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Never Enough: Challenges Facing Private Colleges

The traditional small, private, liberal arts college model of higher education has been under stress for some time. Viewed as economic entities, these institutions — like their larger peers, the research universities — rely on three main sources of income: tuition, fees and grants, and distributions from their endowments. Unlike research universities, however, small liberal arts colleges are facing a unique combination of headwinds that deeply challenge their operational model and may, in many cases, pose threats to their continued existence. In this article, we describe those challenges and outline some steps that governing boards and administrations may have to take in order to ensure the survival of their institutions.

The Tuition Dilemma: Less from More

Press headlines have for years trumpeted the seemingly unstoppable upward march of tuition at private colleges and universities. Posted tuition figures, which have increased at a rate well in excess of the Consumer Price Index (CPI) and the Higher Education Price Index (HEPI), have attracted increasing criticism from the public, from policymakers and from other stakeholders, and have been implicated in the general debate about unsustainably high levels of student debt.

What is less well understood is that posted tuition rates are paid by a relatively small proportion of families. In fact, according to the 2016 NACUBO Tuition Discounting Study[1] (the "Study"), an estimated 90.9 percent of first-time, full-time first year students at small private institutions received some form of tuition discount (called in the Study an "institutional grant") for the 2016-17 academic year. At these institutions, moreover, the scale of the grants was not trivial, amounting on average to 55.8 percent of tuition and fees.

Looking briefly at the other two categories of educational institutions surveyed in the Study, tuition discounting at research universities occurred at a substantially lower rate, with just 65.0 percent of families receiving institutional grants, but with a much higher grant of 71.6 percent of the posted tuition rate. Comprehensive institutions were in the middle: 84.6 percent of families received grants, which averaged 49.2 percent. Overall, for the 411 institutions participating in the Study, 87.9 percent of families received institutional grant aid which, on average, was 56.3 percent of the posted rate. This grant level represents an all-time high in the multi-decade history of the Study.

Why do colleges discount their tuition? The most selective, which could in theory simply choose from a pool of qualified students able to pay the posted rate, use discounting as a tool to shape the pool of accepted applicants in ways that achieve institutional goals such as economic, geographic and ethnic diversity within a given class. It is felt by these institutions that all students will benefit from an environment in which a wide variety of human experience is present. It is also believed that even — and perhaps particularly — those families that are able to pay the posted tuition rate will be attracted to institutions that, in addition to rigorous academic and other programs, can offer a desirably diverse class environment in which students may learn from each other as much as from the faculty. For institutions with large endowments, the ability to offer admission to all, regardless of financial need (so-called "need-blind" admission) gives greater flexibility in achieving these goals. In that sense, for these institutions tuition discounting is a strategic, rather than a tactical, measure.

For institutions that, for academic, financial or other reasons, cannot be as selective, the equation is very different. These schools, by definition, lack the ability to fill their classrooms with qualified full-pay students. Instead, their applicant pool tends to contain students from families that, for financial or other reasons, require the incentive of a discount from the posted rate. In addition to offering these families a rate that they can bear economically,

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[1] The 2016 NACUBO Tuition Discounting Study surveyed 411 private institutions, of which 318 were defined as "small", meaning that they had enrollment of less than 4,000 and awarded only associate's and bachelor's degrees. The remaining institutions were classified as "comprehensive/doctoral", defined as master's and doctoral degree-granting institutions with enrollment above 4,000 (56) and "research", defined as doctoral degree-granting research universities (37). The Study does not survey public institutions because, it says, "independent colleges . . . award the largest proportion of [institutional grant] aid". Copies of the Study can be ordered from the National Association of College and University Business Officers at http://www.nacubo.org/Research/NACUBO_Tuition_Discounting_Study.html.

tuition discounting at less-selective colleges can be used to persuade the families of desirable students to choose their institution instead of a more-selective one, perhaps by offering a steeper discount. Seen from this point of view, tuition discounting may be interpreted as a tool for enhancing the overall academic level of the student body, perhaps with the added goal of raising the institution's ranking in the various college rating surveys. The longer-term result, however, can be an economic race to the bottom, as less-selective small colleges offer higher discounts to fill each class with desirable students.

