

# THE STRUCTURED EXIT

## A Four-Part Series on Limited Government in Wyoming

### Part 2: Privatizing the University of Wyoming

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**Disclaimer:** This paper proposes a reform model that would allow the state of Wyoming to turn the University of Wyoming into a private institution. The analysis that leads to the conclusion in favor of privatization is based primarily on financial and fiscal variables. The author is well aware that there are major legal and constitutional questions to be answered before there can be a complete plan for privatization. The status of the university as a land-grant institution is one of those.

While it would have been desirable to present a report that fully covers those issues as well, there are two valid reasons for leaving those issues out.

First, the paper series of which this report is a part is focused on reform models to expand economic freedom in Wyoming; the path to more economic freedom runs through the reform and eventual termination of tax-funded, government-provided entitlements. Education is one type of entitlements on this list. However, reforms of entitlements must be executed based on a solid understanding of economic principles and the functioning of free market system. By necessity, this means that any reform proposal must begin with an understanding of the economic conditions under which such reforms can be executed. Legal analysis can follow only when there is an economic case to be made for privatization.

Secondly, while it is highly desirable that laws and especially a constitution remain unchanged for as long a period of time as possible, it is also worth noticing that laws of government can be changed; laws of economics can not. If the laws of economics make it likely that an entitlement program can be reformed, and if legislators with the appropriate jurisdiction approve of the reform, then it is their moral duty to change all the laws necessary to allow the entitlement reform to happen. A need for popular vote to complete a change to the state constitution does not liberate state legislators from their moral duty to pursue reform.



Not even the constitution is beyond reform if that reform promotes economic freedom. If a constitution prescribes that government provide entitlements, and if it can be established by analytical argument that said constitutional prescription is antithetical to economic freedom, then there is a strong case for constitutional reform.

### *Thinking the Unthinkable*

Budget deficits are as old as government but did not become a topic relevant to economists until tIn a speech in 2000 at Erfurt University in Germany, then Chancellor of the University of California at Berkeley, Robert Berdahl, explained how both America and Germany have benefited from a long tradition of private higher education.<sup>1</sup> The history of independent, private colleges and universities is long on both sides of the Atlantic Ocean, though for obvious historic reasons longer in Europe, but it is in the United States that the private tradition has reached its fullest potential. Not only do private universities dominate domestic U.S. rankings of academic institutions, but they also populate a clear majority of the spots on the global list.<sup>2</sup>

At the same time, as Berdahl explains, there is a key role for government to play in education. Toptier American universities would have difficulty sustaining some of their world-leading research programs, and by implication their graduate schools, if the federal government did not fund some of their research. Berdahl specifically points to the role that federal money plays in the sciences.

Public universities, while rarely matching private schools in terms of research and academic excellence, have provided a path for many students to a successful professional career that may otherwise not have been open to them. However, it is important not to confuse the existence and continuous funding of state universities with the federal grants that pay for important research at private (and public) universities.

State colleges and universities provide under-graduate education for large numbers of students, subsidized by state appropriations. These appropriations pay for the production of a service at an artificially reduced cost, i.e., a cost that is lower than what the free market would have priced it at. (If the free market offered the same service at a lower price than the tax-subsidized cost, then the state university would be an inefficient institution the continued existence of which would lack fiscal merit.) Because the cost is subsidized below free-market costs, it is by definition an income-redistributive entitlement. A student benefiting from the tax subsidy is paying less because someone else – the taxpayer – is paying more.

Established microeconomic theory explains why this kind of economic redistribution is distortionary. It is possible to make a case against economic redistribution based on such theory. However, this paper will take the argument of distortion as given. Instead, this paper acknowledges three arguments for privatization that are more directly related to legislative considerations. The first two are mentioned briefly:

- The principled argument, which is based on natural-rights philosophy along the lineage of John Lock and Robert Nozick.<sup>3</sup> Briefly, it concludes that government should be strictly limited to the functions of protecting life, liberty and property within the confinements of the minimal state. Any government activity beyond that violates rightly earned property rights (Locke), the principles of justice in acquisition (Nozick) and, by implication, the sacrosanctity of life (Nozick). Since education requires redistribution of property (financial or other) between private citizens, it violates the principles of the minimal state.
- The practical argument. Private universities consistently perform better academically than public universities. According to the U.S. News and World Report annual ranking of national universities, eighteen of the nation's 20 top national universities are private. Among four-year liberal arts institutions, only the United States Naval Academy can compete with the nation's top private colleges. While public schools are a somewhat larger minority among top law schools, the overwhelming conclusion – admittedly solely these rankings – is that a college or university is better off academically being private than public.

