Universities engage in a variety of activities ancillary to their central mission of education. Most provide athletic services and food services both to students and faculty and staff. Many run book stores, art museums, hospitals, and health maintenance organizations. Most universities manage endowments and process a range of financial transactions. Increasingly, in the last decade, universities have begun to privatize many of these ancillary services, to move them out from under the university umbrella and contract for their provision by (typically) for-profit providers. This paper examines the move toward privatization of the support services associated with high-
er education, drawing parallels with a similar, earlier trend in the public sector. It provides a simple framework for evaluating the costs and benefits of such privatization and then explores some of the management issues involved with alternative contracting practices.

Privatization in the Public Sector

In the last several decades, the federal government has been engaged in a process of devolution to states and cities of much of the authority over the composition and level of services provided to the populace.¹ Increasingly, the role of the federal government has been to generate funds through its powerful taxing mechanisms, and set broad priorities, while leaving the business of providing required goods and services to other agents, both governmental and not. Lester Salamon, one of the most interesting current writers on governmental privatization, has referred to this as the emergence of “third party government.”² One measure of the extent to which the federal government has contracted out its work is the low growth in public sector employment relative to the growth in the federal budget itself. Much of the federal dollar is going to pay wages to nonfederal employees.

As states and localities have been given increasing control over service areas and incremental funding, a parallel, albeit somewhat later, revolution has occurred in the way these local governments have gone about their business. States and localities have begun to push out the responsibility for much of the actual service provision to contracted organizations, both nonprofit and for-profit. In most cases, the stimulus for the privatization was cost reduction. The perception that government is, by and large, an inefficient producer of services is almost universal. As the National Governors Association articulated in 1993, “Proponents of privatization believe that private enterprise can deliver the same services government provides for less money, with higher quality services and more flexibility.”³ Indeed, studies indicate that the early adopters of privatization were disproportionately localities with high union coverage and high wages and find that there are substantial cost savings from private provision of such services as garbage collection and the like.⁴

Nor is the trend toward privatization of local services confined to the United States. Beginning in the 1980s, a policy called Compulsory Competitive Tendering required all local governments in Great Britain to open a wide range of services to bidding by for-profit operations. The result has been considerable privatization within Britain of services such as garbage collection, provision of food services in schools and other public facilities, grounds maintenance in public areas, and security. Again, cost savings appear to have been considerable.⁵

Of course, not all public services have been privatized, nor have all observers been equally enthusiastic about the process. Turning again to the National Governors Association, “Opponents [of privatization] believe such efforts undermine the quality of services, destroy public employee unions, invite corruption and weaken government control of services key to the public interest.” Current debates
on privatizing large segments of welfare reform, including most prominently employment services, similarly question whether for-profit firms will be appropriately incentivized or easily monitored. As we will see, the battle lines have been similarly drawn in the university setting.

The Magnitude of the Issue

The twin core missions of the research university are to educate its students and to further the production of research, a public good. In accomplishing these missions, the typical university supplies its students and faculty with a number of other services: it houses and feeds them, sells them books and computer services, and provides security and health care. It is the provision of these ancillary or support services that universities are increasingly beginning to consider turning over to other providers. At the University of North Carolina, for example, a task force is currently investigating privatization of 51 university services, from housekeeping and grounds maintenance to food service.6 A look at an actual university budget gives an idea as to how large a piece of the pie these services occupy. The situation at Yale University is illustrative.

In 1995-96, Yale University had an operating budget of approximately $1 billion. What fraction of this budget might be on the table in a discussion of privatization? At present, Yale provides health care to both its students and its employees through the Yale Health Plan, a staff-model health maintenance organization under the Yale umbrella. Its 1995-96 expenditures were just over $20 million. The campus security program of approximately 80 officers and a budget of $7 million might plausibly be privatized. Computing facilities, including a retail outlet, have expenditures of approximately $10 million and might be turned over to a private operation. Academic and student support, largely food services and housing, comprise approximately $25 million and is currently a hotly contested category for potential privatization at many universities. Yale’s several museums have a combined budget of about $10 million. Finally, the largest category for potential privatization at Yale and elsewhere is the facilities budget. This budget is largely comprised of expenditures for repair and maintenance, and equaled about $50 million in 1995-96, some of which is already being paid to outside contractors. The hospital and bookstore, both of which are under university auspices at many institutions, are already outside the system at Yale. Using a modest reckoning, expenditures for support services make up about 10 to 15 percent of Yale’s total budget. To the extent that privatizing some or all of these functions could reduce costs, the effect on the typical university budget could be substantial.

