The Economic Bases for Regulating Philippine Higher Education

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Abstract

This paper explores how Philippine higher education may be organized so that its institutions and incentive structures would be consistent with national aspirations. It identifies several market failures in higher education – its club-good attribute, its externalities, the monopolistic cost structure of higher education institutions, and its information asymmetries – that, under a free market setting, would result in suboptimal outcomes. But it is also wary that direct state provision can result in government failure due to bureaucratic inefficiencies, policy volatility, and the high cost of public funds, the combined effects of which in the case of the Philippines may outweigh the market shortcomings. Thus, the paper advocates for a carefully designed, independent regulatory agency dedicated to higher education (a) that is empowered with a clear mandate to drive progress toward the nation's higher education related aspirations; (b) whose regulatory framework aligns the incentive structure of stakeholders with these aspirations; (c) whose rules explicitly (*i*) insulate the agency from government interference, (*ii*) require strict adherence to norms of behavior, such as maintaining arms-length relationships with all stakeholders, transparency, public accountability, and fairness, and (*iii*) anticipate and prevent failures of regulation, such as capture and time-inconsistent policy making; and (d) is staffed by technical experts who can design and enforce targeted interventions to address identified market failures.

The Challenge

How ideally should Philippine higher education be organized such that its institutions and incentive structures support the achievement of the national goals for which higher education may be both a means and an end in addition to the sector's own social welfare objectives, while ensuring that higher education institutions (HEIs) fully perform their institutional roles, and the proposed reforms are cognizant of the widely varied contexts in which they will be introduced? In a textbook treatment, the economist-as-social planner would explore this question as a mode-of-provision design challenge, where the proposed solution(s) would optimize social welfare.

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The Aspirations and Settings

The economist-social planner would likely begin his quest by articulating national aspirations for higher education. And he may come up with the following list (which implicitly acknowledges that (higher) education outcomes are a distinct dimension of human flourishing but contribute to its full realization as well, so that (higher) education is an end in itself):

- The goals that (modern) Philippine society sets for (basic and) higher education are to:
  - (a) develop the country's human capital in breadth and depth in order to make its workforce globally competitive and future-proofed against the technological and other disruptions of the 21st century, especially so that the Philippines would be able to maximize its demographic dividend, and
  - (b) transmit Filipino culture, values, history, and identity to future generations (in a mature-adult sense) to ensure the cohesion of Philippine society and inculcate love of country.
- The (welfare economics) sectoral objectives of (basic and) higher education are to improve:
  - (a) access to education, in general, and schooling, in particular;
  - (b) operational efficiency in school administration (and other delivery modes of education);
  - (c) the distributional equity of schooling opportunities (rather than schooling outcomes); and
  - (d) education quality, learning outcomes, and student success.
- The roles that (modern) society expects higher education institutions (HEIs) to perform are to (see, for example, Barber et al., 2013):
  - (a) confer academic degrees (as certifications that graduates have the necessary life skills (for human flourishing) and are adequately prepared for the world of work);
  - (b) conduct research to push out the boundaries of knowledge (since HEIs are a modern society's primary repositories and vanguards of knowledge); and
  - (c) enhance the economic prospects of the geographic area within its sphere of influence, which may be the city or local district, the province or domestic region, the entire country, the international region, or even the whole world (since, among modern society's various institutions, HEIs have the widest and deepest intellectual resources).

Lastly, the planner could note that, in the Philippine context, there is wide diversity in the local conditions of communities; the specific visions and missions of schools (along with the faculty and their academic fields); and the education-based aspirations of students and their families, private industry, the local and national government, and other stakeholders – all of which his proposed solution(s) will have to account for, so that at the outset a one-size-fits-all, top-down administrative and governance structure cannot be the proposed mode of provision.

The Market Constraints

Under ideal conditions (including that stakeholder preferences are consistent with the articulated national aspirations), the market – guided only by Adam Smith's invisible hand (pun intended) – would deliver socially optimal outcomes. The planner would readily see, however, that market failures are rife in (basic and) higher education. And his list of problems and observations may include the following:

- Education, arguably, is a club good rather than a pure public good;[2] its benefits are excludable but nonrival. On excludability, the argument is that, in principle, a school can restrict admission to its campus and program offerings. On nonrivalry, it is that, barring congestion in the learning environment, students may *simultaneously* attend the same lectures, study the same learning modules, work on the same assigned homework, and use school facilities such as the library, gym, and computer and science laboratories.
- Education has external or spillover benefits (or costs). It is generally believed that educated people are more informed as well as civically responsible and engaged citizens and that public information is more easily disseminated among educated citizenry. A more educated workforce is also thought to set an economy on a higher growth trajectory. (On the other hand, educated persons have been known to apply their skills for ends detrimental to the common good.)
- A school has a monopolistic cost structure.[3] Its upfront fixed costs are very large in proportion to total cost. To set up a campus, a school has to have property rights over and to develop a relatively large tract of land on which buildings, with classrooms, laboratories and other facilities, and offices, have to be constructed and maintained along with other physical infrastructure (such as roads and foot-traffic pathways, parking spaces, potable water and waste disposal services, and the campus's internet backbone, among others). At low enrollment levels, variable costs (such as faculty and personnel compensation) are minuscule relative to the initial fixed costs.

[2] In economics, goods (and services) may be classified by their consumption benefits, which are evaluated on two criteria: rivalry and excludability. The following table shows the resulting four categories of goods:

Types of Goods by their Consumption Benefits

	Excludable	Non-Excludable
Rival	Private Goods	Common-Resource Goods
Non-Rival	Club Goods	Public Goods

Because nonrivalry and nonexcludability each give rise to some market failure, the free market is not an ideal mode-of-provision institution for common-resource, club, and public goods as its outcomes would be predisposed to overutilization (for common-resource goods), cream-skimming or underutilization (for club goods), and free riding (for public goods).

[3] This issue is explored in the essay "The Monopolistic Cost Structure of Higher Education Institutions."

An unfettered monopoly facing a downward-sloping demand curve yields suboptimal social outcomes. At the decreasing segment of the average cost curve, if a (natural) monopolist charges the socially optimal price (i.e., at the quantity where price is equal to the marginal cost), the firm would be operating at a loss, while if it charges the zero-profit price (i.e., at the quantity where price is equal to average cost), the resulting demand would be below the socially optimal quantity and generate a deadweight loss (which is the loss in consumption benefits because some would-be students can no longer afford the higher price).

And at the increasing segment of the average cost curve, for-profit monopoly pricing would generate a suboptimal outcome and exact a deadweight loss as well.

- Education is beset with information asymmetry.
    - Education-financing mechanisms have to contend with adverse selection (or hidden attribute) and moral hazard (or hidden effort) problems. Loan programs may have features that make them more attractive to students with diminished capacities to repay – an adverse selection problem. Full scholarship grants may induce beneficiaries to be less diligent in their studies (because they have no "skin in the game") – a moral hazard problem.
    - Education is both an experience good and a credence good.[4]

      In standard economic models, goods are assumed to be homogeneous and therefore of uniform quality, allowing the analysis to focus on price-quantity interactions. When quality matters, goods are classified on a spectrum according to how readily consumers can assess quality. Search goods are those whose quality can be evaluated before purchase; experience goods, during consumption; and credence goods, only well after consumption, if at all.

      Examples of experience goods are books, movies, and travel-tour packages. At the point of sale of these goods, the buyer cannot know what the quality of her consumption experience will be. It is thus typical of experience goods that expert critiques and previous buyers' feedback are sought. Regardless, it is the individual consumer who discerns – for herself – the quality of her *unique* consumption experience, that experience being dependent on the predispositions of the consumer herself. If inattentive or unwilling to accept the good's experience premises, she will likely not enjoy the "ride."[5] In contrast, a consumer who completely immerses herself in the experience, fully engages it, and totally buys

[4] The issue is explored in the essay "Higher Education as both an Experience Good and a Credence Good."

[5] An illustrative example: literature (cinema) presents an imagined world to its readers (viewing audience), where the rules and conditions of the real world may or may not apply. Readers (viewers) who are unwilling to suspend disbelief are unlikely to enjoy a book (movie) and may render critiques about it being "unrealistic."

its premises – in a word, a super fan – is more likely to squeeze out the full impact (whether good or bad) of the consumption experience.

Arguably, education is an experience good because, when admitted to an academic program, a student is unlikely to know what the effects would be on her growth and development. It is her school that has a better understanding of the value proposition on offer – in other words, the information sets of the school and student are asymmetric. But the schooling experience is likely to be more transformative, the more fully the student is immersed in and engaged with the school's curricular and co-curricular activities as well as the world (including its myths and legends) that the particular school opens.

