THE COST PROJECT

An initiative on college costs.

Strengthening Board Capacity for Overseeing College Costs

By Jane V. Wellman

The United States is home to some of the wealthiest colleges and universities in the world, yet many observers inside and outside of academe believe our system of financing higher education is becoming unsustainable. Our generation faces the daunting task of providing greater opportunity, at higher quality, to more Americans than ever before, on a funding base that will be more constrained than ever. This collision of well-established trends in how our nation funds higher education and our society's future needs is cause for concern for the governing boards of all colleges and universities.

Tuition has been rising at rates well above inflation for the last 25 years. Financial aid also has grown—particularly in the form of student borrowing and grant aid that institutions themselves provide from endowments and scholarships. Still, college access for students from low-income families remains well below that for students from middle-income and upper income families. Taxpayer funding from state and federal resources continues to grow, but not enough to keep pace with both the rate of enrollment growth and inflationary cost increases within higher education. As a result, among public institutions, per-capita funding from state resources reached a 25-year low in 2005. [The chart on page 3 shows state funding trends over the last 25 years.]

Students everywhere are borrowing more to finance the costs of their education—and borrowing is particularly prevalent in the private sector; nearly three-quarters of bachelor's recipients in private institutions graduated with debt in 2004. Moreover, the prospects for growth in state funds allocated to higher education are not good. In most parts of the nation, enrollment demand is likely to outpace the rate of growth in state and federal subsidies for at least the next ten years. This will place more pressure on public and private institutions to rely on tuition and philanthropic giving for a good deal of their revenues. It also will lead students and their families to depend on the fragile system of financial aid to make higher education affordable. [The chart on page 4 shows the rising price of tuition in relation to family income.]

As public institutions continue to raise tuition levels, the fiscal differences between public and private

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institutions are beginning to blur, with the result that both types of institutions are competing for the best students with offers of "tuition discounts." Such discounts are a *cost* to institutions in the form of forgone tuition revenue. The practice is greatest among regional private colleges with low enrollments and relatively low student selectivity, but its popularity is increasing among public institutions as well. Studies of discounting among private institutions show that nearly 80 percent of freshmen receive some form of tuition discount, averaging $9,000 per student.[1]

Despite increases in this type of financial aid, continued tuition increases inevitably sour public opinion about higher education, risking the goodwill needed to sustain philanthropy, public funding, and support for continued institutional independence. Opinion polls consistently show that the American public places a high value on higher education and has great respect for the institutions and the individuals working within them. But the goodwill is not infinite, and underneath the positive views are disquieting signs for the future. For example, a significant portion (though still a minority) of Americans questions whether colleges and universities share their values. Nearly half the public questions whether students get what they pay for by attending college—a negative opinion that is even more acute among parents with children in college.

Several other factors color the public's perceptions of higher education. Differences among institutions that are so important within postsecondary education are irrelevant to the public, with most people unaware of the distinctions between the public and private sectors, research universities, and community colleges. The public overestimates the cost of college and underestimates the availability of aid. They do not understand the system of higher education finance—most believe institutions earn profits from tuition, for instance—and fail to make the connections among public-funding policies, the cost of operating and sustaining these institutions, and tuition increases. They see rising tuition as a sign of misplaced

[1] NACUBO Study of Tuition Discounting, 2005.

About The Cost Project

This paper is the first in a series of reports and initiatives that will constitute AGB's Cost Project. Supported by a grant from the Robert W. Woodruff Foundation and a planning grant from the Lumina Foundation, the project is designed to build governing board capacity to monitor institutional costs effectively and strategically.

Costs and productivity are not new issues in higher education. AGB and its member governing boards have long recognized the importance of responsible stewardship of institutional resources as central to the work of effective boards. But the rapidly changing environment in higher education has brought a new urgency to the topic. Many institutions have been at the forefront of change, having reengineered core functions and decentralized responsibilities for resource management. The Cost Project intends to identify such successes and promote them broadly within the higher education community.