The interest in privatization is far from academic in the current environment of budget tightening at most universities. The difficult question is whether there is any basis for thinking that privatizing any of these functions could reduce costs, and, if so, whether there would be any concomitant adverse effects on the ability of the university to achieve its overall mission. We turn to that issue now.
The Comparative Advantage of Nonprofit and For-Profit Systems

Organizational form affects the ability of an organization to accomplish various tasks to survive in its marketplace. The different governance structures associated with the nonprofit and the for-profit impose different constraints on the behavior of managers, and offer different incentives to them. Organizational form may influence the perceptions of the customers of the organization and the government officials regulating those organizations. In some markets and for some tasks, large, well-integrated, highly diversified corporations are most successful. In others, small, flexible entrepreneurial operations can best meet the changing needs of the marketplace. In still other markets, with different tasks, nonprofit organizations or public institutions are the most efficient producers of goods and services. Because different forms are more or less able to meet the technological, social, and economic demands of a market, as markets change, so too the right organizational form for a task may change. Thus, we ask: What are the advantages and disadvantages of the nonprofit form and how does the comparative advantage of the nonprofit map into the requisites of the ancillary operations of the university? Is there reason to think that the nonprofit university, which may be well suited to the task of educating undergraduates, has an advantage in running a book store or health maintenance organization to serve these undergraduates?

The economics literature on the reasons nonprofits developed is illuminating as we think about the comparative advantage of the nonprofit. Early theories of nonprofits emphasized the role of contract failure in the evolution of the nonprofit. In the traditional markets described in elementary economic textbooks, products are assumed to be easily judged by consumers who both pay for the good and then use it. Under these conditions, products that are a bad value are ultimately forced out of the marketplace by consumers who eschew their purchase and use. In the nonprofit sector, the typical good looks very different. Many nonprofits produce goods or services that are complex, and difficult for a user to judge in terms of quality. Much health care falls into this category, as does education. Moreover, many of the goods and services produced in this sector are paid for by people who do not ultimately benefit from the good or service. For example, a donor to Save the Children is typically an affluent North American, while the beneficiary of the donation is often an impoverished Asian, African, or South American. Much of the true cost of a college education is covered by returns on endowment funds, given many years in the past by long-dead alumni and by the foregone taxes of the public. As a consequence of this profile of the typical nonprofit product, the usual story about bad value products being forced out of the marketplace is less compelling. Indeed, firms may have an incentive to produce goods of lower quality (and thus lower cost) than they claim to be producing, since the ability of customers to monitor quality is low. In situations in which goods and services are not easily judged by purchasers, these purchasers will begin to seek other ways to guarantee that firms are delivering on their claims.

What is the competitive advantage of nonprofits
in markets where reputation and trust are important? The hallmark of a nonprofit organization is that it cannot redistribute its profits; it operates under the nondistribution constraint. Such organizations have reduced incentive to exaggerate the quality of their products, since it will not result in an appropriable surplus. Consumers tend to trust nonprofit organizations because they recognize that the managers in these firms have different incentives than their for-profit counterparts. Of course, this same difference in incentives may have adverse consequences under different production conditions, as we will explore later.

The contract failure arguments just developed could equally well be thought of as an explanation for the public provision of goods. The public sector supports these activities with taxation and creates trust with the ideology of government and the civil service. The nonprofit sector uses donations and creates trust with its ideological staff. Part of the shift from the public to the nonprofit described earlier comes from the diminished belief by the public in the efficacy of the public servant.

