gotten so out-of-hand that in 2008, there were over 3,600 employees in the UC system making more than $200,000.

Marketing Enrollment

Mirroring the free market star economy is the market-based enrollment system. Universities now believe that to get the "best" students, they have to offer the best aid packages, and what has happened is that many top universities have moved much of their financial aid from need to merit. One of the problems with this structure is that merit is often based on SAT scores, and SAT scores have been shown to be heavily correlated with wealth. The end result of switching from a need-based to a merit-based financial aid system is that lower- and middle-class students end up subsidizing the wealthiest students because in order to give the top students large aid packages, the universities have to raise the tuition on everyone else.

In his book Tearing Down the Gates, Peter Sacks has shown that not only do SAT scores predict the wealth of the students' parents, and not the success the students will have in college, but SAT scores also determine a school's ranking in the all-powerful U.S. News & World Report college guidebook. Therefore, by accepting students with high SAT scores, universities not only increase their rankings, but they also bring in wealthy students who will help build the schools' endowments in the future.

The speculative market-based system that universities use to recruit students is coupled with the way these institutions spend lavishly on new facilities to attract potential enrollees. It seems that universities believe that is easier to please students outside of the classroom rather than inside, so they pour money into new fitness centers, entertainment complexes, sports arenas, restaurants, and shopping malls. Of course, all of these extracurricular activities require expensive new buildings, which require more debt, and more efforts to please the bond raters.

The expansion and revenue diversification of American universities has gotten so out of hand that research universities, like UCLA, now spend less than 5% of their total budget on undergraduate instruction. No wonder universities feel free to expand class sizes and hire people off of the street to teach required courses; instruction is just a small part of what these institutions now do, and since there are no accepted methods to judge the quality of undergraduate instruction or learning, there is no incentive for schools to put their resources into educational activities.

The lack of educational quality control in higher education results in a continual increase in tuition costs because universities have no incentive to concentrate their efforts and budgets on instruction. Since no one is rating or ranking these schools on what students are learning or how effective the professors are at teaching, these institutions feel free to spend student tuition dollars and state funding on expensive research and bloated bureaucracy. In fact, while most schools insist that students are not paying the full cost of their education, UC Berkeley professor, Charles Schwartz has shown that virtually every university inflates the advertised cost of education so that they can constantly raise tuition and use the added income to support profit-making ventures and risky financial investments.

Possible Solutions

To make the spending habits of universities more transparent and to make them prioritize undergraduate education, the first thing that has to be done is that the federal government needs to insist on a shared system for assessing instruction at American universities. Rather than basing a school's reputation on the SAT scores and the high school grade point averages of the incoming students, the new system of assessment should actually look at how much the students are learning in their classes and how effective the teachers are in promoting quality education. It is important to stress that this type of national quality control already exists, but universities refuse to publish the findings of the National Survey of Student Engagement (NSSE) and The Collegiate Learning Assessment (CLA). Instead of using these scientific methods of assessments, schools, students, and parents rely on highly questionable rating guides like The U.S News & World Report.

If education, and not just research and SAT scores, became the key to a school's reputation, these institutions would be forced to put money into instruction, and this process would reverse the current practice of using student tuition dollars to subsidize research and administration. Furthermore, once there is an accepted method for rating the quality of instruction, we can begin to drive down the costs. After all, what often makes tuition go up is that students and taxpayers are forced to fund the escalating salaries of professors and administrators who often have no connection to undergraduate instruction.

The next essential change for universities is to admit that some researchers should only research, and some teachers should only teach. Therefore, universities need to establish three types of professors: Teaching Professors, Research Professors, and Hybrid Professors. This model will help to clear up many problems because if we stop forcing all research professors into the classroom, we will be able to allow them to concentrate on what they do best and avoid what they sometimes do in an ineffective manner. In fact, the common practice of states and students paying for expensive research professors to teach ends up driving up the cost of instruction and allows people who have a proven record of being ineffective teachers to continue to lower the quality of instruction. Furthermore, the entire incentive system at research universities privileges research over teaching, and so for many research professors, we should simply make the research priority the rule and get rid of the false myth that research and teaching go hand-and-hand.

If we allow researchers to be rewarded for what they do best, we should also provide incentives for teachers to concentrate on instruction. By providing tenure for the people who do most of the teaching at research universities, undergraduate instruction can become an important priority. While some professors may say that by splitting research off from instruction, we are losing the whole point of going to a research university, studies show that the research mission often robs the instructional budget, and there is no proof that a good researcher will make a good teacher; in fact, the opposite is often the case. Once teaching becomes a priority and schools stop robbing their instructional budgets to pay for other things, it will be possible to teach students in small, interactive classes. Moreover, if we create a third class of professors, the hybrids, who would be judged equally for their research and their teaching, we can reward the people who do bring together new knowledge with effective instruction.

To help motivate research universities to make some of these changes, parents and students should sue schools for false advertising. The simple fact of the matter is that many universities present false information concerning class size and who really does the teaching at their institutions. Also, schools make inaccurate claims concerning the cost of undergraduate education, and by inflating budgets, tuition is driven up. Universities have to clearly state how they spend their money, and the federal government, which provides financial aid and research dollars to both private and public institutions, should be able to hold these institutions accountable. The government can also step in and stop guidebooks from using false and misleading information. After all, a college education is one of the most important and expensive purchases in a person's life, and accurate and truthful information should be provided.

Finally, the federal government must insist on budget transparency and a careful monitoring of how grants and endowment funds are managed. Currently, Senator Grassley is investigating how the UC medical schools are using NIH grants, and his office is trying to determine how billions of dollars of federal money are being allocated. His staff has insisted on an external audit of the medical schools' budgets, and so far the senator's office has been unable to determine if federal grants are being used for their intended use. This lack of budget transparency and clarity shows why we need to force universities to provide clear and reliable information. Without increased regulation and oversight, these institutions will continue to function as volatile hedge funds that ignore their central mission, which is after all instruction and not construction.