Set the WRONG TUITION and YOU'LL PAY A PRICE

Raise tuition or increase student aid? Such decisions are much more a matter of strategic planning and market positioning than of pricing.

FLORIDA'S PUBLIC UNIVERSITIES are rapidly pricing themselves out of the market for out-of-state students, the *Palm Beach Post* observed recently, a trend the paper said "spells trouble for in-state students and their education." During the past three years, the *Post* noted, out-of-state enrollment had dropped nearly 13 percent, removing almost $19 million per year in out-of-state tuition dollars that help underwrite Florida's "bargain-basement costs for in-state students."

At the same time, Hendrix College, a selective liberal arts college in Arkansas, raised its tuition by $5,000 in one year without substantially reducing the number or quality of entering students. The tuition increase, paired with new academic initiatives and changes in financial aid, put the college on a path toward increased revenues needed to strengthen programs, faculty, and facilities.

• BY DAVID W. STRAUSS •

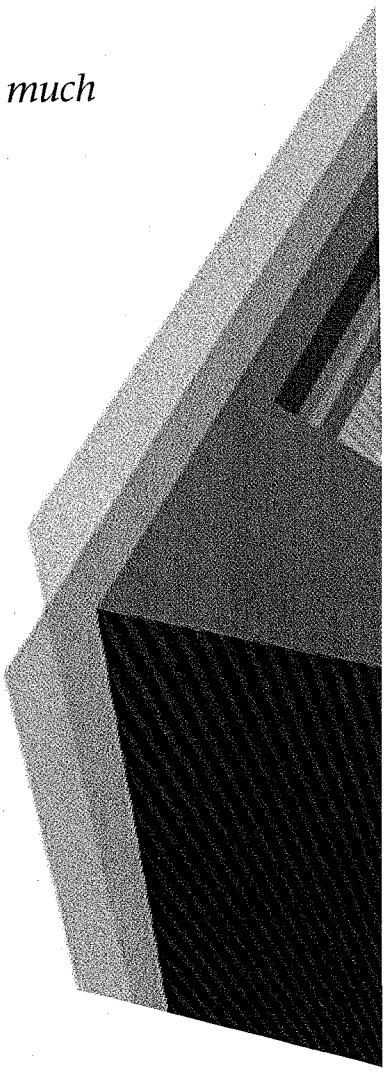


Illustration by Steve McCracken


THE TUITION TARGET
TILT
HOT MARKET
COOL MARKET
RAISE TUITION NOW
ENROLLMENT UP
ENROLLMENT DOWN
INCREASE AID
CHIVAS EFFECT
FLIPPER
FLIPPER
BAD MODEL

Why the difference in outcomes? Florida officials appear to have made a classic tuition-pricing mistake: relying on anecdotal assumptions about market behavior and price "elasticity" (the change in enrollment demand that results from a change in price). By contrast, Hendrix made no assumptions. Instead, it based its pricing decisions on the most advanced pricing-research methods.

For all of the attention rising college costs continue to receive, it is striking how poorly informed many decision makers are when it comes to setting tuition and fees. And it's equally astounding that so many institutions are learning the consequences of pricing decisions undertaken solely by trial and error.

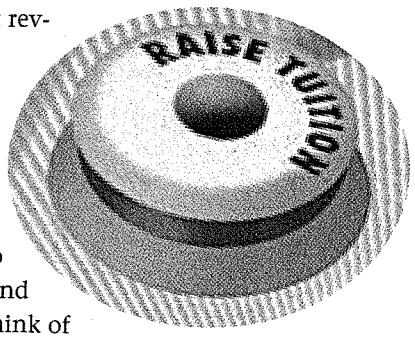
Setting the price of tuition is a high-stakes endeavor. The difference between right and wrong pricing decisions can add up to millions of dollars a year in lost revenue for a small college or tens of millions for a large university. A wrong judgment can affect everything from the size, quality, and diversity of the entering class to the institution's relationships with its financial supporters and the public.

Faced with rising operating costs, volatile political support and appropriations, and intense competition for students, boards and chief executives cannot afford to ignore or make rash assumptions about price sensitivities.

Caveat Venditor. Seller, beware. In making any significant changes in pricing levels or strategies, it is essential to "do it right." In my view, that means following six key principles.

1. Treat pricing as a long-term strategic question, not a short-term cost issue. A short-term view can blind an institution to market sensitivities. "This 30 percent tuition increase is just a one-time correction forced on us by this year's budget crunch," a public university official might argue, rather than considering whether long-term trends suggest that the university should adopt a radically different model of tuition and financial aid. "An 8 percent increase this year won't have that much larger an effect than a 5 percent increase," a private college administrator might assert, ignoring the compound effect of repeated annual increases that will stretch price elasticity to the breaking point.