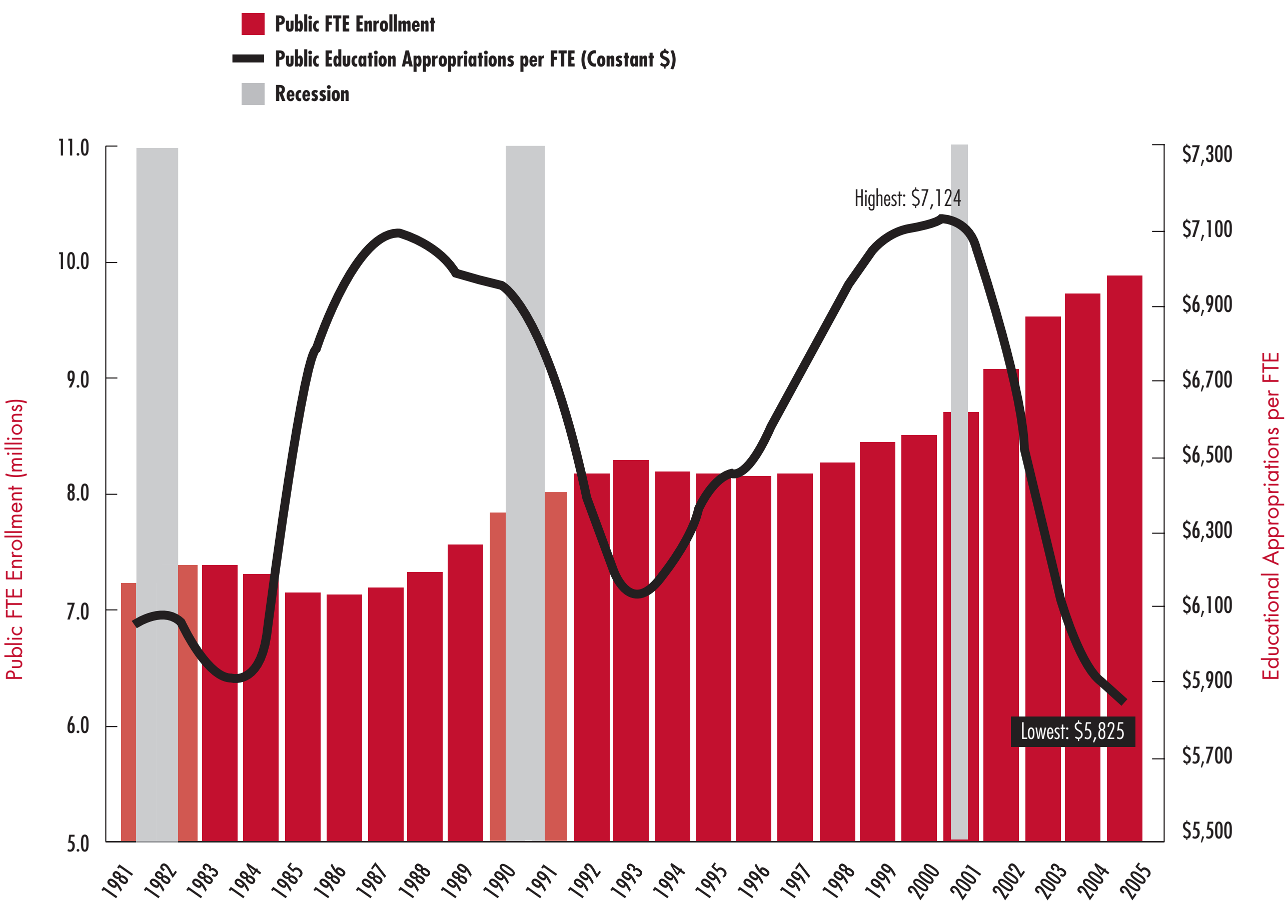
AGB is mindful that containing costs and sustaining quality require active partnerships among institutional leaders and others in the higher education and public-policy communities. A comprehensive effort needs to be built—to forge partnerships, to make the conversation more data-driven, to connect better with public audiences, and to find strategies to reach out to accreditation agencies and others concerned about ways to sustain quality and improve institutional effectiveness. While institutional chief executives must lead such efforts, boards should be actively engaged in these issues. Encouraging and enriching this process are goals of The Cost Project. As it embarks upon this work, AGB will collaborate with other groups interested in contributing to the agenda.

