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Appropriate Tuition Adjustment: Recasting Financial Figures, 2015–16

Each fall, ISM publishes a set of conversion factors to simplify recasting previous tuitions into current dollars. (See the accompanying table.) We continue to use the Urban Consumer Price Index (CPI-U).[1] However, we also realize the CPI-U does not reflect expenditures in private-independent schools. *It can only serve as a base figure.* There are compelling arguments for adjusting your tuition at a rate of at least 2% above the overall inflation rate.

The CPI has a built-in "productivity factor." It assumes the workforce is increasingly productive as technology and other laborsaving developments provide greater output with fewer personnel. The more efficient a business becomes, the more it can stabilize or reduce the impact of inflation.

Education, however, differs from industries in that it is people-intensive and not truly "product"-driven. Education cannot offset the effects of inflation by increased efficiency—the classroom still basically consists of a teacher and a group of students. If more students enroll, we create more sections with more teachers. Even as the demand for additional programs (and teachers) occurs, schools often refuse to remove any standing programs to lessen the budgetary crunch. Costs go up even as productivity remains static.

Baumol's Cost Disease

All service industries—including education—suffer from a phenomenon commonly called "Baumol's cost disease."[2] William Baumol, renowned economist at New York University, developed data that showed costs in service-related businesses inherently rise faster than those in product-oriented industries. This occurs because productivity in the labor-intensive service sector lags behind manufacturing, and salaries in the service sector have to keep up with salaries in more productive industries. In short, the costs for health care, entertainment, insurance, law enforcement, and education will always rise faster than the CPI.

Concerning service-related businesses, Baumol points out that it's difficult to reduce the labor content because "in many of them quality is … inescapably correlated with the amount of human labor devoted to their production. Teachers who cut down the time they spend on their classes or who increase class size … are held to be shortchanging those whom they serve. This, then, is why the stagnant services have consistently proved unamenable to productivity growth."[3]

In an *Economics Letters* article, economists Xin Chen and Charles Moul reviewed the cost disease concept in the context of U.S. public school education.[4] Although they reviewed data from public schools, the issue is also significant for private schools. Baumol identified and explained the core phenomenon that low productivity sectors, like schools, must increase wages (and thus tuition levels) to compete with high-productivity sectors. This places pressure on private school leaders to explain why tuition gradients exceed inflation gradients. "Expenditure growth outstripping inflation is now well-documented in many sectors, with education and health care the canonical examples. The cost disease concept introduced by Baumol (1967) offers a compelling, if grim, explanation of this trend in labor-intensive industries."

Writing 45 years later, Baumol (2012) writes that "a country can continue to consume essential services from low-productivity sectors if its people simply recognize their increased wealth from the productivity gains of the progressive sector." Chen and Moul found little evidence in their study that the populace recognizes that it is experiencing increased wealth. People may be as skeptical as ever that tuition levels must rise faster than inflation.

School leaders must take pains to account for the need to elevate tuition levels at rates at least two percentage points ahead of rises in the CPI. ISM also has fresh descriptive-study evidence that school leaders in lower-tuition settings must work harder to make this case than will those in higher-tuition settings.

The Higher Education Price Index

Unlike the CPI-U, the Higher Education Price Index (HEPI) measures a fixed selection of goods and services that typically contribute to college costs. (The index tracks college faculty and staff compensation; salaries and benefits for nonprofessional personnel; contracted services; library acquisitions; and utilities).[5] Although the HEPI might reflect some boarding schools, it does not mirror most private schools. College costs are not comparable to those in K–12 education. However, the HEPI is closer to the costs of private-independent schools than the CPI, and reflects the service sector that Baumol discussed.

Over the past few decades, the HEPI has shown that higher education faces a higher inflation rate overall than the CPI-U, validating Baumol's theory. "Looking back over the past ten years, the rate of price change for HEPI has averaged about 3.6 annually versus 2.4% for the CPI. The point is that HEPI demonstrates that costs for higher education historically run at a rate substantially higher than the CPI."[6] (We've added columns for the HEPI and those conversion factors in our annual recasting table.)

The 2% Factor and Your Tuition

Tuitions must rise faster than the CPI because expenses to run private schools outpace inflation, just as in higher education. Faculty compensation goes up annually, but production generally does not. To increase productivity, each teacher would have to teach larger classes (unpopular with parents and students) or teach more classes (unpopular with overworked faculty).

To maintain an equivalent operation, year-to-year, ISM suggests income that is at least 2% greater than inflation to cover the additional hidden inflation. If your school does not keep one step ahead of real inflation, quality will be eroded through decreased faculty morale, diminished services, and deferred maintenance.

Educate your Trustees and parents about the 2% factor. They must recognize the justification for raising tuitions at a level higher than the CPI-U to preserve the quality of your school programs. Trustees also must consider implications for endowment and other investments—*a return greater than the national inflation rate is needed just to maintain the status quo.* I&P

[1] More information concerning the Consumer Price Index can be found at **www.bls.gov/cpi**.
[2] For a detailed explanation of Baumol's "cost disease," see "What Ails Us," from the Financial Page of *The New Yorker* (July 7, 2003), available online at