Of course, some institutional leaders speak laudably about keeping price down and acting responsibly in trying to cover their costs of operation. But most have essentially allowed the cost side of the ledger to drive pricing decisions and assumed the market would absorb whatever increases were necessary. That assumption can be painfully wrong. It can lead an institution to overshoot, as was apparently the case with out-of-state tuition in Florida, driving down enrollment and net revenue.



Or perhaps more commonly, it can lead an institution to constrain its price unnecessarily as it constrains its costs, resulting in underpricing that leaves on the table money that is critical to strengthening programs, faculty, and other priorities. It is essential to think of the cost of attendance not only in terms of internal budgetary needs, but also in terms of external market sensitivities. This is not simply the *crisis du jour* but a long-term strategic matter of devising an institution's price positioning vis-à-vis its competition.

2. Don't assume what works for your competitors will work for you. The most common approach to pricing in higher education is the "Keep up with the Joneses" strategy, a classic example of misguided conventional wisdom. Proponents of this approach assume that if their institution imitates its peers, it will have essentially the same results. The institution draws up a list of colleges or universities it views as peers and then sets its price in relation to theirs.

This approach can lead to disaster. At one mid-sized private research university in the

Midwest that competes nationally for highly qualified students, board leaders pressed the administration to raise the relatively low tuition to match the price of its highest priced peers. The trustees argued that the university was the academic equal of those competitors and should command an equal price.

Fortunately, the administration commissioned a rigorous analysis, which indicated that the price changes envisioned by the board would have driven away more than a third of the institution's matriculating students, harmed the qualifications and diversity of the entering class, and reduced rather than increased net tuition revenue.

Why is such conventional wisdom so problematic? First of all, the assumed competitive set is usually inaccurate. Most colleges and universities define their peers as institutions like them (or, more often than not, institutions they aspire to be like). Typically, however, most of a college's prospective students consider a broader range of institutions. In an extreme example, a recent pricing study for a leading public university in the South revealed that only 9 percent of admitted applicants' decisions were made between the university and the institutions on its peer list.

Much more important, the "Joneses" approach ignores the idiosyncratic nature of price sensitivity in higher education. Each institution functions in discrete markets—geographic, demographic, and psychographic. Every college or university competes against a different mix of institutions for its students, and the competitive strength of each institution's value proposition differs from that of every other institution. It is these critical factors that control the role of price and influence prospective students' decisions whether to apply and to enroll at a given institution.

The key to establishing a successful pricing strategy is recognizing that the optimal price positioning is particular to each college or university. Decisions about the cost of attendance and the mix of price and aid must reflect the market dynamics that underlie price and aid sensitivity for that institution.

3. Don't buy the Chivas Regal argument without proof. A college president recently asked: "Doesn't the Chivas Regal effect still apply?" She assumed, as many do, that the idea that colleges that price themselves expensively will be perceived as more desirable applied broadly across American higher education.

The Chivas Regal effect, a reflection of America's culture of conspicuous consumption, works in some cases. Consider the case of a small, private college competing mostly against other regional institutions in the Northeast. A recent study surprised the college's leaders with the finding that the school could raise its price substantially with no negative effect on enrollment. Many more studies have identified public and private institutions that could increase enrollment of desirable students by combining a significant price increase with smaller increases in financial aid.

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But the Chivas Regal effect is not universal. Our work has shown that some institutions would have to return as much as the entire tuition increase through financial aid in order to neutralize the negative effect of the increase on enrollment and net revenue. In one instance, the university would have had to give back more than the full amount of the price increase.

The flipside of the Chivas idea—the argument that a low price brings clear competitive and financial benefits—cannot be applied broadly, either. The pricing study for the university in the South provides a perfect example,

because the effects of price changes were wildly different with different groups. This university, like public universities in many states, was under political pressure to keep the cost of attendance as low as possible for in-state students and to increase out-of-state tuition to provide additional revenue. Yet the study of "sticker price" and aid sensitivities indicated that the university was substantially underpriced for in-state students and already dangerously close to being overpriced in out-of-state markets.

In fact, the study revealed, in-state students tended to come from highly affluent families, immediately raising public-policy questions about the wisdom of the state's taxpayers subsidizing the education of the sons and daughters of the privileged.

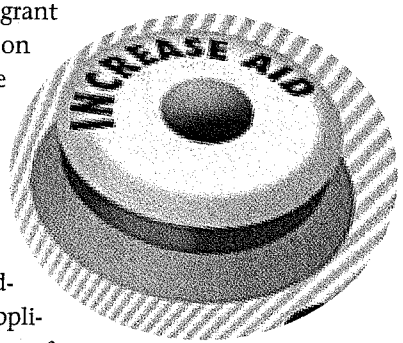
Again, price and aid sensitivities are idiosyncratic, both across institutions and across different prospective student populations within an institution. Each college or university should gain a solid empirical understanding of those sensitivities before making pricing assumptions.