Details about the project, additional readings, and updates on current research are available at *www.agb.org/cost*.

institutional priorities and a willingness to spend money rather than keep prices down. Yet at the same time, students and parents expect colleges to have state-of-the-art dormitories, Wi-Fi access, and fitness centers that rival those in exclusive spas. This tension between the public's increasing consumerism and its expectation that higher education should be more affordable is one of the great challenges affecting higher ducation public policy.[2]

As college affordability has eroded, public-policy makers increasingly are calling for higher education institutions to take action to improve "accountability" for performance—in particular, to slow the rate of tuition increases by containing costs and improving productivity. By way of recent example, the Secretary of Education's Commission on the Future of Higher Education places institutional responsibility for cost containment at the center of its recommendations for heightened accountability for higher education. It calls for better data, greater transparency, and better

ENROLLMENT GROWTH AND PUBLIC HIGHER EDUCATION APPROPRIATIONS PER FTE U.S., FISCAL 1981-2005



Source: State Higher Education Executive Officers, 2005.

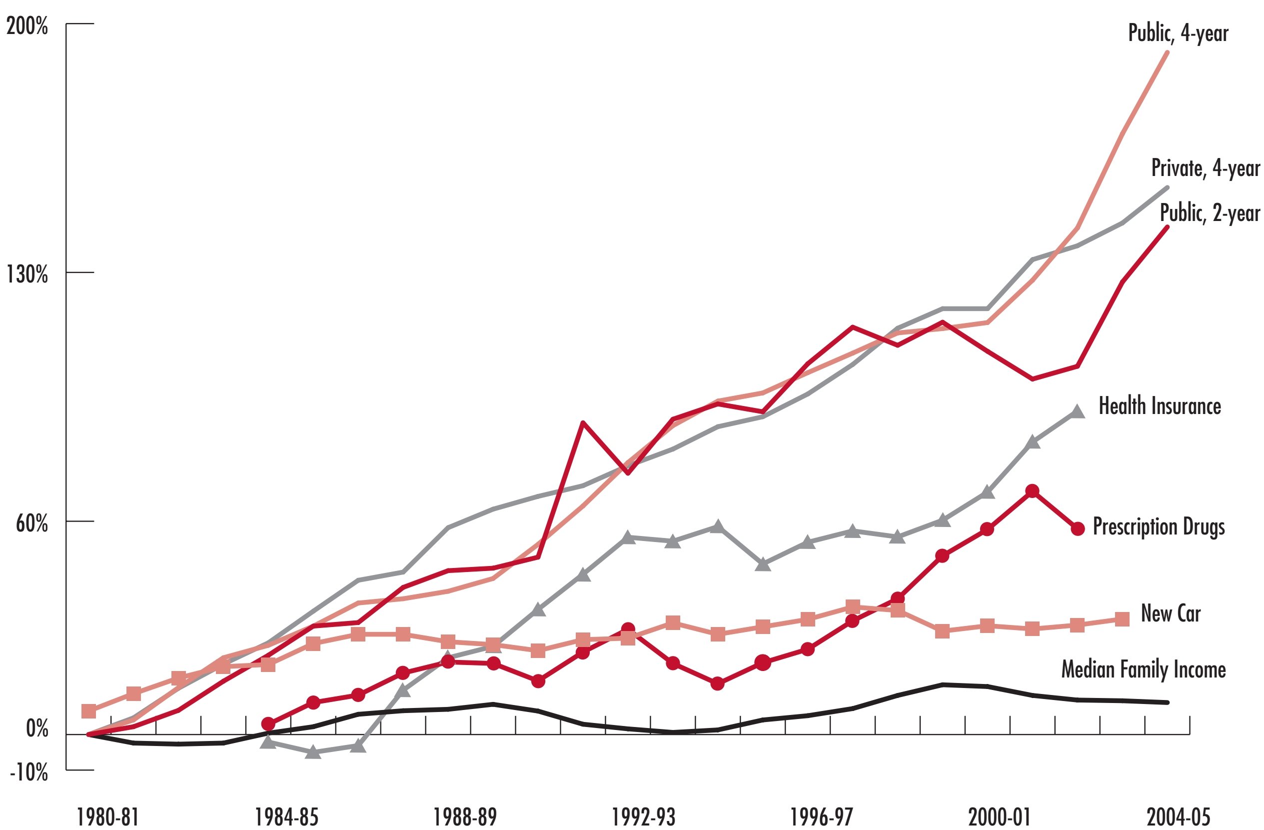
[2] See Winston and Hart, research done for the American Council on Education "Solutions for Our Future," 2005; Hart, P. & Teeter, R. (2003). "Quality, Affordability, and Access: Americans Speak on Higher Education, Key Findings from Surveys and Focus Groups." Princeton, N.J.: Educational Testing Service; Isenberg, S.O. and Hartle, T.W. (1998). "Too Little Knowledge is a Dangerous Thing: What the Public Thinks and Knows about Paying for College." Washington, D.C.: American Council on Education; Immewahr, J. (1998). "Public Attitudes on Higher Education: A Trend Analysis" (1993, 2003). San Jose, Calif.: National Center for Public Policy and Higher Education. Available in pdf format at *www.highereducation.org/reports/pubatt/Pub_Agenda_040210.pdf*.

consumer information about college costs and prices. Most important, it urges governing boards to engage this agenda.

