Concerns Growing Over Rising Cost of Higher Education
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Is there a crisis in college affordability? Americans rank education as one of the most important domestic issues, according to recent polls, and there is growing concern about the rising cost of higher education. On the heels of some of the steepest increases in college and university tuition in years, the U.S. Congress began pondering this issue, and how to make college more affordable for the masses has also emerged as a major domestic policy debate between President Bush and his Democratic challenger, Senator John Kerry of Massachusetts.

Higher education costs have long exceeded the general rate of consumer inflation, and recent increases, especially, have been significant relative to the slower growth in real wages and income. On top of this inflation, most not-for-profit colleges and universities report that even rising tuition doesn't always cover the full costs of providing education. They rely on unrestricted gift income, spending a portion of their endowment, conducting sponsored research, and providing other sales and services (including athletics programs) to fully cover the costs of providing education.

"The ability of colleges and universities to charge students to recoup some of the costs of higher education is a major reason for the general credit stability of the sector," said Standard & Poor's credit analyst Mary Peloquin-Dodd. "It is this pricing flexibility--the ability of private universities and of most public universities--to set a price relative to what the market will bear that has helped to keep ratings relatively stable during the last two to three years," she added. "However, competition and market demand are powerful checks, as are perceptions of differences in quality."

Pricing Is Market Insensitive

Pricing at some of the nation's most selective universities has long appeared to be market insensitive. Despite student charges, which can exceed $40,000 per year, these institutions are besieged by far more applicants each year than they can actually admit. "Many people believe that there is a pricing threshold in higher education, a price at which people will no longer demand a particular institution or educational product," said Ms. Peloquin-Dodd. "Applications at some selective private institutions dropped for the fall semester 2003, and it is possible that many students chose to enroll at public universities instead."

Public colleges and university tuition increases, while nominally less steep than the lower percentages at private universities, were certainly much higher than most other broad-market consumer products. During the past three years, some public universities adopted greater use of differential pricing, midyear tuition increases, and increases of 25% or more in an academic year. Some of these institutions also implemented onetime increases that equaled 40% of the prior year's tuition base. While increases were lower on a percentage basis for private colleges and universities, the absolute amount of increase still means a sizable increase in nominal student charges. For a private college or university with a sticker price of $36,000 (all costs included)
for the 2004 academic year, a 5% price increase in student charges can mean a year-to-year increase of $1,800.

Many of these increases, while nominally less steep than the lower percentages at private universities, were certainly much steeper than most other broad-market consumer products. Public colleges and universities also used price increases to close the gap created by reductions in state support, especially during fiscals 2002-2004. In aggregate, total state funding for public colleges and universities fell by 2.1% in fiscal 2004—the first decrease since fiscal 1993 and perhaps the largest in percentage terms in several decades.

529 Plans
Meanwhile, the price of higher education has created a flourish of new state-sponsored college savings plans, also known as 529 plans. However, the SEC announced this year that it is reviewing concerns surrounding these plans. Issues cited include lack of investor information, transparency of financial and investment information, and high fees charged to participants.

Tuition Discounting
The stated amount of tuition at a college or university, especially a private one, is often not the amount actually paid by many students. Tuition discounting is a common practice now in U.S. higher education, and many colleges indicate that they would lose a large number of incoming students if they didn't discount. Keeping stated prices high, however, is often related to "perceived" prestige—the higher the tuition and fees the better the school must be.

"It appears to be better for an institution, from a competitive position, to keep tuition and student charges high, and discount when necessary to feed the applicant pool," said Ms. Peloquin-Dodd. "Many competitive private institutions feel that if their tuition is significantly below that of their competitors, then potential students and their families may perceive it as a weaker option for higher education." The difficulty that higher education institutions face is that tuition discounting peaked in the early 2000s, before U.S. job losses, at the height of the economic cycle. Higher education now faces a double-edged sword: "needier" students and the rising costs of running higher education businesses means there simply is no flexibility to increase the amount of tuition discount.