A third argument concentrates directly on the relation between the overall funding of a university and the appropriations that states provide on an annual basis. This argument has its roots outside the college market itself. As a result partly of an extended recession, partly of structural overpromising of entitlements, states in general have recurring problems funding their spending obligations.

Wyoming is no exception. As reported in the first paper in this series, the Cowboy State suffers from a structural budget deficit where welfare-state spending (health care, education, income redistribution and poverty relief) is growing at least twice as fast as the state's broadest tax base, GDP. In a nutshell: even if the state government taxed every economic activity that contributes to GDP, and even if those taxes had no negative effects on the growth of those activities (an audacious assumption), state tax revenue would still not be able to keep up with the growth in welfare-state spending.

The existence of a structural budget deficit leads to the inescapable conclusion that the Wyoming state government must begin reforming its spending programs. But not any kind of reform would do the trick, so to speak: since the excess spending growth is permanent in nature, reforms to fix it must be permanent in nature.

It is not a permanent reform if the level of an existing spending program is reduced. The nominal reduction does not change the parameters inherent to the program itself. The growth rate, in turn, is determined by the quality of the promises made in the program – the entitlements provided – and the eligibility criteria.

A permanent reform must terminate the spending promise itself. Put plainly: transfer the entirety of the promise to the private sector.

In terms of higher education, there is really only one way to do this in Wyoming that will have any substantial effect on state spending: to privatize the University of Wyoming.

### *Arguments for privatization of public universities*

Proposals to privatize American universities are few and far between. It is not an item that tends to rise to the top when state legislators need to reduce the size of their budgets. (It is possible that one reason for this is that examples of state legislators considering budget reductions are themselves few and far between.) This in itself indicates that proponents of limitations on government are not inclined to use principled arguments against state higher education; principled arguments are independent of circumstances and can forcefully be made at any time.

In the rare instances when privatization of state higher education are discussed, the argument for privatization is driven by fiscal circumstances. A good example is the debate about the future status of the University of Michigan.

The debate started with a paper published in 2004 by the Mackinac Center, a free-market think tank in Lansing, Michigan. The paper proposed a complete transfer of the University of Michigan into private hands. While the idea did not get much political traction at that time, it was revived six years later on a 27-page long list, produced by the state budget office. The list suggested future spending cuts but was, according to the Ann Arbor News which reported on the document, not endorsed by either outgoing Governor Granholm or incoming Governor Snyder. It therefore once again fell on the political back burner.

The idea of university privatization keeps popping up, though, most recently in Louisiana. However, the Mackinac Center report is thus far the most elaborate and compelling proposal of its kind, and therefore a good reference point for an analysis of the potential for privatization of the University of Wyoming.

The Mackinac report's primary argument for privatization is financial, though it does tangentially mention the principled and, more in depth, the performance arguments. As for the principled argument, the report points to the effective imbalance between the university's formal status and actual funding: while being an almost 200-year-old public university, the university receives less than six percent of its funding in the form of state appropriations.

Academic performance plays a bigger role in the privatization case:

Since its founding in 1817, the University of Michigan has attained a global reputation as an academic and research powerhouse, attracting some of the world's brightest students and top faculty. Its ranking among other universities, however, has dropped sharply in recent years, and the school has seen top faculty lured away by more generous offers from private universities.

This argument for privatization, while valid in itself, should be put in perspective of the ranking of the University of Michigan at Ann Arbor. According to the U.S. News and World Report it places 29th in the country, with a fall-semester acceptance rate of 33.3 percent, a freshman retention rate of 97 percent and a 90-percent 6-year graduation rate.

In other words, with retention and graduation rates comparable to top-ten ranked private universities like Duke and Dartmouth, the University of Michigan is still a strong educational institution. Using its ranking as an argument for privatization can come across as eclectic flea killing.

Nevertheless, it is an indisputable fact that the nation's top universities are almost without exception private institutions, and one could make the case that a university needs to be private to be able to rise to the top tier.

In addition to the performance argument and the tangential principled point about the status of the University of Michigan, there is a compelling financial reason for its privatization: the taxpayers of Michigan would save more than \$300 million per year.