A complementary literature on the sources of the nonprofit form has focused on the preferences of the people who work for the nonprofit sector. Nonprofits are often ideological organizations; in fact, religion has been called the “godmother of nonprofits.” A substantial number of nonprofits, including many private universities, have an ideological origin, religious or secular, and their continuing ideological focus serves to attract workers. Indeed, there is some evidence that workers give up salary and benefits to take nonprofit jobs. Thus, potential workers sort themselves out: those principally interested in economic incentives will move into the for-profit sector, while those interested in psychic income will move into the nonprofit sector. This worker sorting meshes well with the reduced ability of the nonprofit to give sharp incentives to its workers. In the context of the complex production functions characterizing the nonprofit sector and thus the absence of clear performance measures, strong reliance on performance type incentives is typically counter-productive.

This characterization accentuates another of the features of the nonprofit sector: the existence of a variety of constituencies, each of whom has some claim over the surplus of the operation. Most nonprofits generate revenue from a mix of donations and product or service sales, and all are granted some tax relief. Thus, clients, donors, and government all have some claim over the organization. To the extent that staff take reduced pay to serve the nonprofit, they too have claims on the operation. As a consequence, nonprofit decision making is inevitably both more complex and more political than for-profit. If we put these various theories together, a picture emerges of the areas in which nonprofits are likely to have a comparative advantage: Nonprofits perform well in the provision of complex, hard to evaluate goods and services. In this environment, the ability to sharply reward managers is less important than the ability of those managers to keep focused on matters of long-term reputation and goals and to balance the interests of the various constituents who have a stake in the operation. These are qualities that could perhaps also belong to the ideal college president.

At the same time, the nature of nonprofits
makes some activities more difficult to perform. One of the central management problems of the nonprofits is raising capital. By virtue of the nondistribution constraint, nonprofits are precluded from issuing equity, since equity is simply the right to a share in the residual revenues of an operation. Even debt is often harder for a nonprofit to raise, since many of its assets may be quite specific to the enterprise and thus worthless as collateral. Yale College buildings are extraordinarily valuable in their current use, but their value in alternative use in New Haven is quite small. Bennington College, which some years ago faced a major financial crisis found that the credit markets placed a low value indeed on their buildings. Thus, nonprofits in general, and universities in particular, may find it difficult to find adequate capital to grow if the minimum efficient scale of some of its operations grow. Some argue that this need to access capital to keep up with the new larger, optimal scale of operations is the driving force behind the recent conversions of nonprofits to for-profits in the health care area.

It is not only lack of access to equity capital that limits the scale of the modern nonprofit. For many nonprofits, including the university, accomplishing the central mission is made more difficult as size grows too large: there are, after a point, diseconomies of scale. The typical nonprofit is best described as a professional bureaucracy. In these bureaucracies, professional codes, developed outside the particular organization, exert strong controls on staff, and independence is a highly valued job trait. Flat hierarchies with decentralized control and informal cultures work best in such organizations. But this form of organization typically does not work well at very large scales. For nonprofits such as universities, comprised of highly autonomous professional workers very connected to their own professions, problems of control and motivation increase rapidly with size. And the success of typical, labor intense nonprofits depends on the efforts of those workers. As William Bowen, a long-term student of the university, suggests, “the production function of a university is peculiarly dependent on the attitudes of the all-too-fallible and all-too-human participants in the enterprise.”

Thus, the typical nonprofit will find it difficult to undertake activities with a high minimum efficient scale. An additional problem area for nonprofits stems from their environments, in which learning to balance the needs of a variety of constituencies is critical, and decisions are almost always political. Successful nonprofits become quite adept at such balancing. The processes of decision making developed in this environment are filled with checks and balances, and attentions to interests of competing stakeholders. For some functions, however, less cumbersome, less participatory, more businesslike decision making focused principally on dollars and cents turns out to be more efficacious. And here the nonprofit governance structure may be dysfunctional. University managers may lack both the incentives and the practice for engaging in non-political decision making.