Underlying the public's call for greater attention to costs is the belief that higher education leaders are uninterested in controlling their costs and the prices they charge. In fact, there is a sense in some quarters that higher education leaders equate higher costs and prices with higher quality. Surely that indictment is an overly broad generalization. Most college and university leaders work hard to control costs even as they operate in a funding environment for higher education unlike any in recent memory. Sustaining public support for higher education—not only in the form of predictable state and federal financial appropriations and continued philanthropic support but also in the form of public trust in the stewardship of our institutions—will require assuring the public that institutions are serious about cost management.

Institutional leaders will need to incorporate new ways of managing resources to increase productivity—to improve quality and performance—without charging more or spending more. Measuring productivity means looking at total costs and how they are used to produce outcomes; in the case of higher education, "outcomes" include graduates, trained workers, and new knowledge. Understanding productivity requires looking simultaneously at access to education, the quality of the educational experience, and the use of financial and other resources. Examining the relationships among the quality of entering students,

THE PRICE OF COLLEGE IS INCREASING IN RELATION TO FAMILY INCOME AND MANY GOODS AND SERVICES (PERCENTAGE CHANGE IN PRICE, IN CONSTANT DOLLARS, 1980-2004)



Source: The College Board, 2005.

costs, and learning outcomes allows institutions, boards, and state policymakers to better understand the consequences of a change in any one of these variables on total productivity. For example, if gains in graduation rates come at the expense of student access or equity or in the quality of student learning, then productivity has declined, even if more students are being graduated at lower cost to the institution.

The topic of "productivity" is not easy to discuss within most institutions, as the language of costs and outputs is seen as anti-faculty and hostile to core academic values. But to address national and institutional concerns about access, quality, and cost, such conversations are needed. Issues of cost and productivity are much easier to tackle if they are understood to be part of an investment strategy to sustain quality and capacity into the future—and not primarily about forcing reductions or hurting quality and access.

UNDERSTANDING COLLEGE COSTS

The economics of higher education are complex because of the diversity of revenue streams and missions of colleges and universities. The financial model of community colleges differs markedly from that of liberal arts institutions, and both are different from research universities. The language of higher education finance and the distinctions among revenues, expenditures, costs, prices, net prices, and cost centers further complicate the discussion. When the public discusses higher education costs, the conversation is about what it costs a family to send a student to college and not about what it costs an institution to provide the education. But for a board to help steer a college or university in the direction of quality and value, trustees will need to untangle the language of price and costs so they can focus on how the institution uses its resources to achieve core functions. Research about costs and prices also will help explain these relationships, but it will first be useful to define the terminology.

> *For a board to help steer a college or university in the direction of quality and value, trustees will need to untangle the language of price and costs so they can focus on how the institution uses its resources to achieve core functions.*

Revenues for institutions come from many sources—tuition and fees, state and local appropriations (which go primarily to public institutions), federal financial aid, private fund-raising, income from endowments, and contracts and grants for research. [The charts on page 7 show sources of revenue at public and private institutions for 2005.] Public institutions depend heavily on state or local appropriations, and private institutions more on tuition and revenues from endowments. Most private colleges have small endowments and thus depend on tuition for core funding. In all institutions—public and private—a good deal of the gift revenues are restricted by donors and do not support the core functions of instruction and research. By looking at revenues from endowments, gifts, tuition, and state and local appropriations, board members will have a better picture of flexible revenues that are available on a per-student basis.

The term *cost* refers to the amount of money an institution spends from its operating budget and where it spends it. The federal government requires colleges and universities to report expenditures in standard categories, such as instruction, research, public service, administration, student services, libraries, and plant operation and maintenance. To standardize measures of spending across institutions, most analyses divide spending by full-time-student enrollments to arrive at an average cost per student. Because not all revenues are used to pay for student-related costs, analysts further distinguish between the "direct" costs of instruction (expenditures that are solely within that category of spending) and "full" costs of instruction (instructional expenditures plus funding for student services, academic support, and administration). This allows institutional comparisons to be put in some context, though it should be noted that such measures as cost per student are poor proxies for determining value or productivity. Improving the quality of cost data—and finding better ways to measure productivity—will help all institutions do a better job of understanding, comparing, and communicating about costs.

