# ONE

# An Introduction to the Higher Education Industry

Higher education affects almost all of us – as students, parents, employees, employers, and citizens or as beneficiaries of scientific, medical, and technological research. A college education is coming ever closer to being considered so basic that, like hospital care, it is too important to be left to the competitive forces of the marketplace.

Higher education today is caught up in conflicting political pressures that are increasingly relying on it to solve economic and social problems. Colleges and universities are called on to expand their already broad missions and make college education available not only to all recent high school graduates but also to older adults trying to adjust to changing labor markets. At the same time, higher education is asked to expand these educational services while reducing revenue from tuition and to avoid pursuit of other revenue sources when they involve questionable relationships with the corporate world. And the richer schools are pushed to spend down endowments that are being deemed "excessive" without a clear definition of what that means.

The higher education industry is complex and diverse. It combines a dominant *public* sector of state universities and community colleges that educate a majority of all students; a varied *private* sector of nonprofit schools that encompass some of the world's most elite research universities, such as Harvard, Princeton, and Stanford; elite liberal arts colleges, such as Swarthmore and Williams; and many hundred less-selective schools, many religiously oriented. Largely overlooked is the rapidly growing private enterprise *for-profit* sector that includes the University of Phoenix, with more than 300,000 students, about a dozen other higher education firms that are traded on organized stock exchanges, and hundreds of other for-profit schools that are not publicly traded, such as those owned by the privately held Education Management Corporation, with approximately 75 campuses that include the 18-campus Argosy University and the 35 locations of The Art Institutes. In addition, there are thousands of for-profit postsecondary schools, once called trade schools, that offer specialized vocational training but not associate's or bachelor's degrees.

Regardless of ownership form, the schools comprising the higher education industry are in competition. They compete for students – sometimes as part of their educational mission but sometimes simply as revenue sources – for individuals' donations, for governmental research grants and corporate research support, and for star athletes and even star academics.

The methods colleges and universities use to compete in all these realms are understandable once it is recognized that every college and university is some combination of a socially conscious provider of educational services and a business searching for revenues and cost-cutting methods. This is the "two-good" framework that underlies the chapters to follow: schools provide teaching and basic research, even when they are unprofitable for the individual schools, and finance these *mission* activities through conventional businesslike *revenue*-generating activities.

## THE TWO-GOOD FRAMEWORK

Explaining how and why colleges and universities pursue both lofty social missions and crass money-making activities is our focus.[1] Colleges and universities somehow balance their missions and their revenue activities, and we examine what sort of balancing act they perform and whether the balancing itself changes what higher education is.

### What Is Mission?

In the private market economy, the fundamental goal, or mission, of a firm in any industry is to make profit. The term *mission*, as applied to higher education, is so commonly used that its meaning is simply assumed.[2] American higher education today embraces three overarching social missions: teaching, research, and public service. The teaching of undergraduates has traditionally been, and continues to be, a primary goal of most schools

[1] For considerations of money and mission issues, see Bok 2004; Geiger 2004; Kirp 2003b; and Zemsky, Wegner, and Massy 2005.

[2] Philosophers and historians of education have written extensively on the purpose, goals, idea, or mission of the university. See, for some very well-known examples, Flexner 1930; Jaspers 1946; Kerr 1963; Newman 1873; and Ortega y Gasset 1930. For an overview of the concept of mission in higher education, see Scott 2006.

in the United States, including two-year schools, four-year vocational and liberal arts colleges, and even research universities.

Access to a college education for all young people, regardless of their family circumstances, is an important need-based element of the social mission. But education of the affluent would not justify public financial support because they could obtain higher education by paying for it. The social mission is to provide access to the poor, who could not afford higher education – although the question of what form and quality of higher education should be made accessible remains contentious. More generally, higher education is not simply of private interest to each individual; it brings benefits to other people. The instructional element of mission leads us to examine how the higher education industry and its public, nonprofit, and for-profit components deal with the cost barriers, especially tuition and financial aid, to full access.

Research universities have the potential to contribute to a second element of the social mission of higher education, through performing basic – as opposed to applied – research. This advances knowledge, which is traditionally disseminated via publications for others to build upon and, increasingly in recent decades, transferred through patent licensing to private firms capable of converting the basic knowledge into practical measures to improve human life. The growing importance of such "technology transfer" activities is another focus of our attention.