This unfavorable financial situation is exacerbated by a number of other negative factors affecting the higher education sector generally.

The first is a secular decline in undergraduate enrollment. According to the Study, 50.2 percent of all institutions reported declines or no change in the number of first-year students enrolled from fall 2013 to fall 2016. In addition to price sensitivity (68 percent) and increased competition (57 percent), a large majority of respondents cited changing demographics leading to a shrinkage in the size of the college-age cohort in the general population (57 percent) as a main cause of this decline. While many institutions have been able to offset this shrinkage in part by attracting full-pay students from outside the United States, there are limits to what such a strategy can achieve at a small college without altering the cultural experience that may be a core part of the institution's offering.

The second factor is the well-publicized competitive trend toward building new and more luxurious dormitory facilities, upgrading dining choices and offering high-end recreational facilities for students. These non-academic features are seen by less-selective institutions as additional tools for attracting desirable students, but unless they are supported by donations or operating surpluses they may come with a cost in the form of debt service, which can create an additional financial burden on the institution.

The third factor — and perhaps the most important from a long-term strategic point of view — is the operational structure of small colleges, which we discuss more fully elsewhere in this article. Despite the media attention paid to online learning alternatives at some institutions, the basic business model for small liberal arts colleges — a residential campus with in-person classroom instruction provided by tenure-track faculty — has remained largely unchanged from at least the early 20th century. While other sectors of the economy — including many nonprofit organizations — have altered their delivery models in response to technological and other innovations, small colleges have remained largely unchanged in the way they carry out their educational mission.

Payment models, too, have been changing fast. The enactment by states such as New York of programs that offer middle-income families free tuition at public colleges and universities has placed additional pressure on private institutions, for which state subsidies, if available, are more limited and may come with further constraints on, for example, future increases in tuition for a student that qualifies for state aid.[2]

Posted tuition, then, is almost completely irrelevant to the actual economics of running a small college. The real metric is per-student net tuition and fee revenue, which the Tuition Discounting Study defines as "gross tuition and fee dollars minus institutional grant aid" (i.e., minus the discount). With the discount rate at an all-time high of 50.9 percent for small colleges, the average family whose son or daughter is enrolled at a small college is paying just under half the posted price — and many are paying even less.

In fact, the steady increases in posted tuition over the years are almost certainly not the result of greed or poor administration at small colleges, though those defects may exist at some. Rather, they are an artifact that reflects the urgent need of these institutions to make up the structural deficit in their operating budgets. Put another way, as the Study report states, "most increases in net tuition and fee

[2] For a more detailed analysis of New York's program, see *"Not so Free: Financial and Investment Implications of New York State's Excelsior Scholarship Program"*. Commonfund Institute, June 2017. https://www.commonfund.org/2017/06/06/new-york-excelsior-scholarship-implications/.

prices have been used to fund even higher institutional discounts". In short, higher posted tuition, which is paid only by upper-income families, is used to partially fund the deeper discounts that the institution must offer to fill the class.

Giving It Away

Since private colleges typically raise endowments to support their programs, it is natural to ask whether these endowments, which are frequently directed by donors to provide financial aid or scholarships, may be able to provide relief. The short answer, unfortunately, is no, barring the opportunity to increase student aid-directed or unrestricted endowment substantially.

According to the Study, the percentage of total institutional grant aid at small colleges funded by endowments in fiscal 2016 was just 12.0 percent. This was a higher percentage than the 4.5 percent provided by endowments at comprehensive institutions, but much lower than the 27.9 percent provided by endowments at research institutions.

