Colleges Flunk Economics Test as Harvard Model Destroys Budgets

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By Yalman Onaran

May 1 (Bloomberg) -- On a Thursday morning in March, the $32 million School of Management building at Simmons College in Boston is all but deserted. Three students lounge in armchairs facing floor-to-ceiling windows that look over the quad with its winding walkways and greening lawn; another makes photocopies.

"This building is always empty," says Raya Alazzouni, a sophomore from Saudi Arabia who's studying graphic design and taking courses in the management school.

Simmons, home to 4,700 students, opened the 66,500-square- foot (6,200-square-meter) center in January, two months before the U.S. stock market hit its lowest point in 12 years. Even before the ribbon cutting, enrollment in the management school had been dropping.

Now, the vacant halls are reminders of the new math confounding U.S. colleges. Students, pummeled by scarce loans and savings plans that have fallen as much as 40 percent, are heading for less expensive schools. The perks designed to lure them during boom times -- from hot tubs to dorm-suite kitchenettes, to in-room cable TV -- are crushing universities with debt. Even projects like Simmons's "green" management building, with its rain-absorbing roof patio and toilets with two flushing modes, can turn into burdens as schools struggle with rising expenses, plummeting endowments and needier applicants.

'Spending Binge'

"The spending binge by colleges and universities was part of the same trend that created the bubble in the rest of the economy," says Ronald Ehrenberg, an economics professor at Cornell University in Ithaca, New York, and author of "Tuition Rising: Why College Costs So Much" (Harvard University Press, 2000). "Now we're seeing it burst."

From Harvard University to California's 3 million-student community college network, the American system of higher education is in turmoil. The economic crash is upending each step in the equation that families use to determine where students will spend four of their most formative -- and expensive -- years. Today is the deadline that most schools set to receive a decision from accepted applicants.

Independent colleges that lack a national name or must-have majors are hardest hit. Many gorged on debt for construction, technology and creature comforts. Now, as endowments tumble and bills mount, they're struggling to attract cash-strapped families who are navigating their own financial woes.

Shutter Their Doors

Such mid-tier institutions may be forced to change what they do to survive. In the best case, they'll merge with bigger schools, sell themselves to for-profit organizations or offer vocational training that elite colleges eschew, says Sandy Baum, a senior policy analyst at the College Board. In the worst case, they'll shutter their doors for good.

Standard & Poor's predicts bankruptcies will rise from the typical one or two schools that fold each year.

"Small colleges with no reputation could go out of business," Baum says. "They're very tuition-driven, so if they can't get tuition revenues, they'll be in really bad shape."

College of Santa Fe, a private liberal arts institution, is one casualty. On March 24, the 1,900-student school in New Mexico announced it was closing. The reasons: It couldn't pay its $30 million in debt, and talks to join with New Mexico Highlands University, a state school, broke down.

Richard Kneedler, a former president of Franklin & Marshall College, a Lancaster, Pennsylvania-based college founded in 1787 with financial support from Benjamin Franklin, says many small schools face the same predicament.

Schools in Danger

Kneedler says 207 independent colleges, or almost a third of the 678 he analyzed, don't have enough capital to keep going for the long haul -- a 35 percent surge from a year ago. These schools are at risk of closing during a prolonged crisis. Failures would rise further if the recession persists beyond 2009, says Kneedler, who's now a management consultant at Towson, Maryland-based Yaffe & Co.

"If the markets normalize in a year, most might survive," he says. "If we've got a second year like this, the number of schools in danger will multiply by 10."

Simmons, founded in 1899, educates a mix of 1,900 female undergraduates and 2,800 graduate students. Its women-only undergraduate liberal arts program accepts 56 percent of applicants; top-tier schools accept fewer than 20 percent. Simmons has five graduate schools, from the 200-student School of Management to the 1,100-student College of Arts & Sciences Graduate Studies.

Colleges like Simmons -- mainly undergraduate schools offering some master's degree programs -- are in the worst financial shape, according to Kneedler's analysis. They turned to borrowing for the amenities they used to entice students to small programs. Now, they're drowning in debt, Kneedler says.

Simmons's Accreditation

Simmons President Helen Drinan says she hopes the new building and accreditation in March by the Association to Advance Collegiate Schools of Business will make it easier to market the School of Management to prospective students. The school hired Deloitte LLP's higher education advisory unit to suggest ways to navigate its current bind and to find further savings.

