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Today's News

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Tuition Caps Could Hurt University Bond Ratings, Moody's Warns

By JOSH KELLER

State-mandated limits on tuition increases may hurt the bond ratings of public universities, because institutions under such restrictions lose the ability to use those increases to offset dips in state and donor support, according to a report to be released this week by Moody's Investors Service.

Tuition caps typically limit the amount universities can raise tuition each year to a small percentage or to the inflation rate. They have become popular among governors and state lawmakers as a way to respond to concerns over the rising cost of attending college. At least 18 states have passed some kind of tuition limit in the past three years, according to the report, and many other states are now considering similar legislation.

The Moody's report warns that those caps make university budgets more inflexible and more vulnerable to shifts in state support. The company rates the bonds of about 200 public colleges and systems in the United States.

:nnis Gephart, an editor of the report, said that tuition caps could throw off the traditional balance of support between state appropriations and tuition that public universities rely on.

"In many states, there usually is kind of a covenant between legislators and universities," said Mr. Gephart. "They might say, 'Yes, we're cutting your state appropriation this year, but we believe you're able to pass along those costs to your students.'" But a tuition cap could make it more likely for those two revenue sources to be constrained at the same time, he said, leading to "deep and lasting stress" on universities.

Universities with lower bond ratings must issue bonds at higher interest rates, and have more trouble financing large construction projects.

Mr. Gephart added that many institutions were raising enough money from donors to offset any long-term harm from tuition caps. And he said that looser tuition caps, such as those that allow relatively large annual increases or tie the limits to additional state funds, may not have much of an effect.

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Contact	Phone
New York	
Susan Fitzgerald	212-553-7762
Dennis Gephardt	212-553-7209
John Nelson	212-553-4096

Hot Topic

State Regulation of Public University Tuition Rates Carries Negative Credit Implications

Summary

The continuing and rapid rise in public university tuition rates this decade has prompted several states to discuss ways of regulating or limiting tuition increases, even though the tuition increases are often generated by cuts in state funding. Moody's believes that formal state regulation of public university tuition rates would negatively affect credit quality because of the increasingly critical role of tuition as the revenue source that enables public universities to sustain fiscal balance while adjusting to state funding volatility. While most state legislatures continue to have significant influence over tuition rates through budget and funding appropriation negotiations, Moody's believes legislated controls would likely limit revenue flexibility during times when higher education institutions need it most and that controls would likely affect the ability of institutions to invest and compete with private universities.

Overview of the Public Higher Education Sector

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Long-Term Trend of Higher Education 'Privatization'

There is a long-term trend of "privatization" of public higher education in the United States. In 1981, according to the U.S. Department of Education, state appropriations accounted for 46% of public university operating funds. Twenty-five years later, Moody's medians show that state funding comprises less than a third of public higher education operating revenues.[1] Moreover, public higher education institutions have assumed increasing responsibility for covering the costs of their buildings, both construction of new facilities and maintenance of existing facilities.

Tuition revenue has risen to fill the gap left by decreasing state support. Based on Moody's data, tuition and fee revenue on the median now accounts for over a quarter of public higher education revenues. From 2002-2006, while state appropriations on a per-student basis declined by 5%, net tuition revenue rose by almost 48%, enabling the sector to sustain, indeed improve, credit quality during a challenging external funding environment. While the 48% increase is large in percentage terms, the median net tuition per-student rose approximately $1,700 in dollar terms over that time frame, a relatively moderate amount.

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States Re-Examining Control over Tuition-Setting Authority

Over the past two years, policymakers have been considering steps to potentially increase state control over tuition and fees in response to mounting public concerns related to affordability and access to higher education. The discussion of tuition caps also can stem from a belief by policymakers that public universities can make efficiency gains through cost controls rather than continuously increasing expenses and passing the cost on to families. According to a November 2006 report from the State Higher Education Executive Officers (SHEEO) based on a survey of the states, 18 had some sort of tuition curb, cap, or freeze placed on tuition over the prior three years while 33 declined to do so and 23 states established study groups to focus on higher education policies, including tuition policies.[2]

The tuition-pricing discussions are most pronounced for in-state undergraduate students, with nonresident and graduate students typically expected to bear a more market-oriented price. The pressure has also been especially felt in states with state financial aid programs that cover tuition expenses. Incremental tuition increases directly raise the cost of providing the politically popular aid, creating a direct impediment to lawmakers considering tuition increases.