For many small colleges, it may be inferred, the percentage is much lower than 12.0 percent. They are likely to have smaller endowments, on average, than comprehensive and research institutions, and their percentage of total institutional grant aid funded by endowment funds in fiscal 2016 is accordingly likely to be lower. For example, among institutions with endowments between $50 million and $100 million, the percentage was just 10.4 percent; for smaller endowments, the percentage was less than 6.0 percent.

To provide further context, according to the 2016 NACUBO–Commonfund Study of Endowments (NCSE), the median percentage of operating budget support provided by endowment is higher at institutions with large endowments than at those with small endowments; for those with endowments between $100 million and $500 million it was 7.3 percent in FY2016. For institutions with smaller endowments it was significantly less, as shown in the table below.

PERCENTAGE OF OPERATING BUDGET SUPPORTED BY ENDOWMENT*

Numbers in percent (%)	Total Institutions	Over $1 Billion	$501 Million-$1 Billion	$101-$500 Million	$51-$100 Million	$25-$50 Million	Under $25 Million
Responding Institutions	473	44	45	175	97	75	37
Average percentage of operating budget funded by endowment	9.7	22.3	16.0	10.1	7.4	3.8	3.4
Median percentage of operating budget funded by endowment	5.4	17.8	14.5	7.3	4.2	2.8	1.8

*Private institutions only
Source: 2016 NACUBO–Commonfund Study of Endowments

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It seems unlikely, given these realities, that endowments at small colleges will be able to contribute significantly to solving the tuition discounting dilemma.

But what about annual giving? At many colleges, annual campaigns can be quite substantial, and annual gifts are frequently unrestricted or specifically designated for scholarships and financial aid.

Here, too, we see that smaller colleges are unlikely to be able to look to this source of funds as a solution to the problem posed by tuition discounting. As the table below, also taken from the 2016 NCSE, shows, the median percentage of operating budget support provided by annual giving for colleges with endowments below $500 million was quite low, ranging between 1.9 percent and 2.7 percent in FY2016.

What, then, is used to plug the financial hole created by tuition discounting and only partially filled with full-pay tuition and endowment distributions? The answer is: nothing. As the Study delicately puts it, “these data reveal that the vast majority of institutional grant aid is ‘unfunded’ — that is, a dedicated revenue source does not support the bulk of aid expenditures”. Put plainly, the posted rate bears no relationship to the actual revenue that is needed to balance the books of the institution. That number is a contingent one, highly dependent upon the level of discounting necessary to assemble a class and the size, performance and spending rate of the endowment.

PERCENTAGE OF OPERATING BUDGET SUPPORTED BY ANNUAL GIVING*

Numbers in percent (%)	Total Institutions	Over $1 Billion	$501 Million-$1 Billion	$101-$500 Million	$51-$100 Million	$25-$50 Million	Under $25 Million
Responding Institutions	447	31	41	168	97	75	35
Average percentage of operating budget funded by annual giving	4.2	5.5	4.0	3.8	3.5	4.0	7.3
Median percentage of operating budget funded by annual giving	2.4	4.7	4.0	2.4	1.9	2.0	2.7

*Private institutions only
Source: 2016 NACUBO–Commonfund Study of Endowments

Getting the Model Right

The increasing unsustainability of the traditional model is highlighted in a recent report[3] which compares five operational structures for small colleges. The "Traditional" model, which posits a strong liberal arts curriculum offered in a residential setting with teaching undertaken by a high-level, tenure-track faculty, is viewed as the purview of a small group of wealthy, selective institutions. For others, four alternative structures are described:

- The "New American College" model adds professional and graduate programs to the undergraduate liberal arts core. This, the author asserts, is the model pursued by the "vast majority of non-elite small private colleges in the country".
- The "Distinctive Program" model seeks to differentiate the institution by offering a specific institutional culture or program which, to its desired applicant group, can in principle justify a higher cost. Examples of this model cited by the author are Agnes Scott College, Carroll College, Connecticut College, Furman University and Dominican University of California, where the author is President.
- In the "Expansion" model, the institution unmoors itself from its single residential location and opens different campuses with a focus on professional and graduate programs. Here, the traditional liberal arts curriculum may become relatively residual in comparison with the new offerings.
- Finally, the "Expansion and Separation" model is distinguished by a virtual abandonment of residential liberal arts education in favor of a multi-campus structure offering primarily professional and graduate programs combined with online courses.

