Weathering the Storm: Generating Revenues for Higher Education During a Recession

Robert K. Toutkoushian

During the past fifty years, a number of changes in the external environment—both good and bad—have occurred that have influenced how institutions of higher education (IHEs) operate. The passage of the GI Bill led to significant increases in the demand for college by opening the doors to postsecondary education to a wide range of students and, in the process, challenged institutions to build facilities and hire staff to meet their needs. Increases in federal funding for research in the 1950s and 1960s also had a notable effect on the type of academic work performed by many universities. The high rates of inflation that occurred during the 1970s eroded the relative earnings of faculty and staff (Hamermesh, 2002) and, together with the swelling enrollments due to the baby boomers, challenged IHEs to simultaneously compete with the private sector for faculty in key areas, serve an ever-growing demand for their services, and fully fund their operations.

Despite recurring efforts at many institutions to control the costs of their operations, expenditures at IHEs have historically grown at rates that exceeded the general cost of living. It is encouraging to note, however, that total revenue growth has managed to keep pace with the expenditure growth over this period (Toutkoushian, 2001). Institutions generally rely on six main sources for revenues: students or parents, federal government, state government, private gifts, endowments, and auxiliary enterprises. During the 1980s and 1990s, IHEs in both the public and private sectors turned to students and their families to finance more
of the cost of providing educational services. Public institutions also began to emulate their private counterparts by developing revenue sources from private giving and endowments.

The latest challenge facing higher education in the United States is that the nation finds itself in the middle of a recession. Despite some evidence that the recession is ending, the federal government and most state governments are now facing significant budget deficits. At the same time, the recession has led to reductions in corporate profits that in turn have reduced the return on investments in stocks and hence the wealth of many individuals. This recession has raised questions among policymakers as to how many IHEs will manage to balance their revenues and expenditures in the future if the recession does not come to a quick conclusion.

In this chapter, I begin by reviewing some of the recent financial trends in higher education. This will draw on some work that I have previously conducted examining trends in revenues and expenditures in higher education (Toutkoushian, 2001). I then turn to a brief overview of the current recession in the United States and offer some views on how this recession may affect the major revenue sources that IHEs rely on to fund their operations.


One of the most puzzling aspects of higher education finances for casual observers is that expenditures at IHEs, even when expressed on a per-student basis, have consistently grown at rates that outpace the rate of inflation for the economy at large. Elsewhere, I have shown that on average, total (current funds) expenditures per student have increased from $1,339 in 1960 to $12,814 by 1995, and that after taking into account the effects of inflation, expenditures per student have still risen by more than 60 percent for this same time period (Toutkoushian, 2001). The largest percentage changes occurred in the 1960s and 1970s as postsecondary institutions experienced dramatic growth due to a greater number of students attending college and increased demands from the federal government for research in the hard sciences. Even for the period from 1975 to 1995, however, net education and general expenditures per student rose at annual rates of 1.3 percent to 1.4 percent above the rate of inflation for both public and private institutions. This growth in inflation-adjusted expenditures per student has raised concern among stakeholders that the spending in colleges and universities is out of control and is largely responsible for the rise in tuition and fees in both sectors.

What is remarkable about this situation is that throughout this prolonged period of growth in inflation-adjusted expenditures per student, most institutions have been able to attract sufficient revenues to cover rising costs. Table 3.1 shows what has happened to the shares of revenues coming from the major sources of revenues over the twenty years from 1975 to 1995. The major sources of revenues shown in this table are net tuition and fees (defined as tuition and fee revenues minus financial aid expenditures); federal appropriations (excluding Pell grants); state appropriations; local appropriations; private gifts, grants, and contracts; endowment income; and government grants and contracts. For the purpose of this table, financial aid is treated as a revenue discount and therefore is not shown (see Toutkoushian, 2001).

It can be seen that for both public and private institutions, a notable increase has occurred in the shares of revenues received from students and their families for funding education. In the public sector, the percentage of revenues coming from students has risen from 13 percent in 1975 to 21 percent in 1995, and private institutions have seen their shares of revenues from students increase from 47 percent to 55 percent over the same period. Even when expressed on a per-student basis and after adjusting for inflation, the net tuition and fees paid by students between 1975 and 1995 increased by 94 percent for students at public institutions and by 45 percent for students at private institutions.