A third social goal, public service, is especially important to state-owned universities. This element of schools' social mission draws on the other two components of mission; it includes educating students not merely to increase their earning power but to be more successful contributors to society as citizens, and it includes recognizing a responsibility for bringing benefits to the larger community. This is the goal articulated in the "Wisconsin Idea," declared by University of Wisconsin president Charles Van Hise in 1904, to "never be content until the beneficent influence of the university reaches every family in the state" (University of Wisconsin-Madison Board of Regents 2006).

All three components of the higher education social mission have something major in common. Each has been widely judged to be socially – for all of society – valuable and worthy of provision, but each is privately – for the individual provider – unprofitable. In the assessment of higher education there are two essential truths: services that can be sold profitably do not need public subsidies. Services that cannot be sold profitably, either because the beneficiaries are poor or the benefits are so dispersed that beneficiaries cannot be excluded from the benefits – knowledge stemming from basic research and public service activities of colleges and universities – will not be provided by for-profit schools and cannot be provided by public or nonprofit universities without subsidization.

### Does Ownership Type Matter When Seeking Revenue?

In the chapters that follow we examine many aspects of higher education industry behavior.[3] How, we repeatedly ask, does this industry differ from any other industry, even those having no public or private nonprofit providers? It turns out that in higher education there is an unusual combination of ownership forms, but even here the industry is by no means unique; mixed ownership has also long existed in other industries such as hospitals and nursing homes, arts organizations, museums, and child day-care. The mixture leads us to ask how public and nonprofit schools differ from their for-profit counterparts. As we will explain (see especially Chapter 4), we expect to find major ways in which the public and nonprofit colleges and universities essentially do not differ from private for-profit schools, and we do find that. But we also expect to find ways in which they differ greatly from private firms, and we do.

There are two kinds of differences or similarities among ownership forms that deserve attention: what missions public, nonprofit, and for-profit higher education institutions pursue and how they finance them. Identifying the finance mechanisms and how they compare across ownership forms is challenging, but it is far more easily observed than is identifying and measuring their success in achieving their missions. Mission and finance are not independent of one another, though what a school is doing – for its students, the community, and society more generally – affects its revenue-generating capacity. And, conversely, a school's ability to generate revenue affects its ability to advance its mission and serve those various beneficiaries.

A good example of the tensions between achieving the mission and obtaining financing can be found in the basic research activities of public and nonprofit research universities. Basic research cannot be patented, and so a private, for-profit firm has no financial incentive to devote resources to it. But if basic knowledge, such as on cell behavior, can be advanced to a stage at which it becomes useful for producing a particular product or

[3] For some important studies on the economics of higher education, see Bowen 1967; Brewer, Gates, and Goldman 2002; Clotfelter 1996; Ehrenberg 2000; Kane and Rouse 1999; Massy 1996; McPherson, Schapiro, and Winston 1993; and Winston 1999.

becomes embodied in a particular production technique, it can be patented and potential profitability emerges. However, for the potential to be realized, the university must obtain a patent and must use it to control access.

There is truly a dilemma: maximum dissemination of knowledge implies not restricting access to it. But without restriction, new knowledge earns no revenue to the school (apart from its direct support through governmental research grants). And with restrictions that limit access to the research knowledge to whomever will pay the most for it, revenue is reaped but at the cost of limiting the dissemination of knowledge.

The dilemma is even deeper. A research university that is eager to raise more funds for the advancement of society's knowledge base is certainly spurred to patent new discoveries, but even when patenting is not directly involved there is another similar conflict. Universities seeking to advance basic research have a financial incentive to contract with private firms to undertake research for eventual publication in scholarly journals available to everyone but, in return for research funding, to allow the contracting firm to see the articles prior to publication. In short, the university has the incentive to limit knowledge dissemination, even if only for two or three months – a period often held to be insubstantial – to generate revenue for the long-run advancement of its basic research or other element of its mission (Chapter 8).

## Scrutinizing What Colleges and Universities Do

"No margin, no mission," the slogan of many a nonprofit organization, is a reminder that public and nonprofit schools, just like any for-profit company, cannot operate without revenue, which is the reason we focus on schools' revenue sources. Tuition is the major form of revenue for most schools, regardless of ownership form; tuition pricing and its close relative, student financial aid, bring multiple pricing, and although the ultimate purpose of such price discrimination may differ greatly for the various forms of schools, the practice is pervasive. We investigate the use of multiple pricing of higher education – charging different net tuition for different students – for the light it sheds on the differential goals of schools of the varied ownership forms (Chapter 5).