With the exception of the Distinctive Program model, all of these alternative models implicitly rely to some extent on growth — the idea that, by increasing the number of popular offerings, the institution can stem the decline in net tuition revenue. In the case of the Distinctive Program model, the goal is the opposite: the creation of an attractive niche offering that is by definition limited in its capacity to absorb more students without a diminution in quality and for which, therefore, a higher price (or a smaller discount) is justified.

But none of these alternative models can be pursued without investment in programs and facilities, which may in some cases need to be significant. In this sense, the risk is asymmetrical: by committing to an alternative model, the institution also commits itself to the expenditure required to offer a credible set of programs that will then generate sufficient net tuition revenue to enable the institution to survive. Without this additional revenue, the institution may even be worse off than before, hobbled by debt and higher running costs but having failed to attract sufficient revenue to set against them. As the author states:

A simple aspiration and plan for growth will not necessarily make an institution sustainable. A focused commitment to educational quality will not necessarily drive student demand. A rigorous analysis of mission, market and expectations for outcomes can help boards and presidents move beyond simplistic assumptions and adopt the institutional model most likely to ensure the long-term health of the campus.

Suggestions for Governing Boards

In the business world, typical responses to overcapacity in a given sector include measures such as merger, consolidation and bankruptcy. While there has been much speculation about the application of these measures to the higher education sector, there does not seem to be a strong trend indicating their actual implementation at the institutional level. Reasons for this could include inertia, opposition from donors or graduates, institutional pride, the absence of suitable partners, and the procedural difficulty of winding up a nonprofit institution, among others. The forces driving tuition discounting and the search for new business models are nevertheless real and demand a thoughtful response from governing boards.

[3] Marcy, *"The Small College Imperative: From Survival to Transformation"*. Association of Governing Boards of Universities and Colleges, May 2017. https://www.agb.org/sites/default/files/whitepaper_2017_small_college_imperative.pdf.

Here are a few questions that boards may want to ask:

Market position:

- How unique are we?
- What justifies our posted tuition rate, and what factors drive the discount that we must offer to fill our classrooms?
- With which institutions do we compete, and with what degree of success?
- Should we consider making changes to our tuition pricing structure, such as cutting or freezing tuition, in order to maintain or gain market share?

Market evolution:

- Where do the students that we desire live?
- Is that group increasing or decreasing in size, becoming more or less prosperous, more or less able to afford the education that we offer?

Physical and financial resources:

- How able are we to maintain the quality of our offering?
- What is the state of our physical plant and what are the recent trends on spending for property, plant and equipment?
- What is the tenure model for our faculty?
- How likely is it that future net tuition flows, combined with endowment and annual giving support, will enable us to improve the quality of our physical plant and teaching?

Alternative models:

- Which of the five models do we conform to now?
- Which should we be in ten years?
- What financial and other resources would be required to make that transition?
- Should we consider merger, consolidation or entering into consortium agreements with other institutions?
- If so, what steps would have to be taken?

Endowment trajectory:

- In what areas should our endowment grow?
- How do our institutional priorities intersect with those of our graduates and donors?
- How large should our endowment be in ten years?
- What path should we take to get there?

Conclusion

The situation facing small liberal arts colleges is severe and could worsen before it improves. Tuition discounting, as it has been practiced, may be reaching the limits of its practical usefulness. Alternative models have their attractions but also require investment that may not be offset by sufficient increases in net tuition revenue. In this environment, governing boards need to undertake a serious strategic analysis of the strengths and weaknesses of their colleges, looking out over the medium to long term to assess the steps that their institutions will need to take in order to survive.

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