How do these arguments from Michigan translate to Wyoming? Assuming the performance argument as given, it comes down to the financial status of the University of Wyoming, and the cost of the institution to Wyoming taxpayers.

### *The role of state appropriations*

When the Mackinac Center proposes the privatization of the University of Michigan, it does so based on the well-established fact that the Michigan state government only makes a marginal contribution to the university budget: in the past two fiscal years less than five percent of its revenue has been in the form of state appropriations. With less than \$300 million per year coming from the state, out of a budget of more than \$6 billion, it is easy to make the general point that the university should have little problem filling the gap if the state legislature terminated state funding.

However, public funding of higher education is a bit more complicated than that. Within the more than \$5.7 billion that is not state-appropriated, there are several grants provided by the federal government. Furthermore, many students go to college carrying with them federally guaranteed student loans – effectively a form of government funding.

Both the federal grants – which are tied to specific and often competitive research projects – and the federally guaranteed student loans can go to both public and private institutions. They are therefore different in kind from state appropriations. The question whether an academic institution wants to accept federal grants and student loans is important, but different in nature from its legal status and its status as a recipient of state appropriations.

For this reason, it is fair to conclude, as the Mackinac Center report does, that the University of Michigan, receiving only about five percent of its funding from the state, is a convenient case for transition into private status.

Can the same definition of transferability make an equally compelling argument for privatizing the University of Wyoming? The answer lies in a side-by-side comparison between the two institutions.



In terms of enrollment and total budget, the University of Wyoming is a small university:

- Univ. of Michigan 28,300 undergraduate students, \$7,674m annual budget;
- Univ. of Wyoming 10,100 undergraduate students, \$528m annual budget.

State appropriations budget shares differ substantially:

**University of Wyoming**

	<b>FY2013</b>	<b>FY2014</b>	<b>FY2015</b>
Total budget	\$544.7m	\$528.4m	\$528.7m
State appropriations	\$260.8m	\$250.8m	\$261.2m
State share	47.9 percent	47.5 percent	49.4 percent

**University of Michigan (no official budget for FY2015 available)**

	<b>FY2013</b>	<b>FY2014</b>
Total budget	\$6,651.3m	\$7,674.1m
State appropriations	\$315.9m	\$321.7m
State share	4.7 percent	4.2 percent

Reformulated as dollars per undergraduate student, the state pays \$24,832 per student at University of Wyoming but only \$11,367 per student at University of Michigan. The Wyoming perstudent state share is 2.2 times higher than in Michigan.

It deserves to be pointed out that the difference in perstudent funding is not an implication of any formula for state appropriations. The University of Wyoming reports the bulk of state appropriations as going into its General Fund, which in turn is used as a platform for paying faculty and staff salaries. The University of Michigan does not report its state appropriations in any similar fashion.

***Three steps toward privatization of the University of Wyoming***

As reported above, the state government in Wyoming is comparatively deeply involved in its university. This is both a compelling reason for, and a challenge to, privatization. It is a challenge in terms of numbers: while it is entirely possible that the University of Michigan, with a little bit of planning, could replace five percent of its revenue in one year, it is beyond all reasonable expectations that the University of Wyoming could replace close to half of its appropriations in that short of a time.

At the same time, the university's heavy dependency on state appropriations makes it vulnerable to future budget cuts. Two analytical arguments align to support this point: the first paper in this series which – again – establishes that Wyoming suffers from a structural budget deficit; and the two latest reports from the state's Consensus Revenue Estimating Groups, which point to a very challenging budget situation in the next 3-5 years.

The longer the state legislature waits with addressing the pending budget crisis, the more likely it is that the lawmakers will resort to panic-style, rapid-fire budget cuts. If they do, the overarching goal will be a reduction in spending numbers; the quality, distribution and long-term effects of the cuts will at best be of secondary importance.

This is a point that the Board of Trustees of the University of Wyoming should consider. If the state legislature gets to a point where its spending cuts are panic-driven, the Board and the university could find themselves facing considerable cuts from one fiscal year to the next. This would seriously impact the ability of the university to plan its own operations under predictable circumstances.

From the state's viewpoint, in turn, a reduction of annual outlays by approximately a quarter of a billion dollars is a reasonable start on a path toward a more sustainable state budget. The question at stake is whether or not there is a reasonable formula for transitioning from heavy dependency on state funding to all-private revenue.