The sources of declines vary across sectors. Although the level of appropriations from state governments for public institutions has increased over time, the share of revenues coming from state funding has fallen from 57 percent in 1975 to 47 percent in 1995. In contrast, government grants and contracts are the main area of declining revenues for the private sector. It is also important to observe that private institutions have historically relied more heavily than public institutions on revenues from their endowments and from private gifts, grants, and contracts.
To gain an even better sense of what has happened to revenues for postsecondary education in this time frame, it is useful to aggregate revenues into three main categories: students, governments, and all others (Winston, Carbone, and Lewis, 1998). Education subsidies are those revenues that are not paid by the student. Grouping revenues in this way reveals that whereas education subsidies have kept pace with inflation, they have lagged behind the growth in educational expenditures. For the period 1975 to 1995, for example, the portion of net education and general expenditures per student covered by subsidies increased annually by an average of 1 percent above the rate of inflation in both the public and private sectors. This meant that the unsubsidized portion of expenditures had to grow at annual rates of 3.4 percent above inflation for public institutions and 1.9 percent above inflation for private institutions (Toutkoushian, 2001).

2001 Economic Recession

By all accounts, the U.S. economy experienced a recession beginning sometime in 2001, and the effects of this recession are still being felt as of the first quarter of 2003. Table 3.2 provides an overview of how the recession is reflected in several leading economic indicators in 2000, 2001, and 2002. According to the traditional textbook definition, a recession is said to occur when the economy experiences two or more consecutive quarters of decline in output (Gottheil, 1996). The economy’s output is typically measured by the nation’s gross domestic product (GDP). Data from the Bureau of Economic Analysis shows that inflation-adjusted GDP declined for each of the first three quarters of 2001 and grew by modest 0.3 percent for the entire year. The recession ended a long expansionary period dating back to the early 1990s. The nation’s GDP has since resumed its historical growth rate during the first three quarters of 2002, perhaps signaling that the recession is nearing its end.

Regardless of whether the nation is still officially in a recession, the recession is still affecting individuals and corporations, and its effects are only now beginning to be felt by federal and state governments. Corporations in the United States have been hit particularly hard during this last recession. The economic downturn, combined with investor concerns about overpriced stocks, stories of corporate accounting scandals, and the effects of the terrorist attack on September 11, 2001, have contributed to a dramatic fall in stock prices in 2001. Figure 3.1 shows how the Dow Jones Industrial Average, perhaps the most widely followed index of stock prices for thirty leading corporations, has changed from 1982 to 2002.

The annual returns on stocks in the Dow Jones Industrial Average fluctuated considerably over time and in general have been positive and particularly impressive during the late 1990s. For the past three years, however, the Dow Jones Industrial Average has fallen by 6 percent in 2000, 7 percent in 2001, and 16 percent in 2002. Other stock indexes, such as the Standard and Poor’s 500, experienced similar declines over this period. Not surprisingly, corporate profits from current production have suffered during this period, decreasing for each of the first three quarters of 2002.

Individuals on the whole have suffered less than corporations during this recession, but they have not been immune to the detrimental effects of

Table 3.2. Selected Economic Indicators for the United States, 2000 to 2002

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
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<tbody>
<tr>
<td>Percentage change in gross domestic product, %</td>
<td>+3.8</td>
<td>+0.3</td>
<td>+2.4</td>
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<tr>
<td>Percentage change in personal income, %</td>
<td>+8.0</td>
<td>+3.3</td>
<td>+3.0</td>
</tr>
<tr>
<td>Percentage change in Dow Jones industrial average, %</td>
<td>−6.2</td>
<td>−7.1</td>
<td>−16.8</td>
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<tr>
<td>Annual federal surplus, in billion dollars</td>
<td>+236</td>
<td>+127</td>
<td>−158</td>
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<tr>
<td>Unemployment rate, December, %</td>
<td>3.9</td>
<td>5.8</td>
<td>6.0</td>
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*Bureau of Economic Analysis [http://www.bea.doc.gov/bea/dn/nipaweb/TableViewFixed.asp#Mld].

Figure 3.1. End-of-Year Dow Jones Industrial Average, 1982 to 2002

Source: Data points represent the final levels of the Dow Jones Industrial Average in each year. Sources: Dow Jones (http://www.djindexes.com/downloads/xlspages/DJIA_Hist_perf.xls).
the downturn. Personal income for Americans grew by 3.3 percent for 2001; however, this was the lowest growth rate for personal income in the United States since 1958. Likewise, the current unemployment rate of 6 percent looks good by historical standards but has increased from 4 percent only two years earlier.