We thus have a sense of the kinds of operations nonprofits in general and universities in particular are not likely to do so well: functions that exhibit a high minimum efficient scale and in which
sharp incentives and single-minded decision making are important for success. Accomplishing the central mission of the university requires relatively small scale economies and an administrative system geared to managing conflicting constituencies. These traits may be dysfunctional in other activities the university seeks to undertake.

Figure 1-1 summarizes the discussion on the appropriate territory of the nonprofit versus the for-profit. On the x-axis, we measure the clarity and singularity of the objectives of the activity. The y-axis measures the extent of scale economies in the provision of the service. Activities in the top left quadrant, for example, are characterized by high scale economies and clear, unambiguous goals. Here the for-profit form dominates for reasons of both scale and decision making efficiency. For goods or services that do not require large scale, but have clear goals, smaller for-profits are typical. For activities with more complexity and lower scale needs, in the lower right quadrant, the nonprofit form is effective. Finally, services like modern health care, which need large scale but are complex, lie between the sectors. These functions are the most problematic in current debates on privatization.

Figure 1-1: Organizational Form Matrix

<table>
<thead>
<tr>
<th>Extent of Scale of Economies</th>
<th>Complexity of Goals</th>
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<tbody>
<tr>
<td>Low</td>
<td>Low</td>
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<tr>
<td></td>
<td>Use smaller for-profit</td>
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<tr>
<td>High</td>
<td>High</td>
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<td></td>
<td>Use large for-profit</td>
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Complexity of Goals

This is not to suggest that activities exhibiting substantial scale economies and clear goals should be excluded from the university setting. Many of these activities, such as food and housing, may be a required part of student life and thus essential to the university setting. The critical question here is not whether these activities should exist but whether they should be run by the university rather than contracted out. The existence of substantial economies of scale makes it expensive for most universities to keep these activities as part of the university system. The existence of relatively simple, clear goals for an activity makes it both less compelling to turn to the nonprofit firm and reduces the transactions costs of contracting out to a more efficient supplier.

In considering the complexity of goals associated with university activities, there is yet another layer to the problem. In particular, some activities appear to have relatively simple goals on their own, but are so intertwined with other pieces of the university that separating them out becomes problematic. In economics, we would say there are either strong economies of scope across activities, or spill-over effects across activities. Here, too, there is an argument for internalization.

Consider now the placement of the variety of ancillary services provided by the typical university in the matrix above. In decades past, bookselling was accomplished by a variety of typically quite small operations; minimum efficient scale was quite low. In 1958, for example, 90 percent of all bookstores, comprising 72 percent of all bookstore sales,
were made by stores that were not part of any large chain. Moreover, college bookstores were considered places to develop young minds, not just market to them. Thus, most bookstores were under the university umbrella and in our matrix would have been placed in the lower right quadrant. But in this industry, technology has proven to be a force of change. Improvements in information technology, particularly in the areas of inventory control and invoicing, have greatly increased the advantages of large size in the industry, creating the super stores like Follet and Barnes and Noble. By 1995, chains encompassed about 40 percent of bookstore sales. Under the force of this technological change, many traditional college bookstores have proven too costly. The University of Pennsylvania is only one of the most recent universities to turn its bookstore over to Barnes and Noble.

Indeed, the large chains now control approximately 35 percent of sales at college bookstores, including ten of the 20 college bookstores in the Tennessee system. What has happened is that changes in the book distribution industry have raised minimum efficient scale—leading to a nationwide increase in the concentration of book sellers—and started pushing book stores up in the matrix, increasing the comparative advantage of the large, for-profit chain. At the same time, and perhaps in part as a reflection of the privatization of bookstores at some college campuses, the mission of the bookstore became narrower, focusing on the business of merchandising, rather than on the added business of intellectual proselytizing. Of course, some have mourned the demise of the broad mission of the bookstore and its transformation from a seller of low margin university press tomes to a purveyor of high margin sweatshirts and pennants. James Shapiro, writing recently in the Chronicle of Higher Education, complained, “In the course of little more than a generation, college bookstores have passed from the center to the periphery of intellectual life on campus.” The typical college bookstore is now firmly lodged in the top left quadrant of figure 1-1, pushed there by the force of new scale economies.