What most people call college "costs" are more precisely *prices*—that is, what families pay to send their sons and daughters to college. The price published in a college's promotional materials is the "sticker price," while the "net price" is composed of tuition and fees *minus* the grant aid (but not loans) awarded to students. Research into the causes of tuition increases from the 1990s found that uneven growth in state revenues was the biggest reason for public-sector tuition increases—although public spending on "merit" aid (tuition discounting) is also a factor. Among private institutions, tuition increases are more clearly driven by spending rather than shifts in revenue, and tuition discounting has been the single biggest cause for such increases.[3]

In general, more is known about trends in tuition prices and financial aid than about trends in revenues or costs. And there is no readily accessible public research that systematically explores the relationship between resource use and educational outcomes—whether measured by student learning, research productivity, or service to communities. Several private consortia share cost information (the Consortium on Financing Higher Education and the Delaware Project for Instructional Costs and Productivity are two examples), and there have been several national studies of why tuition rises how these increases can be controlled. Despite problems with the data and the metrics, the picture that emerges from the research can help give boards a context for thinking about how these trends affect their own institutions.

■ ***Revenues drive costs (or what you spend depends on how much you have to spend).*** Higher education institutions operate under what economist (and president of public and private colleges) Howard Bowen called the "revenue theory of costs." Bowen asserted that colleges and universities raise all the money they can and spend all the money they raise.

■ ***Prices are not costs; colleges and universities operate through multiple cross-subsidies.*** The fact is that all public and private institutions spend more to educate students than they receive in tuition revenues, so a conventional business model does not apply to higher education. Tuition revenues go into an institution's general fund, where they are mixed with dollars from state appropriations, unrestricted private gifts, and earnings from the endowment. In using these dollars to finance a student's education, institutions allocate varying amounts to different types of students and within different degree programs.

For example, a lower division English literature student who is paying full tuition costs the institution much less than an upper division chemistry major with a tuition waiver. The "savings" from educating the low-cost student are used to pay for the higher cost student. This distribution of funds is known as a "cross-subsidy," even though actual transfers of funds typically do not occur. In most institutions, lower division courses provide cross-subsidies for upper division courses, and undergraduate education helps subsidize more expensive graduate education.

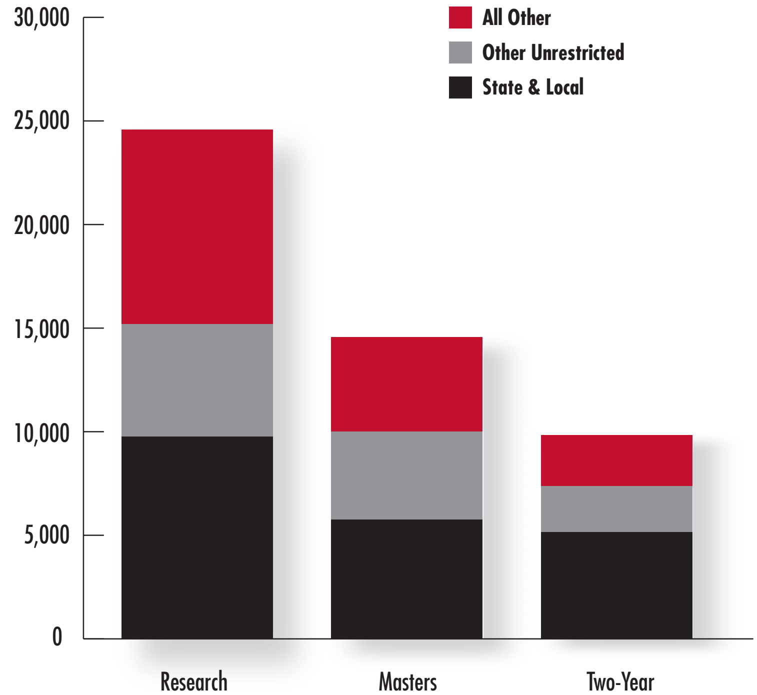
> "*Sustaining public support for higher education—not only in the form of predictable state and federal financial appropriations and continued philanthropic support but also in the form of public trust in the stewardship of our institutions—will require assuring the public that institutions are serious about cost management.*"