Although the recession has already hit individuals and corporations, it is now beginning to affect federal and state governments as well. The effects of recessions on governments typically lag behind those on other sectors because governments rely on personal income, corporate earnings, and capital gains for their revenues. The Congressional Budget Office reports that the federal government experienced a 7 percent decline in revenues for 2001 and 2002, driven largely by reductions in individual income tax receipts. This represents the largest percentage drop in revenues at the federal level in the United States since 1946. The falling revenues resulted in a federal deficit for 2002 of $158 billion, and projections for 2003 are calling for federal deficits of either $199 billion according to the Congressional Budget Office (Booth, Chirico, and Gramp, 2003) or $304 billion according to the Office of Management and Budget forecasts (2002). This decline follows an unusual four-year period during which the federal government enjoyed annual budget surpluses. All indicators suggest that state governments are also beginning to feel the effects of the current recession (Hebel, Schmidt, and Selingo, 2002). It is estimated that two-thirds of the states are facing cumulative budget deficits of approximately $26 billion that they must close by the summer of 2003 (Selingo, 2003).

Effects of Current Recession on Higher Education Revenues

Although IHEs have been successful over the long run in finding enough revenues to meet their expenditure needs, what are the prospects for their continuing to do so in the current recessionary environment? To answer this question, I review in more detail each of the major sources of revenues for higher education and how they might fare in the near future given the prevailing economic climate in the United States.

State Appropriations. Despite its declining importance as a revenue source, state funding for higher education is still the largest single pool of funds used by public institutions and is thus the first logical place to turn for funding. However, the prospects for increased state appropriations to meet higher education's planned expenditures are poor. Higher education is only one of a number of competing interest groups that vie annually for financial support from state governments. Recent history has shown that whereas total state appropriations have risen, they have not kept pace with expenditure growth at institutions nor with the ability of states to fund education. Mortenson (1996) and Halstead (1996), for example, have demonstrated that state funding for higher education has fallen relative to the ability of states to pay, when expressed as a percentage of tax revenues or per $1,000 personal income.

The results from theoretical and empirical studies of state funding for higher education suggest that in the current economic environment, state funding for higher education is more likely to decline than it is to increase. Economists rely on the median voter model to explain how legislators make decisions about funding for higher education (Clotfelter, 1976; Coughlin and Erekson, 1986). Under this model, legislators who wish to be reelected will vote in accordance with the preferences of the middle, or median, voter in his or her district. Using state-level data on all fifty states from 1982 to 1996, Paula Hollis and I showed that state funding for higher education increased when per-capita tax revenues and median family income increased (Toutkoushian and Hollis, 1998). The sharp decline in tax revenues and slower growth in family incomes in most states due to the recession would argue that appropriations for higher education will decline in the near term.

Possibly offsetting this negative effect, however, is that state appropriations for higher education are positively correlated with enrollments in public institutions (Clotfelter, 1976; Leslie and Ramey, 1986; Hossler and others, 1997; Toutkoushian and Hollis, 1998). Hoenack and Pierro (1990), for example, found that a 1 percent increase in public university enrollments led to slightly less than a 1 percent rise in state support for higher education. Some states use funding formulas to set higher education appropriations, and these formulas often tie appropriations to enrollment levels (Hossler and others, 1997).

Many states are currently projecting notable increases in the demand for postsecondary institutions throughout the 2001–2010 decade due to two factors. First, the college participation rate in the United States has increased steadily over the past twenty years, rising from 49 percent in 1980 to 63 percent in 1998 (U.S. Department of Education, 2002, Table 184). The data from New Hampshire in Table 3.3 are illustrative of this trend, with the percentages of public high school seniors either aspiring to go to

### Table 3.3. College Participation Rates of New Hampshire Seniors, Selected Years

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<td>Public seniors attending four-year college or university, %</td>
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<tr>
<td>Public seniors attending two- or four-year college or university, %</td>
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<tr>
<td>Public or private seniors taking the SAT, %</td>
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<td>SAT = Scholastic Assessment Test</td>
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college or actually enrolling in college increasing substantially between 1976 and 2001.

In part, the rising college participation rate may reflect the success of federal, state, and institutional financial aid programs in maintaining access to higher education for needy students.

The second factor contributing to the increasing demand for higher education is the demographic trend created by the children of the baby boomers. At the height of the baby boom (1957), there were 4.3 million births in the United States. By 1971, the number of births had fallen to 3.1 million. Subsequently, as the baby boomers reached their prime childbearing years, annual births in the United States began to rise again, peaking at 4.1 million in 1990 (U.S. Census Bureau, 2001). The larger birth cohorts of the late 1980s and early 1990s—the “baby boomer echo”—are now approaching their prime college years, which should translate into a higher demand for postsecondary education in many states throughout the 2001–2010 decade.

