C | A

CAMBRIDGE ASSOCIATES LLC

PRICE COMPETITION IN HIGHER EDUCATION

JUNE 2001

Ann Bennett Spence

PRICE COMPETITION IN HIGHER EDUCATION

Now would be an excellent time for colleges and universities to examine closely the long-term financial implications of continuing to compete on programs and facilities. That is because, while this competition can be slowed or halted, price competition cannot. And only a very few universities and colleges have the resources to finance both forms of competition.

Recently Princeton University announced that henceforth its financial aid would consist only of grants, in lieu of loans. This marked a highly significant increase in the competition to attract talented students, and not long afterwards several other institutions publicly announced their own expanded financial aid offerings, favoring grants. Many others are doing so without announcement, as parents of admitted students negotiate for more generous financial aid packages. The intensity of concern about price competition has suddenly and sharply increased.

The concern is well-founded. The overwhelming majority of colleges and universities lack the resources for sustained financial aid competition at this level of intensity. The reasons most commonly cited for the seemingly inexorable slide toward the financial abyss are the relentless competition for high position in college rankings such as those invented by *U.S. News & World Report*; competition from taxpayer-subsidized public universities; and the inclination of even relatively affluent parents to bargain for more financial aid.

Most at risk are the institutions that are not "top-tier" in terms of admissions selectivity; i.e., the vast majority of private colleges and universities. These schools have been deeply engaged in two forms of competition: price competition (through financial aid) and what might be termed "enrichment" competition (more buildings, fancier buildings, broader academic offerings, expanded athletic programs, more student counseling, and more auxiliary facilities such as art museums). Price competition means reduced growth in revenues. Enrichment competition means increased growth in expenses. It has been obvious for some time that these trends are unsustainable.

The broader ramification of Princeton's decision is that it signals that even the most selective schools will now compete publicly on price, as well as "enrichment." Given the size of their endowments, and the breadth of their other resources, this is competition indeed. Less well-endowed schools have been muted in their public response, in part because of the public relations challenge of criticizing a school that is offering its students the extraordinary opportunity to graduate without debt.[1] Many commentators, however, have suggested that the Princeton move will ultimately damage students with financial need, by funneling dollars toward those who can afford to pay a larger portion of the tuition. The university has even been likened to a "car dealer" by more than one commentator.[2] They and others have urged colleges and universities to avoid price competition, particularly financial aid awards based on "merit" and the increasingly common practice of "leveraging" financial aid. They have decried with good reason the adverse effects of the ranking systems promoted by mass circulation magazines. They have even suggested that tuition at public universities be increased for those who can afford to pay more than the relatively low tuition charged to state residents.

Most of these arguments have gone unheeded. Why? Most likely because they are usually premised upon two assumptions: (1) that those who can pay more *should pay* more, that they have an obligation not to use the financial aid dollars that could otherwise go to those in greater need; and (2) that the price of a college degree is a given, since it is based upon a cost structure deemed necessary for a quality education. The latter assumption further leads to the observation that even at full price, the tuition at most schools is *already* subsidized; i.e., the cost of educating an undergraduate exceeds even the very high tuition that is charged. Hence, it is argued, every student is already on financial aid, in a sense.[3]

Neither of these assumptions stands up well, and both are now under serious assault in the "marketplace." That is why financial aid competition will continue unabated until the competing institutions are forced to lower their costs (i.e., begin to trim their "enrichment" strategies). While few would deny that higher education is an important industry or even a "special" industry, it is nonetheless an industry that is subject to the same laws of economics that apply to virtually any industry in a market-based economy. Thus, it is futile to expect well-to-do families to pay more for a college education just because they can afford to do so. These families would not accept that argument from a car dealer. Why, they ask, should they accept it from a university? They do not have the patience to listen to an explanation of the convolutions of a college's financial structure, any more than they want to hear about what it takes to manufacture a car. This may be regrettable. But it is fact.

---

[1] A teacher from one independent school wrote that an outstanding African American student had been undecided between Princeton and another Ivy League university. But then Princeton's all-grant financial aid won her over, because "she can get out of Princeton without being up to her eyeballs in debt . . .she's smart, hardworking, and funny, and she'll do great there."

[2] See, for example, Gordon Winston, "Is Princeton Acting Like a Church or a Car Dealer?" *The Chronicle of Higher Education*, February 23, 2001.

[3] The subsidy is financed by endowment and gifts.

