UNDERSTANDING HIGHER EDUCATION FINANCE

INTERVIEW WITH RICHARD STAISLOFF AND DONNA DESROCHERS

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As part of a project on higher education finance supported by the Bill and Melinda Gates Foundation, Nate Johnson interviewed a number of experts and leaders to gather different perspectives on how major budget choices are made. The interviews have been condensed for publication so that the key insights are available to anyone who is interested.

This interview is with Richard Staisloff and Donna Desrochers, both with rpk GROUP, which consults with higher education institutions, systems, and state legislatures. Staisloff has been a leading voice in developing a new business model for higher education; Desrochers has worked on cost and price metrics in higher education, and was the lead data architect for the Delta Cost Project. Their discussion highlights why costs are rising in higher education, the financial dynamics of funding innovation, the importance of good leadership, and how auxiliary services are influencing institutional budgets.

Donna, regarding your work the Delta Cost Project, was there anything that surprised you or insight you thought wasn't available in the macro perspective that you had before?

(Desrochers) I think the biggest surprise is most everyone assumes that prices are rising because higher education spending is out of control. Certainly, higher education spending has been rising for most of the past 20 years, but a lot of the increase in the tuition price is really cost shifting. As states have been disinvesting in state higher education systems, that's really increased prices. Students are paying a larger share of the institution's cost to education them.

Private research institutions are where you really see the spending increase. It's something of an arms race. If they're spending more money, then other institutions are trying to keep up as well. There's a real inequality between what they're spending and what other intuitions are spending, and the gap's been growing.

One of the things that we saw with the volatility in the state funding is that when state appropriations per student declined, largely after recessions, tuition revenue increased. But interestingly, once there was a recovery and state and local appropriations per student started to go back up again, we didn't see tuition revenue decline. It still kept going up. Maybe not quite as fast, but certainly there was not a one-to-one trade off there.

It does seem to me that some forms of subsidy for higher education, especially the most broad-based ones or the most poorly targeted ones, would be more likely just to lead to price inflation. Colleges could just take into account that the students coming to them have these resources available that they didn't have before.

(Desrochers) My understanding is the bulk of the research has not found that strong of a connection between aid and tuition price increases as you would expect to find. Certainly, we have seen tuition prices increase over the past decade, but there's also a growing disconnect between the sticker price and the net tuition price that students are actually paying. The sticker price on the website has increased faster than the price students pay.

Individual institutions are going to continue to expect students to contribute a certain amount, and a category of students now has a larger state grant or a bigger tax credit. They can plug that into their model and move their money somewhere else. Is that something you've seen in your consulting work or your other work with institutions?

(Staisloff) That's exactly what's happening. Any wise institution is looking at all the resources that are being brought to the table and moving their own resources around to get the result they want. Sometimes that's a more qualitative result: "I want a different kind of student." But first and foremost, it's quantitative: "I need a certain number of students to make this whole thing work."

(Desrochers) There's been a lot of controversy lately about the number of out-of-state students that public institutions are recruiting, and particularly with merit aid. You see the institutions trying to get these students, as well as international students, because they're full pay, essentially. The institutions are trying to move the needle on that front so that they're getting as many of these students as they can.

We talk about all financial aid as equal, but it seems that there's a qualitative difference between financial aid that discounts to the marginal cost of education and financial aid that discounts below that. One of them is just a pricing, marketing strategy, and one of them is a subsidy.

(Desrochers) When I've looked at this in the past, it seems that the out-of-state tuition price was pretty close to the cost to educate students. So, I'm not sure they're making much of a profit on out-of-state and international students. And when they provide merit aid to these students, that lost revenue has to come from somewhere. The student aid provided by institutions is often tuition revenue from other full-pay students that was recycled into aid.

What do you think the range of definitions is for "return on investment" among the institutions you work with?

(Staisloff) I think that is really one of the most powerful parts of what we try to accomplish certainly in the work that we do: introducing the idea of return on investment and shifting people from that spending-only lens; transitioning from "how big is the budget" to an ROI lens, and what do I get for the people and time and dollars I use? Redefining return on investment to not only look at the financial return, although that's critical, but also to look at the return defined in terms of student success. How does this shift us towards more student completions and therefore lower unit cost of what's happening in higher education? That's a second key component.