Fortunately, Wyoming is one of a very small group of states that is in a position to address this question. Our state is financially well suited for structurally reforming its spending programs: while the state budget suffers from a structural deficit, the state has big savings that make it a relatively simple matter for the legislature and the governor to fund a privatization plan for the University of Wyoming.<sup>4</sup>

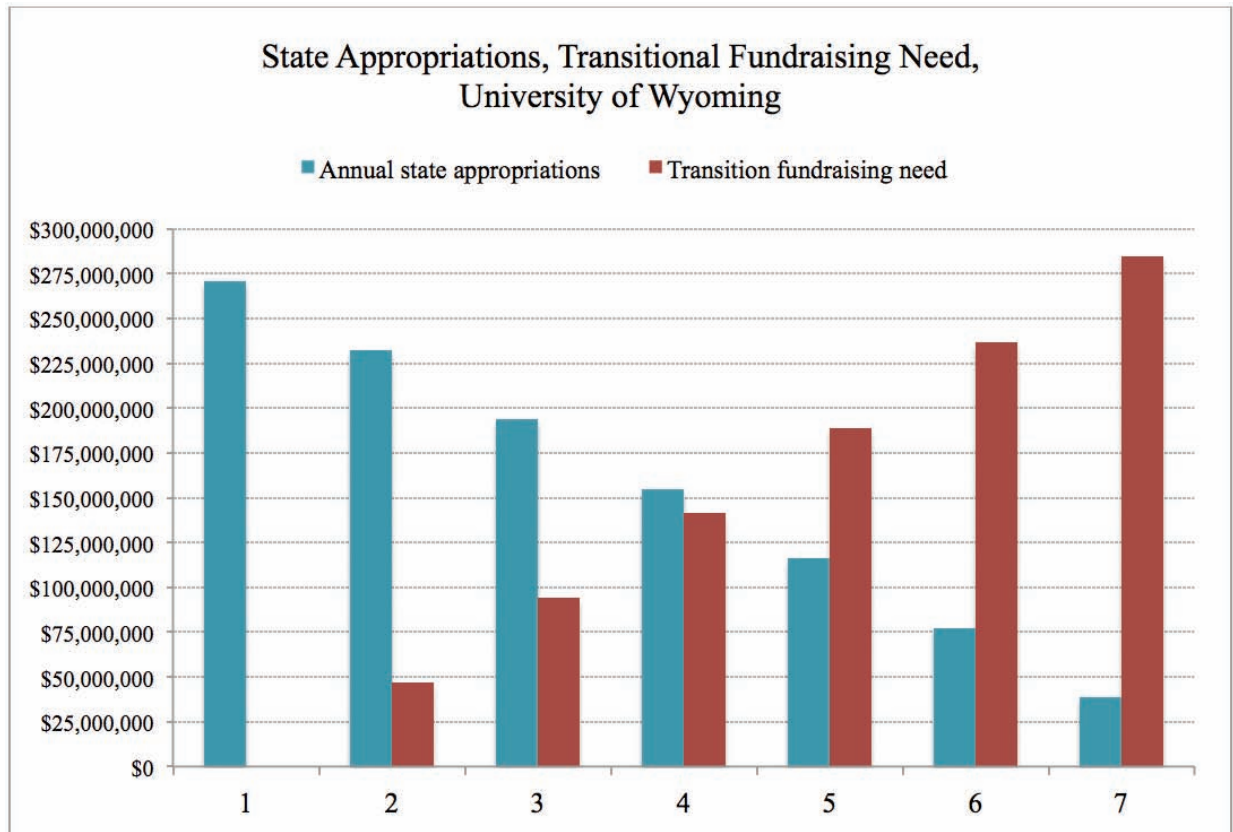
The following plan is based on two assumptions: the reform period is eight years and Sections I and II of the university budget will grow by three percent per year over the reform period.

### **Step 1 - Set aside \$1.12 billion in a transition privatization fund.**

The state will pay down this fund over a period of seven years. Year zero, the state increases its appropriations for the university from current \$260 million to \$320 million. This one-time increase gives the university some "breathing space" in its budget to reorganize its efforts in compliance with the privatization plan.

