

The Economics of Higher Education

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Two thousand five promises to be a significant year for colleges and universities in large part because of the impending reauthorization of the federal Higher Education Act (HEA). This Act currently provides \$38 billion annually in loans to support postsecondary study and \$14 billion annually for programs, over \$10 billion of which are awarded to college students in the form of Pell Grants. The HEA also enacts policies to be administered by the Department of Education that range from regulation of postsecondary distance education providers to institutional accountability for educational outcomes. HEA programs and policies potentially affect 6,600 postsecondary institutions and 15.1 million students.

In this article, I address one particular complex of issues being considered by Congress as part of the HEA reauthorization process. These issues have to do with the rising costs of college attendance, their consequent impact on accessibility, and the appropriate federal role, if any, in regulating price increases.

In the ten-year period between 1994-95 and 2004-05, average tuition and fees, after being adjusted for inflation, grew by 36 percent in private four-year institutions and by 51 percent in public four-year institutions (College Board 2004a, Table 6b). Such increases have fueled concern that college is being priced beyond the means of low- and middle-income families and of black and Hispanic students who are inordinately represented in the ranks of the economically-disadvantaged. Critics have cited tuition increases in excess of inflation as evidence of mismanagement and waste. In Congress, discussion continues on whether the HEA should be amended to include sanctions against institutions whose future tuition increases exceed a to-be-determined federal formula based on cost-of-living indices. Threatened sanctions might

range from institutions being put on a watch list, which would require them to submit a detailed accounting of expenses to the Department of Education, to the discontinuation of federal aid to students enrolled at those schools.

As a higher education administrator, I find the prospect of federal legislation to monitor or control the price of tuition alarming. The proposal is based on a misunderstanding of the economics of higher education, especially of institutions like Butler University that are dedicated to personalized undergraduate teaching. I would like to dispel some of that misunderstanding.

The Economics of Liberal Arts Teaching Institutions

Unlike the 248 doctoral universities in the United States, which balance teaching with cutting-edge research and economic enterprise, teaching institutions include 217 national liberal arts colleges, which award at least half of their degrees in the liberal arts, as well as 572 master's universities and 324 comprehensive colleges, which offer both liberal and professional studies leading to the baccalaureate.¹ These 1,100-plus institutions comprise the classic image of American undergraduate education, where small groups of students interact with professors in and out of class, and each student is known by name and face.

In teaching institutions, our product is our graduates. We cultivate mature human beings who can think critically, communicate effectively, work collaboratively, and act ethically. Liberal education is not simply about the inculcation of knowledge; its end is the development of each student's capacities to interpret and serve the world. This kind of education is necessarily personal and relational, for its outcomes are taught by modeling and exhortation as much as by testing and writing papers. My wife Suzanne has described classic baccalaureate education as an instance of preindustrial production. The object is not mass production of a standardized unit.

Like shopping for fine clothes, each graduate should be “custom-tailored,” not fitted “off the rack.” Undergraduate education done right is an apprenticeship, not a production line.

What are the economics of this kind of education? It is relatively costly. It eschews the “efficiency” of lectures to 600 students in favor of small classes taught by professors, not teaching assistants. Increasing productivity by reducing the workforce, having a professor teach more students, would be contrary to the ideal of personalized education. It also entails serious consideration of institutional size. Butler University, for example, has made a commitment not to grow beyond 4,000 full-time undergraduate students because there is evidence that, beyond that number, the quality of educational outcomes declines (National Survey of Student Engagement 2001, 12). For the last three years, we have capped the freshman class at 915. While this has led to increased selectivity as the applicant pool has continued to grow, it also means that the university does not realize potential savings found in increased scale of production. Teaching institutions like Butler do not become more economical by producing more graduates every year. The very quality of the education they provide depends on limiting production.

If the ratio of students to staff is fairly inelastic, and production is limited, then two customary avenues to increased productivity in industry are closed to teaching institutions. College administrators continually seek ways to control costs, stemming in recent years especially from rising expenditures for health care and technology—two recurrent pressures on businesses in general. But mechanisms for increased productivity in industry cannot be thoughtlessly applied to higher education. The very mission and educational pedagogy of teaching institutions may militate against cutting costs by reducing staff or increasing net revenues by simply accepting more students.

Tuition and Fees

These economics of baccalaureate education, however, are underlain by a more pervasive reality that is often not understood: tuition and fees have never covered the cost of college. In the public sector, tuition levels traditionally have been significantly lower than institutional costs because of state funding to subsidize costs (College Board 2004b, 2). However, that arrangement may not be sustainable. In Indiana, state appropriations for higher education rose in the 1990s, but with more students attending college, the actual share per student became smaller. Because of state shortfalls in recent years across the nation, the proportion of total costs covered by state appropriations has declined, necessitating the increases in tuition and fees mentioned earlier. Private colleges and universities charge higher tuition than public institutions, but even their tuitions don't cover the full cost of education. The difference is subsidized in large part by endowment returns and annual giving, and shortfalls in these areas caused in recent years by the economic recession have contributed to tuition increases. At the same time, much of the rise in tuition and fees has gone to increasing grant aid to students in order to maintain accessibility. According to the College Board (2004b, 5), "Institutional grants doubled in constant dollars over the decade."