The point is: these families do not *want to* pay more. They don't think it's worth it. Or they deny that that it is *their* obligation to subsidize those who cannot afford to attend the college. Trying to persuade them to pay more, and basing the amount on a calculation of parental income and assets, has taken on the negative connotation of a tax upon those assets and income. One even hears families refer to the need-based financial aid system as a tax system. Were state legislatures to act upon the suggestion that tuition at state universities be geared to a student's ability to pay, it would be necessary for all college-bound state residents to submit to a state review of family assets and income, in order to determine who is eligible for low tuition. It is doubtful that they would happily comply, or that the legislatures would want to introduce such a potentially explosive issue.

The "market" is being heard. Although heavily subsidized by endowment and gifts, the price of higher education is too high to attract the individuals the colleges and universities want to attract. This is true even for the most selective schools—they have to "buy" (to use their expression) diversity by awarding financial aid. It does no good to chide families who refuse to pay what they can afford to pay—any more than it would to criticize them for not buying an expensive car at sticker price. And if one were to ask the state legislatures to raise the price of other cars, so as to support the demand for expensive cars, price-conscious families would be deeply annoyed. So too would they be annoyed to be told that their desire to bargain on car prices comes from a failure to recognize the rightness of helping the automobile industry offer a financial break to those who cannot afford an expensive car.

Whatever the reason, higher education has lost its place apart from other industries. It will increasingly be governed by the same economics that govern other industries. College leaders may risk sounding both moralistic and self-serving if they seem to chastise the public for being price-sensitive, or criticize other colleges for responding to this price sensitivity by "buying" students (granting more financial aid).

The real problem is the *cost structure* that drives the tuition. The higher education "industry" can no longer avoid this very real elephant in the living room, namely, the cost of providing the vast array of services and facilities that they continue to choose to provide: the huge proliferation of course offerings (at universities more than at colleges); the immense and expensive facilities that keep going up, often with costly debt financing; the special academic "centers"; the athletic programs and facilities; the extraordinary array of extracurricular and student support offerings; the subsidized study abroad; and on and on. Whether it stems from competition (the "enrichment" competition noted above), or from insufficient strategic financial planning, or from the frail assumption that the economy would continue to boom and likewise the capital markets, the cost explosion has the effect of pricing the college degree ever farther beyond the market the schools want to reach. It has the effect of excluding earnest students of limited means who might want a no-frills college degree. Particularly among the colleges, the "enrichment" competition is driven largely by the attempt to attract the "full-pay" student (read: the children of the well-to-do). So by catering to the well-to-do, these institutions maintain a cost structure that forces them to charge too much for a college education-and by "too much" we mean only that it is more than people are willing to pay.

How to break this very destructive competitive cycle? The only way is for each institution to decide firmly what it will not do. Each college or university must decide on a more limited range of offerings, whether it be fewer courses, fewer facilities, fewer extracurriculars, or whatever. Each must decide, firmly, that it cannot be all things to all people. Further steps should be taken to permit students to graduate more quickly.[4] If it were at all possible for the school to offer a "no frills" version of its college degree, that would be a bold experiment. Unfortunately, this cannot be done without seeming to have a two-tier system of education. In their determination not to discriminate among students in terms of their offerings, the schools require all students to pay (or their parents to seek financial aid for) the full range of ever growing offerings. People are prepared to buy bread, but they're permitted only to buy cake.[5]

The end game might be that higher education will lose much of its market. This is already threatening to happen with the liberal arts colleges. The awarding of a college degree is not closely regulated, notwithstanding laborious accreditation exercises. Hence the "barriers to entry" are not very high by comparison with other industries. How long will it be before a University of Phoenix starts offering a BA, in addition to the BS (business) degree it now confers? Or before a growing percentage of the population favors a BS over a BA? Proprietary institutions are likely to appear in greater numbers, producing higher education at an affordable cost. Their governance will be entirely different: they will be managed, not governed. The management will decide exactly what needs to be taught, and it will hire the faculty to do the teaching. The education provided may be far more limited, but it will lead to a degree and it will be affordable to most Americans.[6] Many of those who choose such low-priced alternatives will not know what they're missing.[7]

---

[4] For example, year-round classes or more emphasis upon recognition of high school Advanced Placement credits, where appropriate.

[5] Thoughtful cost reduction will also require the development of a ranking system that competes effectively with the *U.S. News & World Reports* system, which encourages overspending on the part of colleges and universities.

[6] Some schools are experimenting with "distance education" options based on internet delivery of curriculum. Despite formidable hurdles to overcome, this may hold promise for even the most selective schools. Note that the accelerated capital investment in physical plant, engaged in by most colleges and universities in recent years, mirrors the enormous recent capital investment in other sectors of the U.S. economy. And, as with these other sectors, higher education's capital spending boom will likely be followed by the recognition that there has been over-investment in fixed assets. Should higher education migrate toward distance education, this recognition will become acute, unless the new facilities that have come on-stream can be used for other purposes.