Presumably, some of this money is invested in fundraising. As a result of the assumed three percent annual budget increase and the gradual drawdown of state appropriations, the university will replace state funding according to a phase out-phase in pattern reported in Figure 1:

Figure 1



### Step 2 - Privatize the graduate school.

Over the past decade the University of Wyoming has maintained largely the same total body of students. However, the share of graduate students has declined:

- In 2003 it had 13,100 students enrolled, of which approximately 28 percent were graduate students;
- In 2013 the total number of students was 12,800 but only 21 percent were in graduate school.

This transition toward being an undergraduate educational institution is not to the long-term advantage of the university, but it is helpful for a privatization. In order to guarantee high-quality graduate education, a university needs to have a faculty with an active research agenda. Active research, in turn, merits grants and independent donations.

By concentrating state appropriations on undergraduate education, the Wyoming state legislature can start its privatization plan by concentrating all graduate education to a separate entity. That entity is then privatized, operating with an affiliation agreement to the University of Wyoming during the period where the university itself prepares for privatization.



Legal issues aside, the major problem with this partial initial privatization is the overlap of educational resources between the graduate and undergraduate entities. Faculty teach both undergraduate and graduate courses; department offices, classrooms, laboratories, etc., are used by both entities. However, these problems are of a practical nature and resemble other “cohabitation agreements”; many universities have research institutes, even think tanks, residing on campus.

The goal is to start the pursuit of private-only funding where it has the greatest opportunity to be successful, and that is the graduate school. If faculty is able to increase outside funding for their research, it will be a sign of rising quality of the work being done by active scholars.<sup>5</sup>

It is a generally established fact that universities with research-active scholars tend to be better at undergraduate education as well. By creating stronger incentives for grants-funded research at the university, the state of Wyoming can raise the likelihood that the university comes out of the privatization process as an overall stronger academic institution.

### **Step 3 - Privatize the under-graduate section and the remaining parts of the university.**

Once the last step is complete, the university will once again be operating as one entity, though this time as a private school.

### ***Conclusion***

There is always more short-term rewards, tangible and intangible, in promoting status quo than in proposing change. Human nature has an inherent tendency toward preserving predictable, static conditions of existence; humans tend to transfer this preference for the predictable to the laws, institutions and cultural and social norms that govern human society. While a good principle by default, this tendency toward habitual conservatism is not always the best choice.

Prevailing wisdom in politics and public policy is colored by the human preference for status quo. This creates an intuitive resistance toward reforms, with the resistance rising proportionately – sometimes exponentially – with the reach of the reform. However, as is well demonstrated by the documented fiscal problems awaiting the Wyoming state government, a generally positive legislative preference for status quo can become a burden and a cause of considerable economic problems.

Put bluntly: with a structural deficit already present in the state budget, and with no plan at its hands to deal with said deficit, the Wyoming state legislature must part with any intuitive preference for status quo. Its members must think out of the box to avoid far more serious problems than they are currently faced with. They must, simply, start thinking about major reforms to major spending programs – reforms that will permanently improve the fiscal shape of the state government.

Solutions to the problem of a structural deficit must be structural in nature. They must reform, on a permanent basis, the spending programs that are the origin of the structural deficit. The privatization model outlined in this paper is an example. While incomplete as the groundwork for

legislative action – as mentioned there are considerable legal and constitutional issues associated with privatization – this paper opens the conversation and explains what tangible steps would allow for a change in the formal status of the University of Wyoming in compliance with sound reform principles.

### *Endnotes*

<sup>1</sup>Berdahl, Robert M: *The Privatization of Public Universities*; Office of the Chancellor of the University of California at Berkeley; May 23, 2000.

<sup>2</sup>The World University Rankings, Times Higher Education. Available at: <http://www.timeshighereducation.co.uk/world-university-rankings/2014-15/world-ranking>

<sup>3</sup>Locke, J: *Second Treatise of Government*, Watchmaker Publishing, 2011; and Nozick, R: *Anarchy, State and Utopia*, Basic Books, 1971.

<sup>4</sup>Please see: [http://sao.state.wy.us/CAFR/2014\\_Report/2014\\_05\\_Financial\\_Basic.pdf](http://sao.state.wy.us/CAFR/2014_Report/2014_05_Financial_Basic.pdf)

<sup>5</sup>There is no reason to doubt the current quality of the research being done at the University of Wyoming. The general point here is merely that good always can become better.

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