Actual tuition-setting authority varies from state to state, but in most states the legal authority now rests with the board of trustees overseeing each individual institution or system. Indeed, during the period from 2002-2005, Texas and many other states took action to loosen direct state regulation of tuition or fees in order to provide their constituent institutions with the ability to respond to large and unexpected cuts in state support. In some cases where tuition regulation has been lessened, institutions have been required to dedicate a portion of tuition increases to financial aid.

More recent regulation proposals include:

- Linking permitted tuition increases to growth in family income levels (proposed in Indiana this session)
- Regulating the dollar or percentage increases permitted each year (Ohio typically establishes caps in the biennial operating budget bill with a current fiscal year cap of 6% or $500 for a full-time student, whichever is less; the Governor is proposing moving to a compact strategy akin to California),
- Guaranteeing tuition levels for four years for entering students (Illinois adopted in 2005).

We believe that these discussions are part of an ongoing dialogue that is likely to continue over the coming years as states and their higher education systems work through broader questions of control and oversight in an increasingly privatized environment. Even absent direct regulation of tuition rates, however, states maintain significant control over tuition increases through the negotiations that occur each budget session. For example, some states link increases in direct state funding to actions by institutions on limiting tuition increases.

1. *DOE and Moody's data may not be exactly comparable due to different calculation methods but we believe these figures accurately reflect the trend that has occurred.*
2. *State Tuition, Fees, and Financial Assistance Policies for Public Colleges and Universities, 2005-2006*

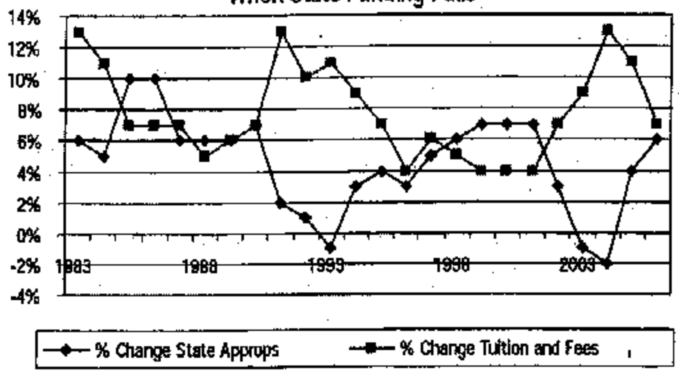
Direct Regulation of Tuition Could Negatively Affect Bondholders

As tuition has become an increasingly important revenue stream for public higher education institutions, we believe formal regulation or control of tuition rates by states could have a negative impact on bondholders in the following ways:

- Many institutions pledge tuition and fees to bondholders in order to pay debt service, either through a direct pledge of specific portions of tuition and fees or through a broader legally available funds pledge. State control would potentially limit the ability to increase tuition to offset increasing debt service costs or limit the ability of institutions to debt-finance critical capital projects.
- Increases in tuition are often used to fund strategic initiatives such as maintaining competitive faculty salaries, sustaining or enhancing academic program offerings, tackling deferred and ongoing plant maintenance, improving available technology, and maintaining manageable class sizes. Inability to raise tuition could inhibit these investments, potentially affecting student demand and enrollment.
- Legislative caps on raising tuition could prevent institutions from being able to rationally react to unexpected cuts in state funding and could make achieving fiscal balance increasingly challenging during the normal swings in state support driven by economic cyclicality.
- As with private institutions, tuition and financial aid policies and strategies have become a critical tool in marketing to and attracting students. The inability of an institution to establish market-appropriate pricing policies could impact student demand. Overall centralized pricing policies ignore substantial variations in the market profile of individual public universities within a state potentially punishing those with uncommonly strong or weaker student demand.

Figure 2

Tuition Rates Rise When State Funding Falls



Sources: Center for the Study of Higher Education Policy, Illinois State University; The College Board

Moody's will continue to monitor legislative proposals regarding the regualtion of tution and report on any that we believe could clearly have a negative impact on credit quality for higher education institutions in that state.

Related Research

Special Comment:

Public College and University Medians 2006, June 2006 (98025)

Rating Methodology:

Public Colleges and Universities, November 2006 (100363)

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Author

Susan Fitzgerald

Senior Production Associate

Charles Omegri