[3] See NCES, Study of College Costs and Prices; NCES, Straight Talk About College Costs and Prices; McPherson and Schapiro, Paying the Piper

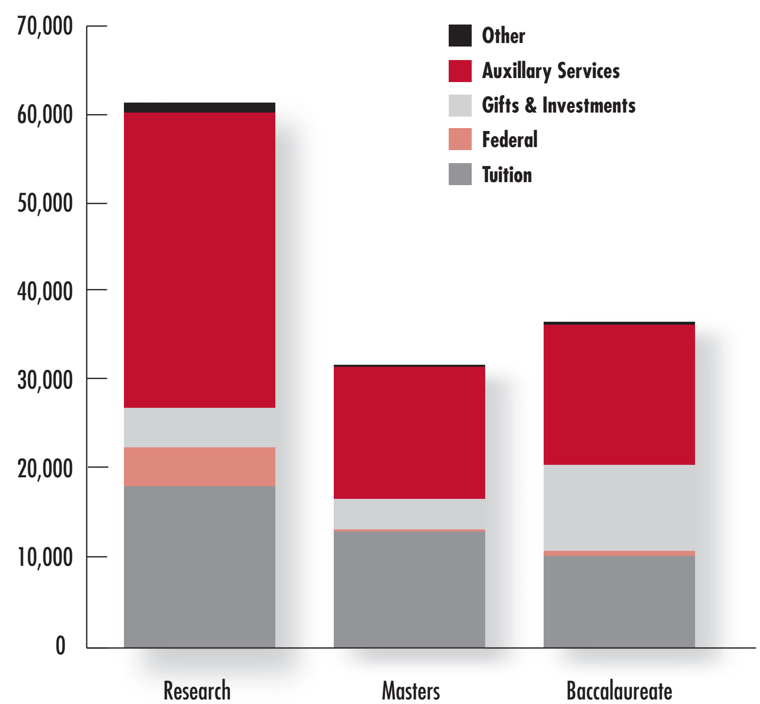
■ *Not all revenues are available for general purposes.* Most colleges and universities operate several different businesses. They are in the business of teaching students, and this is arguably their "core" function. But they also perform contracted research, run bookstores and dormitories, maintain complex physical plants, and many administer hospitals and clinics. Most of the noninstructional functions, which may constitute a majority of the spending in some universities, are paid for by funds that are restricted by the donor. Most research funding is "designated" or restricted by the donor and may be spent only on specific projects. This point is important especially for public trustees to understand, because a frequent response to state budget shortfalls is to increase efforts to raise private funds—dollars that often do not support core purposes. And though the proportion of state funding has declined (as has state funding per student at public institutions), state subsidies to public institutions are still substantial, particularly among research universities.

■ *Where the money goes.* Spending patterns within institutions can be measured through standard reports of expenditures by key functional areas. Institutions are required to report spending within major categories according to standard formats called for in IPEDS (the federal government's Integrated Postsecondary Education Data System). These include instruction,

AVERAGE REVENUE SOURCES PER STUDENT BY TYPE OF PUBLIC INSTITUTION, 2005



AVERAGE REVENUE SOURCES PER STUDENT BY TYPE OF PRIVATE INSTITUTION, 2005



Source: IPEDS, 2005.

organized research, administration, academic and student support, operation and maintenance of the plant, scholarships, public service, and transfers. These expenditure categories are very broad and do not include information that would allow a board to understand cross-subsidies between activities or the use of resources to produce specific outcomes.

In general, the expenditure patterns over time show distinct similarities in the general shapes of spending within these categories by the mission or type of the institution (research, masters, community college, and baccalaureate). The proportion of total spending that goes directly to the "instructional" category is highest in the public two-year and four-year institutions. This is true even though the absolute level of spending in these institutions is less than in research universities. The differences reflect the volume of resources associated with other categories of work in research universities, particularly in research and service. [The tables on pages 8 and 9 show levels of spending in various categories.]

Over the last 30 years, the proportion of spending going directly to the instructional category has declined in every sector, with the greatest declines in public two-year colleges. Spending has increased in other areas directly related to student support, particularly in student aid and in such services as counseling and recruitment. The other major trend affecting spending has been a decline in spending on maintenance of the physical plant. Because higher education institutions maintain separate cost centers for capital and operating costs, the trade-offs between savings on maintenance and the increases in capital costs cannot be documented—although many college leaders believe such a shift has occurred.