In the case of credence goods, examples include medical consultations and surgical procedures, car repair services, and herbal remedies or dietary supplements. With credence goods, quality is difficult to assess even after consumption because consumers do not know the extent of their need in the first place, and therefore how to appropriately address it. Rather, it is the expert who is able to diagnose the consumer's condition and prescribe a remedy. But this gives rise to information asymmetry – findings about the consumer's condition are discovered by the expert during the consultation or diagnostic procedure but hidden from or unobserved by the consumer (a case of adverse information about or a hidden attribute of the consumer discerned by the expert).

Due to the information asymmetry at the heart of credence goods, their markets are characterized by:

(a) being expert-driven – unable to assess their degree of need and the associated appropriate treatment, consumers generally go by the experts' diagnoses and prescriptions;

(b) consumers having to rely on the trustworthiness and honesty of the providers, because they are unable to verify the soundness of expert advice;

(c) unreliable feedback due to imprecise or even misleading consumer reviews, since consumers cannot clearly evaluate outcomes; and

(d) being prone to fraud (as the outcome of provider-initiated moral hazard[6]) and the total breakdown of the market (as a market-for-lemons like consequence of adverse selection) (see, for example, Dulleck and Kerschbamer, 2006)).

Arguably, these market characteristics resonate with higher education. The following adverse outcomes add weight to the claim that higher education is a

[6] These include: over- or under-provision of services (vs. what the consumer needs), charging for services not rendered, and providing low-quality service but charging the high-quality price.

credence good: a significant proportion of graduates are unable to pass the licensure exam of their academic program or find employment; when employed, they are unable to be promoted from entry-level jobs or they need additional training in order to meet their firms' minimum productivity standards.

- Higher education expenditures constitute a significant proportion of the household budget.

  The direct and indirect costs of higher education are considerable, and higher education is likely to be a luxury (rather a necessary) good.[7] This is not a market failure. But goods that take up a nontrivial fraction of the monthly household budget often become politically-sensitive, headline-grabbing issues and the object of public demands for government intervention, whether through direct provision, price subsidies, or regulatory oversight.

Given all the constraints just identified, the planner is left with the conclusion that a free, unfettered market will be unable to deliver the aspired for outcomes in higher education.

The Problems with Government Provision

An alternative mode of provision that the planner may explore is direct state provision. But given the Philippine experience he would be most wary of government failure[8] – the phenomenon that government intervention results in a worse outcome than market provision. The reasons: government provision operates at a remove from the discipline of the market, while being vulnerable to political pressure and the expediencies of governance as well as being direly afflicted with bureaucratic inefficiencies, if not outright corruption. More specifically, government provision, being insulated from market forces, need not be responsive to social welfare considerations, such as operational efficiency and stakeholder preferences. As a consequence, government bureaucracies tasked with day-to-day operational missions tend to be overburdened, bloated, or both. Rather than be focused on addressing stakeholder concerns and enhancing social welfare, these bureaucracies can be distracted by political firefighting

[7] Goods may be classified by the responsiveness of their demands to changes in consumer income. Measured by the income elasticity of demand, defined as the percentage change in quantity demanded due to a percentage change in income, a good is said to be normal if its income elasticity is positive (i.e., consumption expenditure increases as income increases) and inferior if its income elasticity is negative (i.e., consumption expenditure decreases as income increases). A normal good whose income elasticity is greater than unity (i.e., consumption expenditure increases by more than the percentage increase in income) is a luxury good, while one whose income elasticity is less than unity (i.e., consumption expenditure increases but by less than the percentage increase in income) is a necessary good.

[8] Levy and Spiller (1994) classifies the country (together with Argentina) as a rent-seeking presidential system with weak political parties; a weak and corrupt judiciary; rent-seeking informal norms, though without outright expropriation of elite ownership; and a weak and corrupt administrative bureaucracy.

activities. And a bureaucrat's leeway to exercise discretion opens ample opportunities for exploitative, self-serving behavior.

Moreover, for administrative ease, direct state provision may take the form of a one-size-fits-all, top-down administrative and governance structure that does not adequately account for the wide diversity of contexts in Philippine higher education. It is also likely to be affected by temporal changes in the preferences of government administrations,[9] which manifests in policy volatility, unstable governance, and considerable uncertainty for stakeholders.

An additional consideration in the Philippine context is the high cost of public funds. Jones et al. (1990) measures the marginal cost of public funds – how costly it is for an economy to raise tax revenues because (a) taxes are distortionary, inasmuch as they shift consumption and production away from optimal levels and cause deadweight losses, and (b) tax collection may be attended by inefficiencies and corruption. The study estimates are 0.3 for developed countries, 1.2 for Malaysia, between 1.2 and 1.5 for Thailand, and 2.5 for the Philippines.