With this as context, I must dispute the perception that increases in tuition and fees have made college too expensive. In a recent op-ed piece, Purdue President Martin Jischke (2004) asserted that "going to Purdue today doesn't cost a student any more than it did 10 years ago." That is correct. A fundamental error is to confuse the rising sticker price of college with the actual cost of attendance. According to the College Board (2004a, 4), which publishes an annual report on college pricing trends, 60 percent of full-time undergraduates receive federal, state, or institutional grant aid, not counting loans that have to be repaid, and about 10 million taxpayers

benefit from federal education tax credits or tuition and fee deductions. This underwriting must be subtracted from published tuition and fees to arrive at a net price. The cumulative effect is that, in constant 2003 dollars, the net price for public four-year colleges and universities nationally in 1993-94 was \$1,500; in 2003-04 it was \$1,300, a decline of \$200 (College Board 2004a, Figure 7). During the same period, the net price for private four-year colleges and universities increased from \$8,600 to \$9,600, a growth of \$1,000 over the decade. Nationally, the rise in tuition and fees has also been accompanied by tax benefits and grant aid that have mitigated those increases. It is simply false to characterize higher education as being guilty of runaway costs that have unreasonably escalated the net price of college.

“Discounts”

Why is there a difference between the published price and the net price of college? In the private sector, the published price is an institution’s best estimate of what it can charge its full-pay students relative to the perceived value of the education it provides. It serves to balance the supply of places in the entering class with the demand of students for one of those places. This would be a straightforward example of the equilibrium point at the intersection of supply and demand curves, but in actual practice no institution charges all students the published price; there are always scholarships and grants that “discount” the price paid by certain students.

These “discounts” take place because a college is not primarily in the business of maximizing revenue. It is about providing education of the highest quality it can achieve. Improving quality includes attracting students of ability regardless of their capacity to pay and ensuring a diversity of experiences in the student body as part of preparing graduates to live in a pluralistic world. Scholarships and grants are merit-based to attract the academically-able and

need-based to reduce the economic barriers to college for middle- and low-income families, including families of color.

Some institutions can fund a large proportion of scholarships out of earnings from substantial endowments. Most private universities, however, create pools of grant aid by redistributing tuition revenues from families that pay all or most of their children's way to students of ability and need. So while the published price may be an indicator of how much the education at a particular institution is valued, the net price reflects a "discount" that is oftentimes redistributed in the form of scholarships and grants to attract the academically-able and the economically-needy. According to the National Association of Independent Colleges and Universities (2005, 2), students in the private sector "receive more than four times as much grant aid from institutional sources as comes from federal sources" and the "proportion of minority students enrolled at independent four-year institutions is slightly greater than at state four-year institutions—29 percent at independent and 28 percent at state colleges and universities."

Far from being complacent about issues of access and affordability for minorities and the economically-disadvantaged, it is inherent in the educational mission of most institutions to strive for cultural and economic diversity in the student body. While the net price of tuition and fees has risen in the private sector by \$1,000 over the past decade, much of the increase has been devoted to "discounting" efforts to ensure that students of modest means aren't locked out; in other words, to maintain and increase their access.

The Role of Government

The suggestion that the federal government ought to monitor or control tuition increases flies in the face of the economics of higher education. Especially as state grants for students

pursuing postsecondary education decline, public colleges and universities have begun to emulate the private sector by using endowment campaigns and tuition increases to create pools of institutional financial aid.

One might object: why should economically prosperous families see part of their tuition payments underwrite grants for other students? One answer is that the diversity of students, whether in terms of talent, culture, economics, region, or legacy, helps determine the value of the very degree that one's own child is seeking. Another is that without access to higher education, the economically-disadvantaged risk becoming a permanent underclass. Unlike many European countries, which place students into vocational tracks in middle school and reserve university education for those in college-preparatory tracks, the United States has believed that the prospect of higher education should be open for all. It is the key to national prosperity.

Historically, higher education has been regarded as a public good, and states have heavily subsidized in-state students at their public universities. In exchange for state appropriations for higher education, the published tuition for in-state students at public institutions is artificially constrained and kept low relative to that charged at comparable private colleges and universities. A better comparison to tuition at privates is what a public charges out-of-state students. Published 2004-05 tuition and fees at the University of Michigan for an in-state student are \$8,868; for an out-of-state student they are \$26,854 (U.S. News & World Report 2004). (The published price for an out-of-state student to attend Michigan is higher than the published prices at most private liberal arts teaching colleges and universities.) For an in-state student from a prosperous family, paying the full \$8,868 for a Michigan education is a bargain. For a low-income student, without scholarships and grants, \$8,868 is a barrier to access. But as state funding has declined, Michigan, like other prestigious state universities, has considered enrolling

more out-of-state students, because they bring more redistributable tuition income, and becoming more independent of the state legislature, which sets tuition for the school at levels lower than the school might want.

Controlling the price of tuition, whether by the state or the federal government, is insufficient to buttress access to higher education because current published prices may already be too high for low-income families. With the decline of state funding, and the prospect dim for significantly increasing federal higher education aid in the face of current record deficits, institutional aid must grow in their stead. If you've followed my reasoning, that growth in institutional aid may entail increases in tuition and fees. On the very grounds of accessibility and affordability, then, federal price controls on tuition are exactly the wrong answer.

What might be more fruitful approaches? For state and federal government, let there be a recommitment to the underwriting of higher education as a public good. President Bush's recent proposal to increase the maximum amount allowable for Pell grants is a step in the right direction. With regard to tuition and fees, let the free market work. Let institutions continue to control their own finances. Higher education has demonstrated a continuing commitment to access and diversity, and tuition increases have actually been a means at colleges and universities like Butler to maintain that access and diversity.

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Note

¹ Numbers for the various kinds of institutions are based on classifications developed by the Carnegie Foundation for the Advancement of Teaching as used in U.S. News & World Report, *America's Best Colleges: 2005 Edition*.