What about the repair and maintenance of college buildings? This function has historically been in the lower left corner of the matrix—low scale requirements combined with clear, uncomplicated goals. Buildings need to be cleaned and repaired at minimum costs. The workers hired for these tasks are interested in wages and working conditions, and not likely to be more or less attracted to a nonprofit versus a for-profit operation. Thus, nonprofits have no particular advantage in accomplishing the task. On the other hand, this is a case in which the complexity and political nature of the university decision making process create some potential pitfalls for nonprofit management. At universities that manage facilities themselves, particularly those like Yale located in poorer cities, managing the facilities staff can become a matter of social policy, with discussions of wages and working conditions tied not to the market, but to fairness and social justice. It is the desire to liberate this area from the interest group politics that characterize the university setting that has led many universities to privatize this function, particularly in light of the tightened budgets that many universities...
currently face. Thus, colleges like Vassar and Barnard have begun to privatize, turning the management of their workforce over to a for-profit company, Facilities Resource Management Group, a newly emerging leader in the field. Emmanuel College, a small Boston school, recently turned its facilities management over to R.M. Bradley, a large property management company.\textsuperscript{21} In this case, in contrast to the example of the bookstore, the position of the activity on the matrix has not changed, but the for-profit sector’s advantage in managing activities within the quadrant have become more manifest as university budget pressures have increased.

The source of the pressure for privatization of facilities management is evident from the nature of the opposition to such privatization. In general, unionized labor at colleges and universities has been the biggest opponent to privatization. Several years ago, a plan by the University of Southern Mississippi to turn over the operation of its physical plant to Marriott was killed by employee opposition.\textsuperscript{22} Similar union concerns have been raised at Yale. The prospect of moving away from the political, stakeholder management style to a more businesslike mode is clearly a matter of concern to nonprofit unions, as it has been to public sector unions in the parallel privatization move.

As a last example of possible privatization, consider the college health service. In the university setting, and in general, the governance structure of health care operations has changed drastically. Increasingly, the roles of health insurer and health provider have become conflated. We see this most dramatically in the Blue Cross/Blue Shield family. These traditional health insurance companies found that to control medical costs it was necessary to move from a system in which independent doctors were reimbursed for services provided to a system in which the payer—here the insurer—controlled the doctor. In the health care area, we have seen growth in both economies of scale and economies of scope, and both developments have pushed the sector towards the for-profit alternative. As was the case in the bookstore example, scale-augmenting technical changes (and here social change) have created pressures on the health centers managed by universities. At George Washington University, for example, the entire medical center was recently turned over to a national, for-profit health care company, which immediately injected $125 million into the system.\textsuperscript{23} But here the movement out from under the university’s umbrella has been less smooth, for in terms of figure 1-1, the health service is best located in the ambivalent upper right quadrant, needing the scale of the for-profit, but the balancing judgment and mission-focus of the nonprofit. The goals of university health organizations are often quite complex, and include serving as a site for teaching as well as healing. The workers are typically health professionals, who may well have ideological interests in working in a university setting; thus, privatization may adversely influence productivity. For large universities, the solution will typically be to retain health services within the academy. Indeed, the University of Texas has recently expanded its university health maintenance organization. As University of Texas spokesman Lester Howe explained, “It’s important we have access to patients to be able to teach our students,
residents and fellows...This [the new HMO] is an effort to make sure our patient base is not deple-ted. As very responsible stewards of our state’s medial education, we must be concerned for our students, interns and residents. For smaller colleges and universities, the situation is more difficult. As minimum efficient scale of operations grows, the tension between the need to realize efficiencies and the desire to preserve the flavor and spirit of the university health service will come increasingly into conflict.

Some Issues in Contracting Out

A college or university should consider contracting out activities that produce goods and services that are simple and relatively easy to evaluate. There are two reasons for this. First, the natural advantage of the nonprofit in dealing with complex hard-to-measure services plays no role in the outsourcing setting and, indeed, may create problems by politicizing what should be simple market transactions. Second, the existence of simple goals facilitates the contracting process. But even services and activities that are relatively easy to evaluate, may encounter complications in university contracting.