For the Philippines, the estimate means that every peso that the government collects in taxes costs the economy ₱3.50 (1 + 2.50) in lost output. To put it in stark terms, the ₱128.2 billion[10] appropriated for state universities and colleges (SUCs) in the 2024 General Appropriations Act (Republic Act 11975) contributed to a ₱448.7 billion loss in the country's gross domestic product.[11]

For this reason, the Philippine government needs to be judicious about public spending and allocate funds only to those projects with the highest social benefits, such as public-goods provision and targeted access to quality education (with the benefit leakage kept to a minimum).

Market Regulation

From the foregoing observations, the social planner may infer that market failures in higher education are likely to be less detrimental to the desired social outcomes than government failure – inasmuch as the culture and practices that result in the latter may be deeply entrenched

[9] An example: the churn of high officials in local universities and colleges after elections when the outcome is a change in the local government executive.

[10] See https://www.dbm.gov.ph/wp-content/uploads/GAA/GAA2024/VolumeI/GENSUM.pdf

[11] To be fair to SUCs, the following questions should be answered: What is the return on investment (ROI) of the budgetary allocations for SUCs? Were there projects with higher ROIs that went unfunded or underfunded as a consequence? Given that SUCs charged socialized tuition fees before Republic Act 10931 (the Universal Access to Quality Tertiary Education Act), which indicated that households were willing to bear the financial burden of higher education costs, wouldn't the funds have been better allocated to support the research and brain-trust functions of HEIs? (After all, with so little work going on for these in many HEIs, the marginal benefits of research and brain-trust capacitation are likely to be high.)

in the country's (not just the government's) institutional infrastructure. If so, market regulation is the only viable alternative, though it obviously is not without its problems.[12]

Nonetheless, it is generally acknowledged (in healthcare financing, energy and utilities, transportation, and telecommunications, to name several) that independent or quasi-independent regulatory agencies – government entities that are legally distinct and functionally detached from government departments, specialized in their regulatory missions, and charged to pursue regulatory goals specific to their sector or industry – have at least two advantages over line-function bureaucracies: First, by design they are insulated from the day-to-day operations of governing and temporal changes in government preferences, and are thus able to project (the state's commitment to) administrative stability and trustworthy governance, at least within circumscribed regulatory jurisdictions. Second, conceived to be staffed by experts in the specific fields of regulation required by the sector or industry, they are better able to carry out their regulatory missions and have better chances to achieve their regulatory goals (Decker, 2023: 233–235).

Furthermore, the regulatory framework need not be limited to formulating and implementing specific interventions to address identified market failures; at the outset, that framework can be designed to align the incentive structure of stakeholders with national aspirations. Regulatory rules can also be specified to explicitly require strict adherence to norms of behavior, such as to assiduously operate at an arm's length from all stakeholders, be transparent in dealings and decision making, be accountable to the public, and be fair to all; in addition, they can anticipate and head off failures of regulation as well, such as regulatory capture,[13] time-inconsistency problems in policy making,[14] and the hold-up catch.[15]

Conclusion

Given the triple challenges that Philippine higher education faces – lofty aspirations, numerous market failures, and the high expected loss of government failure – the planner's best option may thus well be a carefully designed, independent regulatory agency (a) that is empowered with a clear mandate to drive progress toward the nation's aspirations for higher education; (b) whose regulatory framework aligns the incentive structure of stakeholders with these

[12] The essay "CHED's (Compromised) Regulatory Independence and the (Lack of) Competitive Neutrality between Public and Private Higher Education Institutions" expounds on this issue.

[13] Regulatory capture is the phenomenon in which the regulator falls under the influence or control of some stakeholders and so acts in ways that benefit them rather than social welfare in general.

[14] Time inconsistency in public policy making arises when policymakers announce and implement a policy, but after stakeholders take action based on it, the policymakers change the policy. A classic example is of the central bank committing to a regime of low inflation but, when low output and employment ensue, surprises everyone by "printing money."

[15] A corollary of the time-inconsistency problem, the hold-up catch occurs when, as a consequence of a time-inconsistent policy, some stakeholders are left with stranded costs.

aspirations; (c) whose rules explicitly (*i*) insulate it from government interference, (*ii*) require strict adherence to norms of behavior, such as maintaining arms-length relationships with all stakeholders, transparency, public accountability, and fairness, and (*iii*) anticipate and prevent failures of regulation, such as capture and time-inconsistent policy making; and (d) is staffed by technical experts who can design and enforce targeted interventions to address identified market failures.

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