[7] From an economist's point of view, one thing they might miss is the externalities accruing to those who choose a highly selective college or university. Among these externalities would be the company and community of other highly talented individuals at the college (which distinguishes a college "purchase" from a car purchase). Nevertheless, over time, more and more individuals who would have chosen that community have migrated toward colleges and universities offering more generous financial aid. This is reflected in the data on the college choices of National Merit Scholars. A "tipping point" may be reached (some say it has already) at which so many talented students choose other educational venues that the positive externalities associated with the highly selective colleges and universities are no longer so distinct.

So, like most observers, we are very discouraged by recent financial trends in higher education, and like them we also think there is need for vigorous action. But unlike most of the college leaders who have spoken out, we would look first at the cost picture. It is interesting to note that rarely do college leaders talk about the need to control costs. This is understandable, because faculty often hear such talk as fighting words. And yet the faculty ultimately have the most to lose. Thus there are relatively few attempts to address the "core" costs (as distinct from administrative costs) of doing business as a college. Fixed costs rise each year (notably debt and facilities costs), and each year this produces tuition hikes that outpace inflation, sometimes by a lot. And each year the growth of financial aid outpaces even the large growth in tuition, inspiring comparisons to a death spiral.[8]

The last straw may be the recent sharp decline in the capital markets. Endowments are down nearly 5% in the first quarter of this year—after years of breathtaking gains—and many believe that the decline has far to go. And we've barely heard from the venture capital and other private equity investments, which are expected to be in negative territory, some of them significantly so. The relatively laissez-faire stance that many trustees appear to have had towards the relentless growth of college/university budgets may suddenly be replaced by a well-founded anxiety about the capacity of their schools to afford the vast array of offerings that they have been adding. The growth in endowment "payout" (while the payout *rate* may have remained low or trended lower) financed a fair portion of the spending binge in higher education. Or, those who had it could spend it, and everyone else pedaled furiously to try to keep up, even without deep pockets. An exhibit following this text compares the amount of financial aid grants to the endowment market value, for each of 21 colleges and universities. Note that the universities tend to have "deeper pockets" than the colleges, with which to finance continued price competition.[9]

[8] Perhaps one bright spot in this picture, from the point of view of the *private* colleges and universities, is that conditions may grow even worse at the state universities. As state budgets are pinched by recession, reduced tax receipts, and growing budget demands, their support of the state universities will be constrained. Meanwhile, in many states, undergraduates already need five or six years to complete a bachelor's degree—a considerable opportunity cost, which reduces the competitiveness of state universities *vis a vis* private colleges and universities. However, even in straitened circumstances, the states will likely continue the "honor colleges" and merit scholarship programs that pose the competitive threat to the very selective private schools. A second bright spot is demographics: an upcoming wave of college-age students (albeit most of them unable to afford private higher education) and the leading edge of a possible wave of bequests.

[9] Of course endowments cannot be entirely devoted to financial aid, and current unrestricted gifts can also be used for financial aid. But there is no denying that the better endowed schools will be the most formidable competitors in any protracted price competition.

Conclusion

For several decades, the most selective colleges and universities held to the view that a student should choose a college by determining which college was "right" for that student—the right programs, the right kind of student community, living arrangements, extracurricular opportunities, and so forth. They believed that such an important choice—i.e., the choice of which college to attend—should not be made on the basis of financial wherewithal. This was a noble policy, and nobly pursued at its inception.[10] However, over these decades, tuition rose relentlessly each year, at a cumulative rate that far outpaced inflation. And furthermore, at the same time, a growing portion of the financial aid packages consisted of loans, not grants. Thus, to the prospective students and their parents, it came to seem unreasonable to ask them to choose a college without concern about either price or the prospect of debt. Price informs the purchase decisions nearly everywhere else in our economy and, over time, it increasingly informed the college decision. At the current lofty levels of tuition, no college or university can escape price competition. It cannot be controlled.

However, what *can* be controlled is the rate of growth of the expense base. As noted in this paper, this will not be easy, since any effort to "downsize" or even to restrain the growth rate will require artful mediation among the many vocal constituencies on campus, many of whom do not understand the role of endowment. It will also involve dealing with influential interests beyond the campus, particularly the alumni and other major contributors. It will require a determined effort to raise money not for incremental purposes (new buildings, new programs, etc.),[11] but for the purpose of strengthening capital structure and operations. Raising money for financial aid will have to become the primary objective of most capital campaigns.[12]

