New study on financial management in higher ed shows that budgeting flexibility is the key to security

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The decades-long decline in U.S. college enrollment experienced its largest two-year decrease in more than 50 years this spring. Universities increasingly face stiffer competition with less money from state budgets, which does not bode well for their financial security. A new study from

the *Strategic Management Journal* (*SMJ*) finds that the universities thriving in this environment are doing more with less simply by adopting more flexible budgeting. The problem is, many universities face internal and external pressures that inhibit financial flexibility.

"Universities that reallocate resources more regularly are more likely to run larger budget surpluses," says Sohvi Heaton, a visiting assistant professor at Santa Clara University. "However, this is far more likely to be true at universities where external governance arrangements allow greater executive discretion."

Heaton teamed with David Teece, a noted economist and professor at UC Berkley, and Eugene Agronin, a data scientist and economist, to study more than two decades of longitudinal data on the financial performance of U.S. public universities. The study digs into the concept of dynamic capabilities and uses 'deviation of expense ratio' (DER), or the change in expense ratio across all budget segments from one year to the next, to measure how easily universities can reallocate funds. They compare DER to the university's annual surpluses or deficits to determine its effect on financial performance.

"In absolute terms over the period we studied, a typical annual change in DER could have added $10.02 million to the average university's income," says Agronin. "The effect is not insignificant given that a public university typically spends about $5 million for scholarships."

The authors then segmented universities into low, medium, or high, levels of regulation based on their state governing board structures, finding 239, 328, and 1,136 respectively. Using a complicated linear regression model of university financial performance in light of DER and governance—while controlling for variables like funding structure, endowments, and university size —they found that low governance more than doubles resource allocation flexibility's affect, while high

governance weakens it.

"In many of these cases, a budget deficit would become a surplus if a university increased DER by just one standard deviation," says Teece. "In that context, governance arrangements that are too prescriptive have a large effect on financial performance of universities by making it difficult to allow necessary financial flexibility and associated resource reallocations."

Multiple corporate studies have established that resources allocation flexibility can improve performance under good leadership, but this study is the first to apply those dynamics to higher education. Academic budgets often sublimate financial performance and market considerations to internal politics—or external politics if subject to heavy government oversight. The authors warn that their results clearly indicate a change to the traditional university budget model is necessary to survive in the current higher education climate.

"A university must be able to not only conduct research and teaching, but also learn how to manage itself well," says Heaton. "In the age of international competition for resources and talent, 'organized anarchies' are no longer an acceptable model for college and university management."

More information: Sohvi Heaton et al, Dynamic capabilities and governance: An empirical investigation of financial performance of the higher education sector, *Strategic Management Journal* (2022). DOI: 10.1002/smj.3444

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