4. Use the right analytic tools for the right questions. The only thing worse than making gross assumptions about price sensitivity is the false sense of security that comes with using analytic methods that are little better than guesswork. Perhaps most hazardous is the belief that an econometric analysis of historical admissions and aid data is an adequate tool for understanding sticker-price changes. Econometric techniques certainly are the most powerful method for understanding the enrollment effects of financial aid. But in the decade and a half since these techniques were first applied, it has become clear that such econometric methods are a poor tool for understanding discrete sensitivities to sticker price.

Proponents of the econometric approach often speak mistakenly about the effects of "net price" and describe their work as measures of "price sensitivity." In fact, all they are measuring is grant sensitivity. The difference is profound, and it is based on a faulty assumption: that a dollar of grant money will have the same effect on matriculation decisions as a dollar of tuition.

That is simply untrue for most institutions. Common sense tells us that the psychological effect of cutting tuition by $5,000, for instance, is different from the effect of a $5,000 merit scholarship. At one private college, we found that the enrollment effect of a price change on the yield rate would be less than half of the effect of an identical change in the level of grant awards. Relying on historical modeling would deceive such an institution into keeping its tuition significantly lower than it could command, while also distorting its aid policies.

Econometric modeling based on historical data has other critical limitations, as well. Prominent among these is its inability to predict reliably the effects of hypothetical changes—in the institution's price or in its appeal—that fall significantly outside the range of its actual historical experiences. For example, if a university plans to strengthen its competitive position by building a new student center, establishing a new co-op program for all majors, or making other significant changes, econometric analysis will not be able to account for the increased appeal of the college and how that might factor into prospective students' decisions.



Finally, historically based modeling of grant sensitivities can analyze only matriculation decisions, while research provides ample evidence that changes in pricing also can have a substantial effect on students' decisions whether to apply in the first place. This cannot be ignored. At a private liberal arts college we studied recently, the tuition increase being considered would have reduced the number of applications by fully one-third (to say nothing of the effect on the yield rate among those who still would apply). Another study, for a large

comprehensive private research university, reached a similar conclusion.

As an alternative, some analysts still advocate using conventional survey research to ask about price sensitivity. In matters of pricing, however, such straightforward polling will not yield accurate results. Most people cannot say what they would be willing to pay; the answer may vary according to a number of variables, and respondents who think they know the answer will often decline to answer honestly. Standard survey techniques, applied to questions of price, simply are unable to yield results with the rigor, accuracy, and precision these questions demand.

5. Over the long run, work to enhance the value proposition of the institution. Although the choice of a college or university is among the most important decisions a young person and his or her family will make, it nonetheless is a transaction. It boils down to how much the student wants to attend each institution he or she is considering, versus how much he or she is willing to pay for it. A high-ability student, for instance, is likely to scrimp together more to attend an Ivy League institution than she would to attend the nearby regional university. Over the long run, the key to reducing price elasticity is strengthening the competitive position of the institution.

This is much more a matter of strategic planning and market positioning than of pricing. Enhancing the institution's competitive appeal tips the scales in its favor, reducing price resistance and putting the institution in greater control of the price it can command in the marketplace.

6. To defuse political and other resistance to price changes, pay attention to the process. Even the best analysis cannot guarantee that an institution will make the right decisions. Just as important as statistical accuracy is the process used to create understanding and buy-in among the various parties that control pricing decisions. This requires taking a strategic point of view and engaging leadership constituencies (which often have conflicting viewpoints and competing interests) to understand how well-advised changes in price and aid can move the institution forward—and how ill-considered policies can send it backward.

At private colleges and universities, a thorough and rigorous study can provide the reliable evidence board members need to evaluate the assumptions that have shaped their pricing decisions. In one instance, such a study headed off a substantial price increase that would have reduced enrollment and net revenue. Another convinced board members intent on keeping price increases below the rate of inflation that the university was underpriced and could accelerate its growth and quality if it positioned its price substantially upward.

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In the case of public universities, legislators, governors, and regents need reliable data to provide political cover. What university officials see as increasing revenue to support critical objectives may be seen by public officials as political suicide. A valid pricing study can play a critical role in diffusing such concerns and in helping shape informed public policy.

The message for presidents and boards of trustees: Measure sensitivities in the marketplace accurately to inform your price and aid decisions. Manage deftly the political obstacles that stand in the way of effective pricing strategy. And determine how best to package and communicate pricing changes to your publics. ◆

David W. Strauss (strauss@artsci.com) is a principal of Art & Science Group, a consulting firm based in Baltimore.