Donations – or what the Internal Revenue Service terms "contributions, gifts, and grants" – from private and governmental sources are growing in importance. Zeroing in on private donations, we undertake new analysis of what determines the amount of donations to a specific school and come to some startling conclusions. We answer the question of whether having a larger endowment leads to more private donations, perhaps reflecting donors' confidence in the school, or to fewer private donations, perhaps reflecting donors' conclusion that the school has less need for additional funds (Chapter 6). Our new research goes on to show that a school's success, measured in various ways, has major effects on some donor groups – alumni, parents, corporations, and so on – but not on others. Moreover, success in academics relative to athletics brings very different responses from these groups.

Examining college and university endowments and how they are managed demonstrates very clearly how the few fortunate schools with large endowments and accumulated savings act as business entities. When it comes to management of that wealth, it is again clear that higher education is not unusual: the rich get richer. The schools with the largest endowments, such as Harvard, Yale, Princeton, and Stanford, make the largest percentage returns on their investments. It is no wonder that some have questioned why wealthy universities with endowments in the billions of dollars need to charge tuition at all. At the same time, the importance of tuition (and other revenue sources) to a college that has only a tiny endowment of a few million dollars is evident. We discuss these endowment issues and more in Chapter 7.

In the course of time, schools have broadened their search for revenue, seemingly leaving no likely source unexplored. Finding ways to attract funding for research from governmental and corporate sources has become commonplace, with, for example, rapid growth in the number of universities establishing "technology transfer offices" with the goal of working with faculty to develop patents and then licensing their use to private firms (see Chapter 8). The University of Florida, for example, now earns about $8 million per year from licensing its most famous invention, Gatorade, and has earned well over $150 million since 1973 on the product (Phillips-Han 2003; Word 2007).

Hundreds of universities and colleges are pursuing revenue from sources they ignored in the past. New groups of tuition-paying students are being pursued, as adult continuing education and Internet-based distance learning programs have mushroomed, and some have become profit centers. Schools have begun to pursue other ways to generate revenue, including the licensing of the school's symbols, logos, and mascots to manufacturers of everything from clothing to caskets. However, some activities are not "substantially related" to nonprofit schools' tax-exempt mission and are subject to corporate profits taxation. Lobbying legislatures and working to gain earmarking of grants for a specific school are yet other revenue-raising mechanisms used by schools (Chapter 9). Any conceivable way a college or university might be able to raise revenue has likely been tried, though by no means always successfully.

We examine colleges' and universities' efforts to develop brand-name reputations and to capitalize on them through marketing activities that are barely distinguishable from what we would expect of a private firm in any other industry. Public and nonprofit schools – not just the for-profit schools we see advertised frequently on television – adopt "total integrated marketing plans" after hiring outside consultants as they compete aggressively in a crowded marketplace (Chapter 10). Schools of all ownership types also collaborate in many ways, often with for-profit companies. These collaborations often raise particularly thorny issues as we observe the balancing act between mission and revenue in higher education today (Chapter 12). All types of colleges and universities also work to control their costs by hiring less expensive non-tenure-track and part-time faculty (Chapter 11).

One indicator of the mission of a school is how it recruits and compensates key employees. In the pursuit of mission (which has important elements of vagueness) and of money (which is far simpler to measure and reward), how do colleges see the roles and importance of their presidents relative to their football coaches, and how does this view affect the comparative compensation? The type of president a school hires and the elements of the employment contract tell us much about what a school is trying to achieve. When we turn to football coaches' contracts, a quite different part of the story of higher education emerges, resulting in part from the ease of determining whether a football team won or lost compared with gauging the "success" of a president (Chapter 14).

With intercollegiate sports playing an important role in the United States, though nowhere else in the world, we also ask: how do intercollegiate athletics contribute to mission and to revenue, in both the powerhouse schools of National Collegiate Athletic Association (NCAA) Division I and the predominantly small colleges of Division III? We see evidence of different missions in the different divisions, with understandably different expectations for the profitability of any and all sports (Chapter 13).