I'm less interested in getting total cost down than I am in getting at the unit cost to do the job we're supposed to do. What's the cost of a completion, for instance, or showing people how to connect shifts in student success into a financial return? We'll model, for instance, how changes in retention and progression actually generate more net revenue down the road. Most students today generate more activity. They're paying tuition dollars, so the extra money from that activity falls to the bottom line. I find that when you're redefining ROI to include more than just dollars, and then you're starting to make the connection between student success and the business model, it frees people up to start to invest and think differently about allocation and reallocation, and all of a sudden, you're having a very different kind of conversation.

If you can figure out a way to reduce the unit cost of a degree to students with competency-based education, it's a win for students, but what's in it for an institution that's going to do that?

(Staisloff) It's the very reason why getting that business model conversation on the table is so critical. Up to this point, we've largely focused on doing things well and assuring quality. Of course, we should do that. Then we've looked at what things have helped student success. We haven't looked at the business model impacts underneath that. Some things actually generate net revenue, and more margin.

That does a particular thing for us from a financial stability perspective. Some things help us increase efficiency and productivity, and lower unit cost. Well, that's great from an outcomes perspective, and it connects certainly strongly back to mission, in my opinion, but it may not necessarily bolster the bottom line. You've got to be able to disentangle those things to ultimately create those sustainable models. It's why we've become very fond of saying you can't have innovation without sustainability, and why you have to look at the financial underpinnings to both the traditional model as well as new models.

What are the other revenue sources that institutions could be looking at to sustain innovation?

(Staisloff) The other opportunity is optimizing the current model to set up a good foundation to launch towards innovation. We've found there are just enormous opportunities, from an efficiency-productivity perspective, to harvest resources—in terms of vacant personnel lines, in terms of restructuring academic portfolios and delivery. These resources can not only be invested in the current model, so that you're not just "let's do what we're doing today a little better next year," but you're harvesting those resources to invest in those innovations. They become economic engines, or at least a way to finance those economic engines.

Are there ways to make it so that there is some intrinsic reward to achieving outcomes around a shared vision?

(Staisloff) It takes good leadership, bringing the mission forward in a different way that connects back to the business model and lets an institution keep doing what it's doing. On a larger scale, we work with a lot of regional comprehensive colleges and even other systems that start to take the harvesting model and use that for reinvestment. Candidly, investment and compensation is almost always on the list. Let's harvest somebody's revenue, and as a way to say, "Hey, thanks for helping us figure out how to maintain quality at lower cost, we're going to reinvest in you for helping us do that," but also making sure that the funding streams are available to figure out the next play for them, which can be a program play. It can be geographic shifts. It can be new forms of delivery. And it works. There's clarity about how you want to invest and what you're driving towards ultimately. That's key.

I still come back to what is a lot of Business 101, but it's got to be coupled with true leadership. Your strategic plan can't just be, "Let's do what we're doing tomorrow a little bit better." You've got to be able to invest in where the shifts are. We have seen that.

I'm not sure you can get the right results with bad leadership. I think I'd hook my wagon to good leadership and a tough business model better than a great business model with lousy leadership. This ability to understand and drive a business model is pretty rare.

Donna, I'm wondering what your take is on some of the more business-oriented or enterprise-oriented revenue opportunities for institutions. The auxiliary enterprises, the contracts and grants, the spin offs, the intellectual property revenue, and maybe even private gifts: What do you think the role of some of those revenue sources is in helping to allow intuitions to scale up their mission-related or their instructional operations? Is there no bearing at all or are some of them better sources of cross subsidies than others?

(Desrochers) Our take on it was auxiliaries were essentially paying for themselves. Certainly, we've been told that there's some murky money; we were initially under the impression that they kept more separate than they are. For instance, revenues from auxiliary operations like bookstores or hospitals generate revenues that can support other parts of the institution. But when we look at other areas like athletics, the money is typically flowing the other way with student dollars supporting those programs. Most athletic departments are not self-supporting.

It does seem to me that most institutions are probably generating some revenue from their auxiliaries in a couple of ways. Do you have a sense of how that money sloshes around a campus' balance sheet and operations?

(Staisloff) There is a difference on the public versus the private side. On the private side, I actually find far more instances where it's driving a lot of net. They're just able to maximize that, and they actually make a pretty good percentage of overall net revenue, particularly private institutions with healthy enrollments in urban environments where the market will actually support a premium even above general market rate. They do very well.

