Testimony Prepared on

The Rising Cost of College Tuition and the Effectiveness of Government Financial Aid

by

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Members of the Senate Committee on Governmental Affairs:

I am pleased to have been invited to testify before your committee on the vexing questions of college costs, affordability, and the effectiveness of federal student aid programs. As one of a small number of economists who specialize in this area, I receive phone calls every week from news reporters seeking comments on these topics, so I know they are of interest and concern to millions of Americans with children approaching the age of college. It is also clear, however, that the reporters' concerns are focused on a relatively small number of the highest priced private colleges and universities, enrolling a tiny share of the nation's college students. Never have I been asked about the high price of community colleges, which enroll over 43 percent of all undergraduates. Rarely am I asked about the rising cost of public colleges and universities, which enroll over 37 percent of all undergraduates. And within the remaining 20 percent of undergraduate enrollment, the concern is directed to those highly selective institutions at the top of the pecking order that may enroll only two to three percent of all undergraduates. The news stories written about those top schools filter down and create a sense of panic on the part of many parents who will never consider such schools, which makes one wonder whether this issue is more one of perception than reality. But, as we all know, people often act on their perceptions, and the polling data do show that the high cost of college is the main concern parents have about higher

education. The question for this committee, I assume, is what, if anything, can or should the federal government do to respond to these concerns.

In my judgment, economist Howard Bowen came closest to giving us a good statement of what determines college costs. Bowen argued that revenues determine costs, in that colleges and universities raise as much money as they can, and they spend it as wisely as they can on the multiple activities of teaching, research, and service. Bowen's concept is known as the "revenue theory of costs," and it emphasizes the fact that no absolute, objective standard exists by which we can say how much college should cost. Institutions index every financial variable to the outlays of a peer group, and judge themselves by where they are in that relative ranking. U.S. News and World Report has reified this relative ranking game into its highly influential annual report on the Best Colleges and Universities, which tends to reinforce what economist Gordon Winston has called higher education's "positional arms race."

An additional aspect of higher education finance that complicates the picture is that most institutions have numerous sources of revenue: state (and local) appropriations, state student aid funds, federal student aid funds, research grants and contracts, gift income, endowment income, income from auxiliary enterprises (hospitals, dormitories, bookstores), and, of course, tuition. When one revenue source declines, administrators search for another one to increase. So, for example, when state appropriations drop, as they did significantly in the early 1990s,

institutions responded by raising tuition and increasing private fund raising.

This diversity of revenue streams is where the oft-cited analogy of higher education to health care breaks down, because higher education does not have a single dominant source of revenue that operates as the third-party insurance source does in health care. Hence, it is simply wrong to use the health care analogy to argue that federal grant aid helps to drive up tuition. Federal grant programs are income-tested such that, in virtually all cases, a student's grant does not rise as tuition increases. The case with federal student loans is a less clear, and hotly contested. I have not seen a definitive study on this issue. Most federal loans programs are capped, but with the addition of numerous private loan programs, plus home equity loans, it seems plausible to me that the availability of loan finance has made it easier for some institutions to raise prices. But even if that were the case, the remedy is not clear. It is hard to believe that parents would welcome a decision by the federal government to curtail severely their access to loan capital for investments in higher education.

I should note that many of us believe that the federal tuition tax credits, enacted and proposed, do set up an incentive for state governments to raise public tuition high enough to qualify for the full credit, and for private colleges and universities to offset some of the credit against institutionally funded student aid, effectively raising their net price to students.

Separate analyses of tuition setting are required for the public and private

sectors of higher education. Tuition prices in public colleges and universities are politically determined prices that may bear little, if any, rational connection with underlying costs. Essentially, the share of costs borne by tuition is a political decision about how to allocate the burden between students and the general taxpayer. For the last 20 years, the trend has been for the student to bear a growing share of the cost, as states have reduced the share that they cover. Periodically, a governor or legislature may conclude that tuition has increased too rapidly, and will buy down some of the tuition increase with state funds--this has happened recently in California, Massachusetts, and Virginia. But my essential point is that I see no role for the federal government to play in state decisions about public tuition, other than to be aware of incentives that federal programs, such as tuition tax credits, may create.