Public and private nonprofit schools differ in important ways. Nonprofits receive far less direct public funding than publics but are major beneficiaries of favorable federal and state tax treatment for the individual and corporate donations they receive and of valuable exemptions from state and local taxation of real estate and sales. These benefits exist in expectation that nonprofit schools, like public universities, will pursue a social mission justifying the subsidies.

A recurring theme of our study is that the pursuit of revenue is a double-edged sword – indispensable for financing the social mission but a danger to the mission at the same time. So we conclude with a discussion of the public policy issues our findings raise about the higher education industry today and in the future. As we examine what colleges and universities actually do to raise revenue and how they spend it to advance their missions, our conclusion is that the public and nonprofit schools that educate the overwhelming majority of postsecondary students are neither unmitigated pursuers of money, acting as for-profit firms in disguise, nor simple altruists interested only in advancing well-defined social goals and making no compromises to advance them. The picture of the industry that emerges has many shades of gray.

TWO

# The Higher Education Business and the Business of Higher Education – Now and Then

Higher education is a large, complex, and changing industry. There is no single measure of the industry's size, but it enrolls some 19 million students and employs 3.4 million people, 3 percent of the entire U.S. service-sector labor force. A small number of schools are very well known, but the industry includes 4,314 degree-granting institutions (U.S. Department of Education, National Center for Education Statistics 2007b).

The higher education industry consists of public colleges and universities, private nonprofit schools, and a small but very rapidly growing number of private for-profit educational firms. About 39 percent of all U.S. degree-granting colleges and universities are public – four-year state universities and two-year community colleges – but as of fall 2006 they enrolled the large majority, 74 percent of all (undergraduate and graduate) students. There are as many nonprofit colleges and universities, about 38 percent of all schools, but their enrollments tend to be smaller than the public ones, accounting for 20 percent of all enrolled students. For-profit degree-granting schools are only 23 percent of the mix, enrolling over 6 percent of all students (see Tables A2.1 and A2.2 in the Appendix). The for-profit sector is vastly larger, though, when postsecondary schools that do not grant degrees are included. Nearly three-fourths of the 2,200 non-degree-granting schools in 2006 were for-profit, and this segment of postsecondary education is growing rapidly; its 330,000 students – an average of only some 160 students per school – is up from 189,000 as recently as 1997 (U.S. Department of Education, National Center for Education Statistics 2001, 2007b).

Does ownership form matter? Common sense suggests it does. However, to answer the question of whether each type of institution behaves differently we must rely on far more than common sense. We begin with an overview of the industry and how it and its ownership structure have changed over time. Next, and in the chapters ahead, we look carefully at higher education's revenue sources and how schools of each type finance themselves, because expenditure decisions by any organization are linked closely with its revenue sources.

## THE DEGREE-GRANTING COLLEGE AND UNIVERSITY SECTOR

Each ownership form does not occupy its own distinct niche in the higher education market. Within ownership forms there is substantial variation of school types or, to put it differently, at each type of school – degree granting and not, research university and liberal arts college, two-year and four-year – there are schools of every ownership form. But that does not mean there is no specialization, with a particular ownership form dominating a particular type of school. There is.

### Two-Year Colleges

The two-year or "junior" college, whether public or nonprofit, is a distinctively American development of the first two decades of the twentieth century. Founded to give students a liberal arts preparation prior to enrollment in a bachelor's degree program, these liberal arts programs were later overshadowed by the growth of technical and vocational curricula at junior colleges (Thelin 2004). Since the 1960s, public two-year colleges, now known as community colleges, have expanded enormously and currently make up 62 percent of the sector, but the nonprofit junior colleges have nearly disappeared. The for-profit two-year degree-granting schools accounted for only a small number of schools into the 1990s, but their number grew, as we discuss later in the chapter, and now make up 31 percent of the schools.

#### *Public Two-Year Colleges*

Public community colleges are playing an increasingly important role over time in the landscape of American higher education. Both the number of schools and the number of enrolled students have steadily grown. In 1949–1950 there were 297 public two-year colleges in the United States, but by 1968–1969 there were twice as many, 594, and by 2004–2005 the number had reached 1,061. Enrollments jumped even more spectacularly. In about 40 years, enrollment soared from just over 1 million in the fall of 1965, 17.6 percent of all college students, to 6.2 million in 2004, 36.1 percent of all college students (U.S. Department of Education, National Center for Education Statistics 2006a).