If these ideas don't work, the business school may have to go co-ed or abandon its emphasis on MBAs to focus on undergraduate business degrees.

Drinan bets Simmons won't have to go that route. It should be able to keep its undergraduate enrollment steady and increase students in its graduate programs, including the business school, she says.

'Political Anxiety'

"If that school cannot grow, then we have another decision to make," she says. "There's been a lot of political anxiety around campus over the fact that the School of Management is a relatively small program. Now we're in a position to say, 'Let's run with it.'"

Like the housing bubble, Simmons's woes started with easy credit. The school borrowed more than $140 million, tripling its debt in the seven years through 2008. It added classrooms connected via wireless networks. It renovated its library. And it spruced up its student center with a coffee bar and mix-your- own-milkshake cafeteria.

"That was a pretty bold borrowing strategy," Kneedler says.

Simmons followed suit as U.S. colleges jacked up tuition by an average of 3 percent above inflation every year. It counted on a rising endowment, parents' bull-market-fed wealth and burgeoning private loans that more than doubled student debt from 1998 to 2008.

Simmons raised annual tuition and living expenses to $41,500 in 2008, 22 percent above the $34,132 average for private colleges. Sarah Lawrence College in Bronxville, New York, the costliest U.S. school, charged $53,166 last year.

Credit Markets Collapse

Then credit markets collapsed. Simmons -- and even better- known schools such as nearby Boston University -- felt the aftershocks. Like many now-struggling companies and municipalities, Simmons had sold variable-rate bonds and hedged against rising interest rates through swap agreements, which fixed interest costs for the school.

When rates fell, Simmons owed more than $10 million on the swaps. When it refinanced the bonds, it had to accept more than triple the interest rate it had been paying before the crisis. Drinan expects to settle the swap with bankrupt Lehman Brothers Holdings Inc. at a lower cost.

Wall Street provided the tools for schools to take advantage of cheap credit. Bankers introduced college finance executives to the interest-rate swaps and similar innovations that are now costing colleges, says Andrew Evans, vice president for finance at Wellesley College in Massachusetts.

Investment Banks

"All these investment banks were offering a wide variety of products," he says. "It's not like the schools and universities thought of these themselves."

Last fall, Moody's Investors Service and S&P downgraded Simmons's debt by one grade to three grades above junk, citing projected budget deficits. Since then, Simmons has trimmed its $100 million budget by $5 million. It wants to cut another $2 million by June. It boosted tuition and living expenses by 5 percent to $43,500 for the 2009-10 school year. The president's residence, a two-story redbrick mansion 3.5 miles (5.6 kilometers) from campus, is for sale for $2.2 million.

"I don't know why they did the School of Management building," says Katelyn Scalera, 19, a sophomore from Massachusetts's Cape Cod, who's studying nursing. "They didn't have the money for it, so we're further in debt. And then they announce these cuts and increase tuition."

Families Hurting

With families hurting, Drinan says it will be difficult for Simmons and its rivals to entice more students.

"Every college and university in America is worried about that," she says. "Higher education needs to pay attention to its cost structure, but we have to have the facilities that are necessary to house and teach our students."

Simmons's neighbors around Boston, a 4,466-square-mile metropolitan area packed with 53 institutions of higher education, are mired in their own financial messes. Even Cambridge, Massachusetts-based Harvard, whose endowment almost tripled to $36.6 billion in the past decade, is offering buyouts to 1,600 nonfaculty employees.

In mid-April, Harvard's Faculty of Arts and Sciences said it would slash 19 percent, or $220 million, from its $1.15 billion budget over two years because of endowment losses. Harvard's holdings plunged 22 percent in the second half of last year, leaving a $52 million budget gap.

Future Woes?

In December, falling interest rates had already forced Harvard to sell $500 million of bonds to cover swaps it had bought to protect against rising rates.

Harvard will have to sell more assets to meet its obligations to private equity firms in coming years, says Steven Davidoff, a law professor at the University of Connecticut, who has studied the school's endowment. Private equity firms require commitments from investors for more money when buying opportunities pop up.