Within the private college and university sector, state policies and programs have less influence, and the market becomes the principal arbiter of prices charged. But the private sector is far from monolithic in its financial circumstances. The majority of private colleges and universities struggle each year to make ends meet and, in some cases, to survive. Many of them discount their stated tuition deeply, 40 percent or more, so that the actual net price that a student pays is well below the posted price. A few of these colleges have tried cutting tuition, and others have frozen it, but in most cases, they know that a three or four percent tuition increase will be eaten up to a significant degree by increased student aid discounts. These

colleges are running hard just to stay in place, and I see no public purpose served by having the federal government attempt to interfere with their pricing.

This brings us to that tiny set of private colleges and universities in which the media invest so much attention--the 50 or so institutions that have enormous wealth. Endowments are very unequally distributed among colleges and universities, and those with the most to start with have experienced phenomenal gains in this bull market. Indeed, one has to modify Bowen's revenue theory of costs in two ways for these institutions: They do not raise all that they can, and they increasingly save much of it through transfers to endowment. They do not raise all that they can because, with the huge applicant pools that they have, they could clearly charge even higher prices. They do not spend all that they raise because, with endowments growing at 20 percent or more, and spending rates of 5 percent or so, the remaining gain more than compensates for inflation. Williams College, one of the members of this wealthy group, recently announced it would not raise tuition in the coming year because of sizable endowment gains. I believe this is an attempt of one college to send a signal to its peers that this group would be wise politically to break the pattern of steady tuition increases. (Appended to my testimony is an essay I prepared for the Chronicle of Higher Education on the Williams College decision.) I submit that if the federal government has any useful role to play in the area of college costs and prices, it might come in helping these few wealthy colleges to mitigate the "positional arms race" in which they are

engaged. The 1989 anti-trust case against these colleges has limited their ability to discuss what they, as institutions operating in the public interest, can and should do about the new economic circumstances in which they find themselves. Allowing that discussion to go forth is my best recommendation for action coming from these hearings.

Finally, what about the students? Your hearings tomorrow focus on student aid, but let me note that family income is still the major determinant of who goes to college, and where. In the rush to provide tuition tax credits, prepaid tuition plans, and tax benefits for college savings, we forget that most low income families cannot avail themselves of these programs. Furthermore, once enacted, these plans, like guaranteed student loans, operate as entitlements, whereas the Pell Grant program remains subject to annual appropriations. We are in danger of severely altering the fundamental focus of federal student aid, which should remain concentrated on helping students from low income families pay for college. Were I testifying tomorrow, I would recommend that Pell Grants be turned into an entitlement program, so that low income students have assured support at a time when billions of state and federal dollars are helping middle and upper income families pay for college.

Thank you for giving me an opportunity to present these thoughts to the committee.

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POINT OF VIEW

A Tuition Freeze Accents the Cockeyed Economics of Higher Education

By DAVID W. BRENEMAN

The recent decision by Williams College to freeze its tuition and fees for the 2000-1 academic year prompts reflection on the cockeyed economics of higher education -- and just how hard it is to do the right thing in our enterprise.

When a profit-making business cuts its prices, or holds them steady in the face of increases by competitors, the reason is usually to gain market share. When Northwest Airlines, for example, refuses to follow the price increases announced by other airlines, its motivation is to attract customers away from those airlines.

That is clearly not the motivation of Williams College, however. It already has around 5,000 applicants for the 500 positions in the entering class, and it is not seeking to expand.

Perhaps, then, the college's motivation is to attract higher-quality students. That does not seem to be a plausible explanation either. The modest reduction of Williams's price next year relative to its peers -- assuming that they do not match the tuition freeze -- will probably not cause students to opt for Williams over colleges that they might prefer. If Williams wanted to attract particular students, a targeted approach using merit aid would be far more effective, and less costly.

In short, it is difficult to see any institutional self-interest operating in the decision by Williams. Why, then, did such an action take place, particularly at a college where the influence of economists is unusually strong in the management of the institution?

The college's explanation was simply that big increases in charitable gifts, along with the remarkable growth of its endowment, meant that Williams could afford to provide stable tuition for at least one year. Although I accept that explanation at face value, it doesn't tell the whole story. The decision must be seen in the context of three forces that have been operating on higher education in recent years.

First, this decade's buoyant economy, sharply rising stock market, and limited inflation have generated enormous gains in wealth for the colleges and universities with strong traditions of private support and large endowments. Historically, endowment gains have averaged 9 to 11 percent annually, and inflation has run about 4 to 5 percent, with spending rates from endowments holding at around 5 to 6 percent. The result has been to keep endowments roughly constant in real, or inflation-adjusted, dollars. In recent years, however, with endowment gains exceeding 20 percent, inflation at 2 to 3 percent, and spending rates unchanged or even reduced, the increase of wealth at the top private institutions has been enormous. The Williams decision is, in part, a response to that new fact of life.