Federal Support. The federal government is a major financial supporter of higher education in the United States. According to the U.S. Department of Education (2002), in fiscal year 2001 (FY2001) institutions of higher education received $22.7 billion in on-budget federal support for research programs. The four largest sources of federal funds for higher education in FY2001 were the Department of Health and Human Services, the Department of Education, the Department of Energy, and the Department of Defense. Overall, federal research support for education at all levels increased substantially during the 1960s and early 1970s and then fell during the early 1980s. The more recent experience for higher education has been good, with federal on-budget support for education rising by 56 percent between 1985 and 2001 even after the effects of inflation are taken into account.

The federal government may prove to be one source that some institutions can look to for added support of their operations. However, the return of federal budget deficits may lead to decreases in funding for IHEs in much the same way as states are reacting to their budget shortfalls. Likewise, most research funding is highly concentrated among a relatively small group of large research-intensive institutions. For many IHEs, to effectively compete with these institutions for grant dollars would require substantial investments in infrastructure and faculty, and these changes may not be consistent with their central missions. Even among the large research-intensive institutions, the competition for federal grant funding promises to increase as administrations look to faculty to offset the direct and indirect costs of their research activities.

The federal government also provides significant support to students in the form of financial aid programs to help offset the cost of attending college. In 2001, college students received over $56 billion in financial aid from the federal government. Although federal financial aid has risen from $23.8 billion in 1992 to $56.2 billion in 2001, the federal government has shifted its aid programs away from grants and scholarships and toward loans that must be repaid on graduation (College Board, 2002). As the federal government wrestles with how to balance its budget, student aid is not likely to increase at the same historical rate as in the recent past.

Tuition and Fees. As noted earlier, in both the public and private sectors, students and their families have been forced to assume a greater share of their education costs over time. The average gross student charges in public universities have risen from $600 in 1975 to nearly $3,000 in 1995, and private universities saw their average gross student charges increase from $2,600 to $14,500 over the same period (U.S. Department of Education, 1999). As a percentage of education and general expenditures, gross student charges in public universities have gone from 19 percent in 1975 to 25 percent in 1995, with similar increases for other types of institutions (Toutkoushian, 2001). Policymakers are naturally concerned that if this trend continues, it will eventually make higher education less affordable for a significant number of students and thus reduce access to higher education.

Surprisingly, studies of the demand for higher education have found that although tuition increases may have affected where students choose to attend college, they have not led to dramatic decreases in college enrollments (see, for example, McPherson and Shapiro, 1998; Wetzal, O'Toole, and Peterson, 1998). Heller (1999), for example, found that a $1,000 increase in average public tuition rates led to only a half percentage point decline in demand for in-state public institutions. The insensitivity of demand to price changes can also be seen in aggregate-level data in that during the 1980s and 1990s, as demographic trends led to fewer college-eligible students and tuition increases outpaced inflation, the college participation rate in the United States continued to rise. Taken together, the rising cost of college would seem to have more of an effect on where students go to college than on whether they go to college. In this sense, it is the relative price of attendance that has the largest effect on student choice (Tierney, 1983). Public tuition rates for 2002 have already increased by an average of 10 percent (Selingo, 2003), suggesting that institutions that raise tuition rates may not dramatically alter the relative price of attendance and thus risk losing market share.

Private Giving. Voluntary support for higher education is a significant source of revenues for many colleges and universities. In 2001, for example, IHEs were the beneficiaries of over $24 billion in voluntary contributions, with the largest shares coming from alumni and other individuals (49 percent), foundations (25 percent), and corporations (18 percent) (Chronicle of Higher Education, 2002). Private colleges and institutions have long relied on the charitable donations of individuals to help support their operations. Although public institutions have lagged behind their private counterparts in this regard, they are turning more and more toward alumni and other individuals for private gifts, with these revenues growing...
by 129 percent on a per-student basis between 1975 and 1995 even after adjusting for inflation (Toutkoushian, 2001).