Across the Charles River, Boston University, with more than 30,000 students, has frozen staff hiring and salaries. It spent more than $500 million in the past five years on a 6,300-seat ice hockey arena, home to the 2009 men's national champions, and dorms with two- to four-bedroom suites. Another centerpiece, the $100 million fitness center, features a 35-foot (11-meter) rock- climbing wall, indoor track, Olympic-size pool and hot tub.

"I'm very athletic, so when I saw the gym during my first campus tour before I came here, it was a very important factor in my college choice," says Katie Burr, 21, a junior from Canton, Massachusetts, who's wearing baggy basketball shorts on her way to exercise there.

Construction Halted

Both Boston University and Harvard have halted construction projects after they and other U.S. colleges spent $93 billion on new buildings and renovations from 2002 to 2008. That's almost double the $48 billion spent in the previous seven years, according to trade magazine "College Planning & Management."

The trauma is worse for small schools like Simmons that lack national cachet. About 20 percent of private colleges reported that fewer students returned this past September compared with the previous year, according to the National Association of Independent Colleges and Universities.

As students leave these private schools, pressure builds on cheaper public universities, which are navigating their own funding shortfalls. Colleges in South Carolina are getting 18 percent less in state aid this year; Florida schools are seeing a 9 percent drop. Meanwhile, their populations are growing: California's community college system has 100,000 more students this year without additional funds.

Hand in Hand

"What's worrisome is states cutting budgets," says Patrick Callan, president of the National Center for Public Policy and Higher Education. "Those schools won't have enough money to educate their growing populations."

The administration of Barack Obama is boosting aid to reeling families. It may not be enough. The president is increasing grants and tax credits and expanding federal loans.

"Economic progress and educational achievement have always gone hand in hand in America," Obama, a Columbia College and Harvard Law School graduate, said in a March speech.

In February, he increased the maximum annual amount for a Pell grant, a government scholarship for needy students, by $619. It's now $5,350 for the 2009-10 school year. He also replaced the so-called Hope tax credit, which was limited to $1,800 per student and covered only the first two years of schooling. Now there's a $2,500 credit for all four years. Families who make less than $180,000 a year -- the income limit was almost doubled -- can deduct that amount annually from their taxes.

Middle Class Needs Help

"Pell serves the neediest students, but our middle-class families need help too right now," says Eileen Wilson-Oyelaran, president of Kalamazoo College, a liberal arts school in Michigan.

Battered on all fronts, many families are recalculating whether the return on their college investment is worth the cost. In New Hope, Pennsylvania, a historic town and tourist spot on the Delaware River, Tim and Laura McNamara are weighing whether to send their son, Daniel, to Gettysburg College, with its $48,050 annual tab for tuition and expenses. The 2,600- student liberal arts school next to the Civil War battlefield in Pennsylvania is his top choice.

Daniel applied early decision and was accepted in November, without getting financial aid. A few months later, Philadelphia- area schools, including Arcadia University, Drexel University and La Salle University, sent their acceptance letters. Daniel, 18, got offers that would cut the price of his education in half, Tim McNamara says.

Brand Name

Even though they can afford Gettysburg, Tim and Laura worry one of them could lose his or her job -- Tim's as a software company executive or Laura's as a medical affairs director. They're anxious that their savings may decline further and have asked Gettysburg to reconsider its lack of aid or relieve them of Daniel's commitment to attend. Students accepted under early- decision programs are required to enroll in that school.

"Gettysburg has a little bit better brand name," Tim McNamara says. "But he can get a great education at all these schools, so we're not sure whether the $25,000 difference is worth that small difference in reputation."

For Carl Erickson and Mary O'Neill of Grand Rapids, Michigan, the answer to the "Is it worth it?" question is yes. They'll pay the extra $43,000 a year for their daughter, Caroline, to attend Northwestern University in Evanston, Illinois, outside Chicago, if she gets in and chooses it over the University of Michigan in Ann Arbor, a state school.

Caroline, a high school junior who turns 17 in June, wants a big-city experience. She might find the art design program at Northwestern a better fit, her father says. The family would spend $10,848 at Michigan compared with $53,608 at Northwestern.

'We'll Pay for It'

"If she decides Northwestern has something that Michigan doesn't give you, then we'll pay for it," says Carl Erickson, 47, who owns a software company.

