An Ivory Tower of Pricing

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The College Board is just out with its annual statistics on college finances and, once again, tuition and fees have risen faster than inflation or household incomes.

Once again, the higher education establishment has argued that this isn't what it appears to be -- an industry whose cost growth is out of control -- but rather a reflection of improved quality of student experience, more scholarships for those who need them, and continued declines in taxpayer support for state colleges and universities.

And once again, politicians have chimed in with well-meaning proposals to "make college affordable" by increasing federal grants and loans.

This debate is as agonizingly stale as it is contentious, driven largely by oft-repeated misconceptions and special-interest hokum.

Part of the problem is that it's virtually impossible to have a coherent conversation about an industry that takes in Harvard, East Podunk Community College and everything in between.

It's also hard to bring economic logic to a market in which the product is usually sold at a loss, competition tends to push prices higher rather than lower, and at many schools, half the customers are forced to subsidize the other half.

Nonetheless, I offer a few observations that might shed some light on the tuition puzzle:

1. College costs should rise faster than overall inflation.

The goods that go into calculating the cost of living include lots of things that have gotten cheaper over the years because of imports and immigrant labor. Those disinflationary pressures are largely absent from a university, where the biggest expense is for highly educated labor.

2. Most price increases are not being used to increase student aid.

The College Board data show that even after discounting for increases in aid, inflation-adjusted increases in tuition and fees have been 2 to 3 percent per year over the past decade.

That said, student aid is a big factor, and universities have now overtaken the airlines in pushing the limits of price discrimination -- charging customers based on their willingness and ability to pay. This reflects an admirable goal by many private schools of making higher education accessible to the poor and middle class.
But schools are quickly reaching the point of diminishing return. There are now so few students paying full price that every dollar increase in tuition yields less and less in added revenue. Moreover, by continually pushing up the posted price, schools are having trouble attracting students from middle-class families that don't qualify for as much aid and can't afford the increases.

3. The most significant cost driver these days is the "arms race" for the best students and faculty.

Schools have figured out that they can attract the best students by offering more "merit scholarships" (aid not based on need), better dorms, better food, successful athletic teams, fancy new gyms, the latest technology. All this costs lots of money.

They have also learned they can attract faculty superstars with big pay packages, well-equipped labs and light teaching loads. The superstars, in turn, attract other good faculty and students.

The problem with these strategies is that once every school starts playing the same game, no school is able to significantly improve its relative position, which is how competition is waged in higher education. But what they all face are increased costs that drive up tuition.

4. Higher education has done a lousy job of trying to lower costs by improving productivity.

The economist William Baumol famously observed that there are some activities, like playing a Beethoven cello concerto, that can't be done more productively -- it always takes one musician 33 minutes. And a lot about teaching, one-on-one or small-group interactions between students and teachers, is similar.

But not all of education need be infected with "Baumol's disease." It may take Yo-Yo Ma 33 minutes to play that concerto, but through the magic of digital recording, an infinite number of people can listen to world's best anytime they want, at a fraction of the cost of a Kennedy Center ticket. And the same could be true of the college lecture, delivered by the best lecturers in the English-speaking world.

Of course, you'd still want the lectures supplemented by faculty-led discussions. But if you combine those recorded lectures with creative use of interactive, computerized instructional materials and quizzes, it's hard to imagine that you couldn't dramatically reduce faculty costs while boosting the quality of education.

5. Colleges raise tuition prices excessively because they can, not because they must.

One reason is that demand is growing faster than supply.

Another is that many customers are insensitive to price increases, particularly at elite universities. Students from lower-income families are shielded from the effect of price increases by various forms of student aid. And students from wealthy families are falling over themselves for the chance to pay an extra thousand or two for the credentialing and networking value of a degree from an elite university. That limits the brunt of the impact on the middle class.

Once elite schools lead the way with their price increases, it's easier for everyone else to follow. And in a strange way, they are almost encouraged to do so by many students and their families who -- despite all their whining about college costs -- believe that higher tuition is somehow a sign of higher quality and status.

In fact, surveys have shown that students would much prefer to go to a school that charges $30,000 in fees and services and offers them a $10,000 scholarship than attend a school that charges $20,000 and offers no aid. And some schools that have found that they can actually boost the quality and quantity of their applicant pool by increasing their tuition.

For the most part, the higher education establishment thinks there is nothing wrong with this perverse market, or at least nothing that a little more government subsidy won't solve. But there are a few brave dissenters, among them William Kirwan, chancellor of the University of Maryland system, whose efforts to improve productivity will be the subject of Friday's column.