Secondly, a growing desire by talented students to attend those wealthy institutions has prompted increasing demand for admission, despite high and rising prices. Indeed, given the excess demand for enrollment, the true economic question is, why

haven't prices gone up faster than they have?

Nonetheless, the rising sticker price of college, especially at elite private institutions, has prompted the news media to promulgate endless critical articles decrying tuition increases, and the U.S. Congress to appoint a national commission to explore ways to contain college costs and prices. Thus, the third, and perhaps most influential, force is that the high price of college, real or perceived, has become every parent's nightmare. And it has produced political responses: the Clinton tuition tax credit, and the tuition freezes that several governors have imposed on their public universities, to cite just a few.

Such forces explain the Williams College decision as an effort to exercise by example a type of price leadership, one that responds to the barrage of public criticism about higher education's endless increase in prices despite new economic conditions. I find it hard to fault that motivation. We in higher education urgently need to discuss issues surrounding rising college tuitions among ourselves and with our key constituencies, and to reevaluate our tuition policies.

Yet the dilemma is that a public conversation about those issues is very difficult to have. In fact, I suspect that most of Williams's peer institutions and other private colleges will ignore the decision, and avoid discussing it with parents and other constituents as much as possible. Why? Because, for peer institutions, it is economically unnecessary and, for less-wealthy institutions, economically disadvantageous, to discuss it, much less follow Williams's lead.

Williams is a tiny part of the market, and the effect of its freeze will go largely unnoticed in the competition for students, imposing no real penalty on its competitors -- the other top 30 or 40 private colleges and universities. Furthermore, many presidents will see the action as undercutting the rationale for fund raising, if the institutions implicitly admit that they currently are able to forgo tuition increases. In the segment of the market in which Williams operates, the decision to freeze tuition clearly leaves money on the table, an unusual action for nonprofit as well as business enterprises.

For less-wealthy private colleges, the Williams action poses not just a potential embarrassment but a real threat. Those institutions do not have the same endowment resources as Williams and its peers, and are therefore more dependent on tuition. If other top-tier colleges follow Williams's example, institutions in the second tier will be in a predicament. On the one hand, they will have lost the umbrella of protection from public criticism provided by tuition increases at all private colleges. On the other, many of them must continue to raise prices, since they do not have the depth of nontuition resources on which to draw. They will be in the difficult spot of being damned if they do, and damaged if they don't. In short, the Williams tuition decision -- rather than starting a much-needed conversation about college pricing, wealth differentials in higher education, and if and how public policy should respond to new economic conditions -- will be seen within private colleges as an embarrassment, a momentary slip, and a misbegotten attempt to discipline the market.

If peer institutions do not follow suit, Williams will almost surely be forced to resume tuition increases next year. And, within a couple of years, the entire incident will be forgotten. Williams will have suffered a one-time loss of revenue, a small but enduring penalty for trying to change market behavior. The "positional arms race" that drives our leading institutions will resume, and an opportunity to clarify the public understanding of the economics of private higher education will be lost.

It will have been lost at our own peril. We can't operate solely according to financial concerns; we must also consider our public trust. If resentment and anger about higher-education pricing continue to build, politicians may well find a way to lash out and do real damage to our private institutions -- as they already have done in several cases to our public institutions. Private colleges and universities would be particularly vulnerable to changes in the tax code that would restrict or eliminate significant tax benefits that they receive through their designation as nonprofit organizations.

The leaders of Williams should be given credit for putting those issues on the table, even if most college presidents wish they had not and conclude that they have ultimately been foolish. The Justice Department's antitrust case against colleges in the late 1980's has brought a chill to conversations about how these hybrid institutions --

nonprofit yet highly competitive like profit-making organizations -- conduct their affairs. We need to revisit that antitrust decision, and instead argue the need for open discussion about college tuitions and the use of resources -- rather than relying on indirect signaling methods, such as the Williams tuition freeze.

Whatever our economic and political concerns, we can only bring about reforms in how we finance and price our institutions by publicly considering the issues together. We shouldn't pin our hopes on one college's unusual act of courage and candor.

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