One thing that has kept families shelling out for higher education of any ilk is the return their children get on the investment. People between the ages of 25 and 34 with college degrees make on average $50,900 a year, or 62 percent more than those without, the College Board says. With an annual gap of about $20,000 a year, it takes about 10 years to recoup a $200,000 investment in a college degree.

For current students, the new reality as they pursue their degrees is crowded classrooms and fewer courses. Kirstin Gardzina, a sophomore studying nursing at Simmons, says that when she showed up for her first microbiology class in September, there weren't enough chairs because enrollment had shot up to 60 from the more typical 40.

'Bursting at the Seams'

Kalamazoo College, with 1,340 students, has told professors to increase class sizes so it can boost tuition revenue. California community colleges are cramming in more people to fulfill their legal mandate to accept every student who applies.

"We're bursting at the seams," says Jack Scott, chancellor of the community college system. "We're trying to serve as many people as possible, but we can't serve everyone without increased funding."

As colleges scale back, some students are changing what they study. Heather Demali, 20, a sophomore majoring in biology at the College of Wooster in Ohio, says she might have to drop her two minors: geology and environmental studies. Wooster offers some courses once and may not repeat them for several years, making it tough to fulfill her requirements.

"Scheduling has become a nightmare," she says.

'Arms Race'

That's a far cry from the bubble years when schools raced to offer the biggest and best -- from dorm rooms to exercise equipment, to food courts -- because that's what families demanded.

"The student coming out of high school today is a very different student than I was," says Robert Brown, president of Boston University. "We participated in the arms race to create community just like all other high-quality undergraduate institutions."

Deborah Moore, publisher and executive editor of "College Planning & Management" magazine, which tracks campus construction, says families were willing to spend to give their children what they had at home.

"When you live in a 3,000- to 4,000-square-foot home, each kid has their own room," Moore says. "They don't know anything else. So they demand singles, apartment-style quarters. Today's kid is more spoiled because that's what the experience is at home."

Floodlit Pool

At the University of California, Irvine, the Vista del Campo Norte student apartment complex looks like a five-star hotel. At night, the curvy outdoor swimming pool is illuminated by underwater floodlights. At Kalamazoo College, the main cafeteria, which the school renovated as part of $14.5 million in spending on the student center last year, lets students pick among pizza, hamburgers, grilled vegetables, make-your-own salads and a dozen other choices.

On a Wednesday afternoon in March, Ryan Hagerty, a Boston University junior who lives in the so-called student village that sports suites with kitchens and private bathrooms, is typing away on his WiFi-connected laptop at the Buick Street Market & Cafe on the ground floor of his dorm.

"I probably won't be living in such a nice building for a while after graduating," says Hagerty, 20, who's from Easton, Massachusetts. "I don't think this building or the arena are necessary; they're over the top a bit."

Even so, he says he wouldn't choose to live anywhere else while his father pays for full tuition and living expenses of $48,468 this school year.

Budget Shortfall

Boston University, where research funding of about $450 million in 2008-09 accounted for a quarter of its operating budget, is surviving the crash because it relies less than rivals on endowment income, Brown says.

The endowment provides 3 percent of its operating budget compared with 15 percent at Wooster. BU has enough of a reputation to fill its ranks so tuition revenue will remain consistent, he says.

Beloit College in Wisconsin, where tuition accounts for three-quarters of its income, doesn't have as many options. It got trapped in a $1 million budget shortfall when it slid 36 students short of projected enrollment in

September.

The liberal arts college, with 1,282 students, had to fire 40 people, including three faculty members. With a 70 percent acceptance rate, Beloit and similar colleges don't have much margin when applications drop.

'Change Our Model'

To keep its numbers up, Beloit accepted the same number of students this year despite a 10 percent decline in applications. Interim President Dick Niemiec is counting on at least 1,250 students next year. Even so, he prepared the 2009-10 budget on an assumption he'd get 1,200, cutting costs further to be safe.

"If the economy doesn't bounce within a year, then, like other businesses, we'll have to change our model," Niemiec says. That could mean reducing faculty over time and shrinking the school to 1,000 students, which was the case in the 1960s, when Niemiec attended.

Kalamazoo College, 240 miles to the east, is scrambling to slash $2.8 million in costs. It needs to compensate for the 28 percent decline in its $157 million endowment and the expected increase in financial aid it will have to dole out next year.