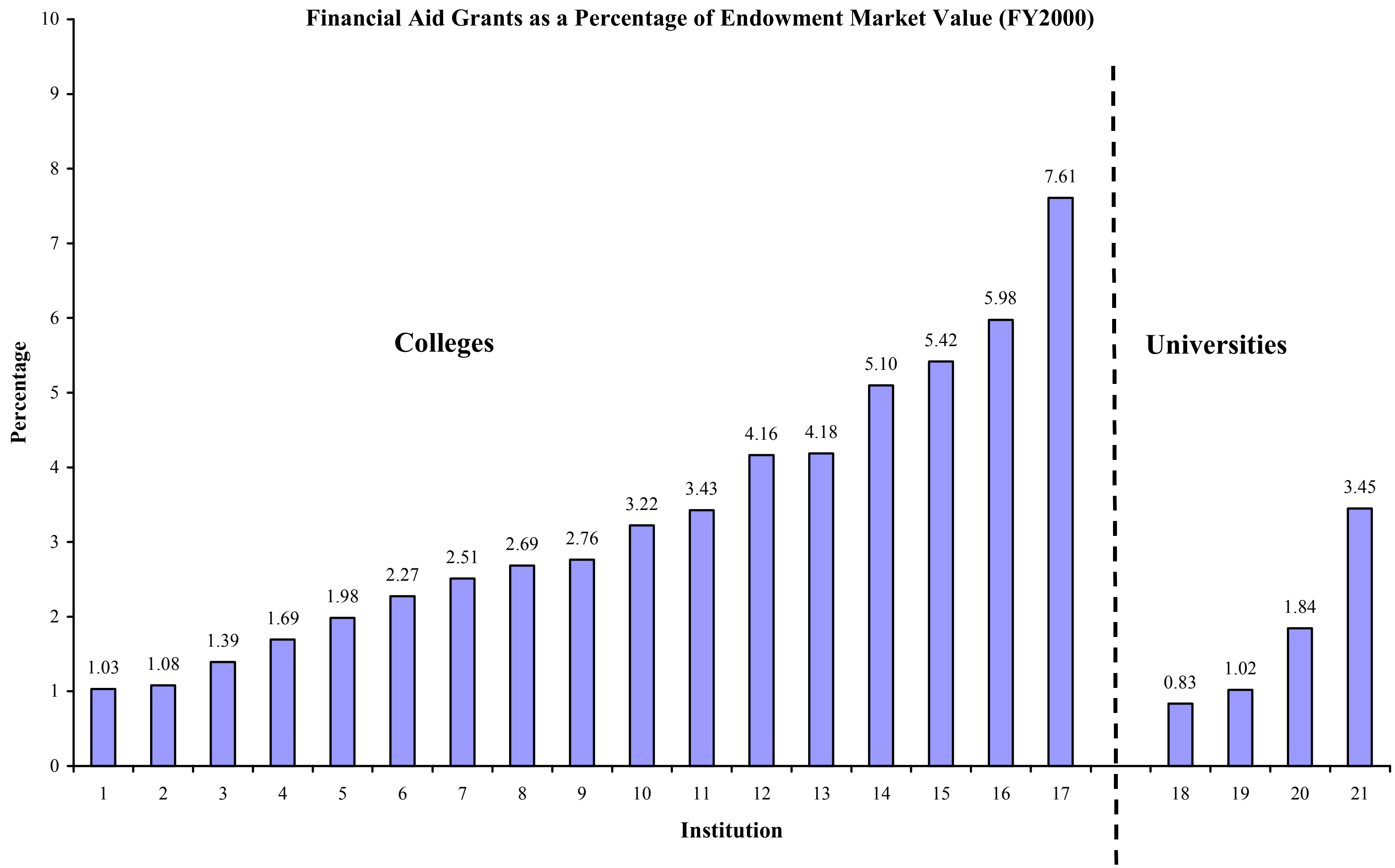
The very unpleasantness of having to deal with the expense side of the equation is no doubt one of the reasons that colleges and universities have always found it easier to raise money or to raise tuition to balance the budget. However, now that raising tuition has brought us to the battleground of price competition, and with both fund-raising and endowment performance unlikely to be able compensate for the downward revenue pressure, there is nowhere to turn but to the expense base.

[10] The implementation of this policy was the task of the so-called "Overlap Group," which was disbanded some ten years ago under pressure from the U.S. Department of Justice.

[11] Unless the new buildings and programs replace old buildings and programs in a cost-effective manner. Technology expenditures might be the single exception.

[12] Tuition *reduction* or tuition freeze are also possible courses of action, though very unlikely to be pursued. However, whether financial aid increase or tuition growth rate reduction, the budgetary consequence is the same: the need to reduce expenses or at least the growth rate of expenses.

DEEP POCKETS?



Source: College and university annual reports and the *Analysis of College and University Investment Pool Returns* (Cambridge Associates, 2000).