Consider the typical situation in which a university is driven to an outside vendor by growth in scale economies in a support service. In large markets, multiple potential suppliers will normally exist, and competition among them will help to insure that efficiency advantages accrue at least in part to the university. When scale economies are substantial, technical efficiency may well be achieved by having only one vendor. Under these circumstances, however, the university may be trading an inefficiently small and bureaucratic internal operation for a highly efficient monopolist with substantial bargaining power. The result may be the market equivalent of going from the frying pan into the fire. Indeed, it may well be that the fear of hold-up by an outside monopolist originally led many small universities, located in isolated areas, to vertically integrate into support services. Even in situations in which a university is forced to confront a monopoly vendor, however, there may be safeguards.

In the typical situation, the university will privatize a service by contracting out to one or more of a number of bidders. The presence of multiple bidders provides some protection for the university, as each seeks to offer a package attractive enough to win the contract. However, even for relatively simple operations, it is unlikely that the contract can spell out all possible contingencies, and when contracts are incomplete, opportunistic behavior on the part of the vendor is likely as long as the interests of the vendor diverge from those of the buyer. For example, some lines of merchandise that have high profit margins for the bookseller may be, in the university’s view, inappropriate in the college setting. A for-profit health plan may place a lower value on physician access than the university would like. In both of these examples, all of the possibilities are hard to spell out in advance. Avoiding opportunistic behavior by the for-profit vendor is one of the central challenges of privatization, both in the public sector and the nonprofit sector.
The opportunistic behavior of a monopoly vendor can be controlled through credible threats to take the business elsewhere for the next contract. The university’s ability to make such threats credible depends, of course, on the availability of other viable vendors. Thus, institutions located in isolated areas with few alternative vendors, or those in situations in which carrying out the contract requires the development of relationship-specific capital that gives the current vendor a substantial competitive advantage in providing the service, the university will find its own bargaining position deteriorating over time. Indeed, it may be profitable in the long run to retain relationships with secondary vendors. In some cases, the institution may need to actively help new firms enter a market, perhaps by sharing capital costs. In other situations, colleges and universities may opt to maintain some level of internal capacity as a way to improve their future bargaining power. Here, the university pursues a hybrid strategy, supplying some of its needs internally, and some via an outside vendor. The presence of secondary suppliers or internal supply has option value for the university.

The presence of internal capacity to accomplish a task could help protect a university against the demands of a monopoly supplier. There are other advantages in pursuing a hybrid privatization strategy. In particular, the outside supplier can discipline the inside bureaucracy. A growing number of universities now use bidding processes for various tasks, in which inside departments compete against outside vendors—a clear attempt to marry market and hierarchy.

**Conclusion**

Colleges and universities across the United States have turned to privatizing support services as a way to reduce costs in the current times of tight budgets. In the higher education environment, as in businesses more generally, the strategy of sticking closer to a core mission while relying on more specialized suppliers for other services has become more attractive. Future challenges for academic administration will involve managing the highly charged, political transition to private operations of services and learning to contract with organizations that are often considerably more experienced in contracting. As those in the public sector have learned, privatization means changing the nature of managing—from managing internally to managing the external relationship. Adjusting to this change will be a challenge for university administrators.
Endnotes


7 The link between organizational form and effectiveness has been pursued in a large and growing body of economics literature. Early work includes that of Ronald Coase, 1937. More recent work has been developed by Oliver Williamson, in multiple papers and books, 1975 and 1985.


14 Sharon Oster, “Nonprofit Conversions in the Health Care Sector,” working paper (June 1997).


16 For some nonprofits, the problems of expansion are overcome by the use of franchises, which allow for a variety of loosely connected, small scale oper-
ations (see Oster, 1996). This form has thus far not been used in university education, though it does appear at other educational levels.


25There is a large literature on opportunistic behavior under conditions of incomplete contracts. See, for example, the classic example Ronald Coase, 1937; Oliver Williamson, 1975 and 1985; Alchian and Demetz, 1978.