On this sunny March day, Kalamazoo's tree-lined campus is bustling with people walking to class and studying on the lawn. Students, mainly from Michigan, and faculty mostly know each other by first name. Classes range from 1 person in an upper- level Italian course to 40 in some introductory classes. For the small classes and personal attention, students pay $38,166 a year, including room and board.

Saving Money

Saving money is a campus-wide affair. On this day, about 40 students, professors and staff gather in a wood-paneled conference room. The group calls out suggestions, and students write them on easels lined with blank white paper: Dorm hall lights shouldn't be on 24/7; videoconferencing instead of travel; rent classrooms to companies.

While those ideas will help, the only savior for a school like Kalamazoo is more paying students. Last year, it had six fewer than anticipated, which means it will lose about $1 million over four years, says Jeffrey Haus, a professor of religion and history who's on the admissions committee.

"They're asking us to increase the size of attendance," Haus says. "Larger classes work against the mission of a small liberal arts college."

Amanda West, a first-year Kalamazoo student from Los Angeles, says she might transfer to a bigger school that costs less and offers more.

"I'm worried that my experience here won't be as rich as it could be," she says.

Trouble Ahead

Colleges will be stretched further as the private equity firms they've invested with make calls for money promised earlier, says Wellesley's Evans.

"You might be liquidating assets that you might not want to be liquidating," he says. "Your asset allocation will be out of whack."

By 2012, the ratio of illiquid assets such as private equity stakes and real estate in Harvard's portfolio will likely rise to 44 percent from 26 percent, the University of Connecticut's Davidoff estimates.

Schools are also hurting as they pay 10 times more for bank lines of credit. The standby cost, or interest paid on the credit when it's not being used, has surged to 1 percent from less than 10 basis points, says James McGill, senior vice president for finance and administration at Johns Hopkins University in Baltimore. (A basis point is 0.01 percentage point.)

'Liquidity Freezes Up'

"We're in the process of deciding whether these are worth keeping," McGill says. "If liquidity freezes up again, they're good to have."

One way schools like Beloit and Kalamazoo may prosper is by offering vocational training, unique majors and other programs that the most-competitive colleges don't provide, says Morton Owen Schapiro, president of Williams College in Williamstown, Massachusetts, which is tied with Amherst College 60 miles southeast as the top U.S. liberal arts college as ranked by “U.S. News & World Report.”

Amherst President Tony Marx says most institutions will scale back financial aid commitments.

“Access to higher education in America is going to be squeezed, become less equitable,” he says. “America will pay an unbelievable price for this 20 years from now.”

‘Math Doesn’t Work’

Public universities will change too.

“State universities have to think about how many resources they’re going to put into being a top-ranked research institution and balance that against their primary educational mission,” Boston University’s Brown says. “Every state wants its flagship university to be a top-20 research university. Obviously, the math doesn’t work.”

More students will start undergraduate careers at community colleges. About three-quarters of such colleges say enrollment increased at least 5 percent this year from a year earlier, according to a survey published on March 17 by the League for Innovation in the Community College.

Financial pressures will prompt more students to cram four years of college into three straight years, says Richard Ekman, president of the Council of Independent Colleges. He’s not sold on the idea.

“You spend 100 years running a college based on a four-year model, with summer breaks for mental assessment,” Ekman says. “Then you suddenly announce you can do it in three years. You do have to ask whether it’ll still have as good an effect.”

Three-Year Plan

Boston University student Burr, en route to the fitness center, says the three-year trend is gaining momentum: Two of her best friends are overloading courses to graduate early.

On the positive side, cost cutting might make universities more efficient. That hasn’t been their strong suit, says Callan at the National Center for Public Policy and Higher Education.

Colleges, unlike businesses, could keep increasing prices without losing market share. Schools hired presidents to raise money and spend it to make their universities more prestigious, he says. Now boards might look for leaders whose strengths run to fiscal restraint.

At Simmons, Drinan says she was working to reduce costs even before the crisis hit. She says financial prudence is the way forward for higher education nationwide. If her cuts and efforts to expand the business program fail, the School of Management -- and Simmons’s $140 million of debt -- may wind up as a case study in what can happen when a bubble pops.

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