On the public side, part of the issue is that auxiliary revenues get locked into auxiliary, so the publics, they have this unfortunate segregation of revenue streams, and it's harder to bring those nets from the auxiliaries over into the general operating budget in many instances. When you think about your term of how it "sloshes" around, there are sometimes artificial limits on how much of the auxiliaries you can drive. I find that the publics could do a whole lot more to drive net revenue there, but either aren't paying as much attention to it or again are somewhat constrained at how they can take that net and apply it to other parts of the organization.

It varies certainly from institution to institution. Can auxiliaries be a profit center? Yes. In general, at least in our experience of institutions we've worked with on the private side and the public side. Not all money's green, unfortunately, in higher ed., on the public side.

It seems like, to the extent that it is a profit center, it is one that is going to incentivize institutions to work with higher income students—i.e., those who can afford expensive auxiliary services. Do you see it as a positive part of the business model or a dangerous one?

(Staisloff) it depends on what you're doing with that net. To the extent that you're generating more margin, that gives you opportunity to reinvest. In a world in which more of the opportunity to reinvest will come from the money that institutions generate themselves, rather than from public funds, then I think it's imperative upon them to drive those economic engines as hard as possible. Now we get back to the leadership question. "Hey, there's some money on the table. What do we want to do with that money?" That's a different conversation in terms of what's the job to be done and what success looks like and how you would know.

I've heard different opinions from different CFOs and college presidents about whether grants and contracts, both federal and general, are a net positive or a net negative for institutions. Is that something you've thought about?

(Staisloff) This idea that, "We're going to drive research and make money on it," I think is totally false. That doesn't mean it doesn't have other benefits, whether it's from attracting and keeping talent, brand identity, on and on and on. My recommendation to a university from a purely generate-more-net-revenue perspective would not be to try to put all your eggs in the external funding basket. Donna, I don't know if you've seen anything different in that regard.

(Desrochers) I would say my sense of it is the same. Institutions are often spending more money to cover the administrative costs of the contract than they generally receive. There's also the notion that there are tuition dollars that are going to subsidize this research portion of the work at some institutions. Certainly, that's more of what I've heard than that they're actually making money off it.

In looking at an institution's balance sheet or just on their audited financial statements, is there anything surprising or that people commonly misread, or that people don't understand in looking at those numbers?

(Desrochers) In general, boards and institution decision makers are not looking closely at this. They tend to look at the top line rather than looking more granularly. They're looking at total expenditures and total revenues, which makes it more difficult to connect to strategic decision making. I think they're more likely to look at where the money's coming from; they're less likely to look at where the money's being spent. What portion of that is going for instructional expenditures, how much is going toward student services, and what is going to administration or overhead or auxiliaries? We look to see if they're spending their money in an area that's going to generate the best returns for students. Is their spending on instruction increasing? Is their student services spending increasing in ways that will help improve student success?

Looking at it little bit more closely and in a little different context, you can really learn a lot of things about an institution. If you are looking at trends over time and across different metrics and contexts, you can get a pretty good sense of what's going on and how it aligns with the student outcomes you want. Even in cases where benchmarks are perhaps not entirely apples to apples, generally they're comparable enough to make some general observations about how you're spending your money and where your money's coming from.

(Staisloff) What we haven't really focused on is why does higher ed. cost what it does? I think that's the next frontier, quite frankly, instead of just focusing on how do we write an even bigger check so that more students can go to college, figuring out the cost side of the equation, and more work needs to be done there.

You talked about financial statements, and I think you mentioned balance sheets. I think there's some work there too. We're getting a little smarter around the statement of activities, the P&L, call it what you will. In terms of revenue and expense, annual basis, and what's going on, people have almost zero idea or ability to interpret what they’re looking at on the balance sheet. Are we healthier this year than last year? What's our capacity, therefore, to invest in ourselves in terms of student success? That skill set is very hard to find in higher education. Our ability to make that transition from what happens in any given year on a P&L into the balance sheet and overall financial health and capacity, I think is the next area of opportunity.

Richard Staisloff is the founder of rpk GROUP, which supports colleges, universities, and other nonprofits with their growth and reallocation strategies. He previously served as Vice President for Finance and Administration at the College of Notre Dame.

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