The methodology for measuring average operating cost per student—or unit costs—within institutions is quite well developed, particularly as it relates to the cost of undergraduate instruction. The standard methodology for measuring costs in the industry has been developed by the National Association of College and University Business Officers (NACUBO); another model has been developed by the Delaware Project for Instructional Costs and Productivity, a data-sharing project based at the University of Delaware. The NACUBO and Delaware efforts show that the dominant determinants of instructional costs are general revenue availability, the array of academic offerings, faculty compensation, and class size. Of these, the foremost reason for variations in average costs between institutions (other than general revenue availability) is the mix of academic disciplines. Laboratory-based disciplines in the health sciences, engineering, physics, and biological sciences are typically the most expensive, followed by computer sciences, and business and marketing.[4] The least expensive disciplines historically have been the humanities and social

MEDIAN PER-STUDENT SPENDING BY CATEGORY IN PUBLIC INSTITUTIONS, 2005

	Research	Masters	Two-Year
Instruction	7,460	5,165	4,124
Research	4,167	143	0
Academic Support	1,910	1,206	736
Student Services	976	1,076	890
Institutional Support	1,774	1,556	1,372
Operations & Maintenance	1,695	1,255	913
Auxillary Operations	2,721	1,576	562
Student Aid	2,561	2,047	1,784
Interest on Debt	300	123	4
Public Service	1,394	341	15
TOTAL	**24,958**	**14,488**	**10,400**

Source: IPEDS, 2005.

sciences. One phenomenon that probably has affected costs in higher education is the shift in the last 20 years in student course-taking patterns, away from liberal arts and humanities and toward high-tech and business curricula.

Board members may wonder about patterns and trends in the emerging for-profit higher education sector. Such proprietary institutions are almost 100 percent tuition driven, and tuition is established at a level that is intended to generate a profit for investors. These companies have small or nonexistent endowments and do not perform the research or service functions that ordinarily draw other revenue sources. A few have very small auxiliary enterprises.

The different mission is reflected as well in expenditure patterns: In public and private nonprofit institutions, instruction and research comprise the two largest spending categories; proprietary institutions spend more on administration and student services. Proprietary institutions keep costs low by employing part-time and adjunct instructors and focusing their curricula in a few specialized areas. If student enrollment is insufficient to maintain a program, it is closed.

> *"Boards can advance effective cost management by helping to shape the conversation about aligning resources with goals and creating a culture of heightened sensitivity to resource management across the campus."*

MEDIAN PER-STUDENT SPENDING BY CATEGORY IN PRIVATE INSTITUTIONS, 2005

	Research	Masters	Baccalaureate
Instruction	12,770	6,261	6,124
Research	4,240	0	4,240
Academic Support	3,182	1,375	1,388
Student Services	2,305	2,110	2,942
Institutional Support	3,510	2,126	3,113
Operations & Maintenance	2,787	1,393	1,886
Auxillary Operations	3,376	1,944	2,637
Student Aid	7,581	5,717	8,006
Interest on Debt	918	399	499
Public Service	0	0	188
TOTAL	**40,669**	**21,325**	**31,023**

Source: IPEDS, 2005.

MOVING FORWARD: OPPORTUNITIES AND CHALLENGES FOR GOVERNING BOARDS

A governing board can help ensure the institution's financial viability by giving the president the responsibility and authority to lead the institution on a day-to-day basis and monitoring progress and results. The board's direct role in the area of college costs historically has been exercised primarily through long-range planning, annual budget development, and fiscal audits. Today, institutions will benefit from a greater level of board engagement with the president on issues of cost.

Most college and university leaders recognize the need to balance the institution's resource requirements with the public's expectations that a college education will remain accessible and affordable. Decisions about programs, priorities, tuition levels, and financial aid are hard fought and carefully negotiated within each institution. Still, at the end of the day, most institutions' highest priorities are to increase revenues and promote the quality of teaching

[4] Delaware Project for Instructional Costs and Productivity, University of Delaware, 2005.

Questions for Boards to Consider

- What have been the trends in full costs per student? What have been the major pressures in spending?

- Where will the institution be financially in the next decade if it continues the patterns of the last decade in undergraduate enrollments, prices, tuition discounting, costs, and student-learning outcomes?

- What are our students' levels of indebtedness when they leave our institution?

- What is the expected turnover of currently tenured faculty in the next ten years? What are the institution's plans for future faculty? What are the consequences of those plans on future costs?

