

# **“Allocation of Public Funding Within the Higher Education System”**

## **Abstract**

There is an ongoing debate related to the issues of quality and efficiency of higher education colleges, and the public funding for these institutions. Our goal is to examine the theoretical justification for the establishment of colleges, subsidized or nonsubsidized, by the government, and their contribution to the economic development. We study an economy in which young heterogeneous young individuals, following the basic education stage, optionally invest in higher education to achieve skills. Initially there are universities subsidized by public funds and with excess-demand. Our analysis explores the impact of adding lower-quality colleges to the higher education system on economic growth, concentrating on two issues. Given that the quality, or productivity, of colleges is lower than that of universities, (a) Should the government establish colleges? (b) Should the government divide the higher education budget between colleges and universities? We obtain positive answers to both questions, and also claim that the subsidies should be merit-based rather than uniform. Our model accounts for several stylized facts that characterize developed countries, including (1) The expansion of colleges: the decline in college admission standards over time and the corresponding increase in the number of students; (2) the decline in government subsidies to higher education and the corresponding increase in the net student out-of-pocket payments to higher education.