A recent Standard & Poor's survey of the financial characteristics of a typical private college rated in the 'BBB' category showed that these institutions were still tuition dependent, with tuition and fees accounting for 70.9% of the schools' total revenues. At the upper end of the rating range, 'AAA'; tuition and fees accounted for just 27.9% of the average revenues for these institutions in fiscal 2003. In contrast, the average 'BBB' category private institution provides significant financial aid to offset the costs of attending the institution. This financial aid, or "tuition discount," is often a very large expense for the institution, and the percentage of tuition discount tends to increase with higher credit quality. In rare cases, Standard & Poor's finds that the tuition discount for some institutions in the 'BBB' and 'A' categories sometimes even exceeds the actual direct costs of instruction. "Institutions with greater levels of endowment offer a higher average tuition discount than less wealthy schools, largely because they can," said Ms. Peloquin-Dodd.

<table>
<thead>
<tr>
<th>Tuition Ratings</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
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</thead>
<tbody>
<tr>
<td>Tuition and fees as % of revenue</td>
<td>27.9</td>
<td>42.5</td>
<td>60.5</td>
<td>70.0</td>
</tr>
<tr>
<td>Average % tuition discount</td>
<td>40.8</td>
<td>31.0</td>
<td>29</td>
<td>26.7</td>
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One element is clear from looking at the table of tuition indicators. "Most schools are not able to charge 100% of their students the full sticker price of the costs of attending," added Ms. Peloquin-Dodd. "At the higher rating category levels, financial aid is more likely a function of demonstrated financial need."

While in the 'BBB' category, financial needs also exist, and more of the aid could be packaged as merit scholarships. The average 'BBB' category institution in the survey discounted less than the average 'AAA' rated institution, but ultimately did so on a much higher portion of operating revenues. As a whole, the average 'BBB' category private university received net tuition revenue of $11,996 per student in fiscal 2003, compared with $17,913 for the 'AAA' category. This data seems to back up a recent College Board Study, which found that most Americans believe that college is far more expensive than it actually is, and that the difference was the amount of financial aid provided by these institutions.

The difficulty is that for higher education, as a business, most schools cannot charge their customers a price that comes close to what it costs to provide that product. "There are some notable exceptions, but they don't tend to be for undergraduate liberal arts programs," said Ms. Peloquin-Dodd. "Medical, law, and graduate business programs typically offer little, other than loans, in the way of financial aid."

**Politics Matters**

The U.S. Congress began pondering the rising costs of higher education following some of the steepest increases in college and university tuition in years. Last year, Rep. Howard McKeon of California announced a proposal that would require any college receiving federal aid to limit its tuition increases or face the possibility of losing federal funds. Recently, however, Rep. McKeon announced that the provision was withdrawn from the Higher Education Reauthorization Act of 1965. The announcement cited Rep. McKeon's belief that colleges and universities have made some progress in striving to reduce costs since the act was proposed. Ironically, the President Bush's proposed 2005 budget sought to freeze the Pell Grant at a maximum award of $4,050 for the third consecutive year.

"Establishing price controls on the industry would have been unprecedented, and Standard & Poor's said at the time of the proposed legislation that its passage would likely have a detrimental effect on the credit quality of the nation's public and private universities," said Ms. Peloquin-Dodd.

There were cost-control measures and standards adopted as a result of the proposed Act, and industry experts are pondering the practical aspects of implementation. If the rate of increase is the concern, private colleges and universities will look as though they're better at controlling costs. For a private college or university with a sticker price of $36,000 (all costs included) for the 2004 academic year, a 5% price increase in student charges can mean a year-to-year increase of $1,800. But a 10% increase at a public university may only mean an increase of $500, if the tuition and fee composite price is $5,000 per year.

Many colleges and universities are attempting to keep their financial aid packages in line with tuition increases by reserving a certain percentage of their increased revenues from tuition hikes for increased financial aid packages. States have also responded to growing concerns about the rising
cost of higher education by offering an automatic financial aid package to students who receive a B average or better in high school, and for those who attend the state's community colleges or universities. In Georgia, The Georgia Hope Scholarship is one of the longer-running programs. In addition, New Jersey recently began offering a similar scholarship program to state residents with good high school grades who are willing to attend the state's county community colleges.

By Frank E. Benassi

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