- What experience do we have in distance learning and the use of technology-assisted instruction? Could that contribute to improved productivity by reducing costs, reducing attrition, or increasing graduation rates?

- How has spending in the area of student services tracked over the past ten years? What do our goals in this area say about future spending requirements?

- What academic programs need to be offered to fulfill the institution's mission and serve the public good?

and learning. Two common assumptions within the industry are that cost increases are inevitable and that prices are well managed if tuition increases are held to just a few points above inflation. With the funding and demographic challenges ahead, institutions will need to do everything possible to use scarce resources to increase access and degree completion, while keeping tuition increases in hand.

Because of their position within the institutions they serve and because of their responsibilities as fiduciary bodies, boards can play an instrumental part in campus discussions and activities related to costs. Here are some ways to do so:

Legitimize the conversation. Boards can advance effective cost management by helping to shape the conversation about aligning resources with goals and creating a culture of heightened sensitivity to resource management across the campus. This does not mean that boards should micromanage. But they can focus on the core issues of value, productivity, and cost in relation to strategic planning and institutional accountability and within the larger context of mission. They also can lend support to the presidents who need to lead the deeper work within the institutions.

Integrate resource analysis with quality review. Boards also can compel greater attention to productivity by asking administrators to integrate resource analysis into ongoing mechanisms for quality and program review. The student-learning assessment movement has taken hold in almost every college in the country, yet resource evaluation is remarkably absent from these discussions. Looking at how funds are spent can shed a helpful light on institutional priorities for teaching and learning. And the key issue of the educational value the institution provides—and the relation between quality and resources—can only be understood if learning assessments include analyses of how resources are used.

Ask for benchmarks. To make better sense of financial data, boards and presidents need better ways to compare their institution's situation with that of other institutions. Boards can encourage presidents to become involved in cooperative information-sharing efforts with other institutions to allow effective comparisons. Several consortia currently provide such services on a confidential basis, or institutions can start their own. Boards also can ask for and monitor trend data for their own institutions to better understand change over time. Establishing enduring indicators allows boards to review trend data year after year. The AGB Benchmarking Service already provides campus leaders with access to comparable fiscal information, and additional measures of costs and suggestions of ways to benchmark costs will be developed through The Cost Project.

Communicate effectively and demonstrate accountability. Boards should have strategies to communicate with key stakeholder groups about the costs of providing education and the price of attending the college. Boards may want to invest in public-opinion research to help them understand what their "customers" think about costs and use this information to shape communication strategies. They also should ask how the institution reports information on costs and price, whether through public "report cards" or to federal or state agencies.

Achieve some early victories. Almost every institution can save money in administrative and back-office functions by consolidating operations, making better use of technology, engaging in competitive contracting practices, and joining consortia. Explaining how such costs will be cut will help defuse institutional fears that productivity is a code word for dismantling the institution's core programs. Administrative costs constitute one of the biggest growth categories in most institutions, and presidents and boards can set the agenda for cost control by encouraging offices to find ways to reduce administrative spending. Another major cost driver has been tuition discounting (often called merit aid). Reevaluating tuition-discounting strategies and finding ways to reduce institutional spending on financial aid also will help control costs and hold down future tuition increases.

Make cost and quality issues a high priority for the long term. Trustees should address these is-

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> ***Boards should have strategies to communicate with key stakeholder groups about the costs of providing education and the price of attending the college.***

sues in committee and full board meetings on an ongoing basis. Solutions will be needed well into the future, and change will take time. Board and committee agendas will need to be structured and institutional goals set to reflect these priorities.

America's diverse system of higher education has historically been the best in the world. One of its unique assets is the blending of public and private resources. It is a flexible system, adaptive and capable of great innovation and rapid change. It can be slow to learn from itself, though, and at times is sluggish and defensive in responding to public expectations for change.

Collectively, higher education is being challenged as never before to show how it can meet national needs for access, accountability, and quality. At the institution level, these challenges are also acute. Success for the nation and for the institution will depend on sustaining the public trust through credible stewardship of resources and effective communication of results.

Ensuring access and increasing quality also mean boosting productivity—managing costs, keeping tuition increases low, and improving student graduation rates. It can be done through better use of data, improved benchmarks, and better communication strategies both within higher education and to key public audiences. Boards have a distinct and necessary role to play in this endeavor. The work is important, and the time is ripe for progress. ■

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