Not surprisingly, private giving to all sources, including higher education, has already been negatively affected by the current recession. Charitable donations by both individuals and corporations are normally thought to be affected by their level of wealth, and the negative returns on equities has eroded the wealth of many potential donors. The Chronicle of Philanthropy’s annual survey of large donors revealed that the sixty largest donors in 2002 pledged a total of $4.6 billion to all charities—an impressive figure except when compared with the $12.7 billion total pledged in 2001. Many large donors also reported in the survey that they would like to defer payment on their previous pledges (Schwinn and Tungoren, 2003). With regard to donations to educational institutions, in 2001 private sources gave almost $32 billion to all levels of educational institutions. This translates into a paltry 0.5 percent increase, which was the smallest increase since the mid-1970s (Pulley, 2003). Moody’s Investor Service, Inc., reports that fundraising totals in 2002 for three out of five colleges surveyed were 5 percent lower than in 2001. As a result of the recession, some institutions are having to scale back their fundraising campaigns or delay starting new initiatives (Pulley, 2003). Unless there is a dramatic reversal in the stock market—which is at least theoretically possible given the historical volatility of the stock market—the immediate prospects for raising significant revenues through private giving are not promising.

Endowment Income. The next major source of revenue that IHEs can potentially use to weather the economic storm is their endowment income. At most colleges and universities, endowments represent a relatively small portion of their total revenues, and this is especially true for public institutions. Nonetheless, some institutions have managed to develop significant endowment funds and use them to support financial aid programs and other needs. According to the National Association of College and University Business Officers (NACUBO), fifteen institutions had endowments exceeding $3 billion as of June 30, 2002, with Harvard University possessing an endowment of over $17 billion (National Association of College and University Business Officers, 2003).

The ability of institutions to use their endowments to help fund operations in the current economic climate is restricted to the small subset of institutions with sizable endowments. Further complicating matters is that the declining stock market has reduced the endowments at most IHEs because portions of the endowment funds are usually invested in equities. The NACUBO study revealed that in their survey of 654 institutions, endowment levels fell by an average of 3.6 percent in FY2001 and 6 percent in FY2002. This downturn has affected even the institutions with the largest endowments, in that thirteen of the top fifteen institutions saw declines in their endowment levels during FY2002 (National Association of College and University Business Officers, 2003).

Summary and Discussion
Postsecondary institutions have been remarkably successful in finding ways to secure revenues to keep pace with expenditure growth over time. As the demands placed on IHEs have risen, beginning with the need to accommodate more students in the 1960s and contribute to research and development initiatives, institutions have adjusted with the times and have turned to a variety of sources for additional funding. Times of economic recession, however, pose particular challenges for academe. During bad economic times such as the recession of 2001, the prospects for increased funding from virtually any source are not good. Almost by definition, a recession will have a negative effect on the financial health of all of the major stakeholders who traditionally provide support to higher education—individuals, corporations, and state and federal governments. Therefore, the question for IHEs is not “What is the most promising source of revenue in a recession?” but rather, “What revenue source is likely to be least affected in a recession?”

Based on my review of the various sources of revenues for higher education, state governments are not likely to step up funding to support higher education in the near term. The significant budget shortfalls in many states are forcing legislators to make hard decisions about what activities to support, and given that higher education is usually treated as a discretionary item in state budgeting, perhaps the best that can be hoped for is that state funding for higher education will grow at below-average rates in the next few years. The only factor that could offset this trend is that projected enrollment growth in some states, especially those relying on formulas to set funding levels for higher education, could trigger automatic increases in state appropriations for public IHEs.

The immediate prospects for raising revenues from other major sources of revenues, including endowment income and private giving, are also poor given that they are closely tied to the health of the stock market. However, the volatile nature of the stock market means that the market could experience a quick turnaround, and such a reversal would obviously have a positive effect on both endowment levels and charitable giving. Although institutions with significant research funding could also tap into federal funding to weather the financial storm, these are relatively few. Even more problematic, this source is subject to the funding decisions of the federal government, which is itself facing a significant budget deficit.

Unfortunately, the most likely candidate for increased financial support for higher education is once again students and their families. The fact that enrollments and college participation rates have continued to climb in recent years despite tuition increases that have outpaced inflation is indirect evidence that students are aware of the private benefits of accruing a college degree and are willing and able to secure funds to pay for it. Several states have already enacted significant tuition and fee
increases for the coming year, and more are likely to do so as private giving to IHEs declines and state budget deficits result in lower appropriations. Concerns about access to higher education being affected by such increases are mitigated to some extent by observing that most college students are enrolled in public colleges and universities where the student charges are substantially lower than in the private sector. The rising price of attendance may have some detrimental effect on college participation at the margin and will certainly affect where students choose to enroll, but access to some form of postsecondary education should not be greatly reduced if the current economic recession forces institutions to turn to students to cover their costs.

Finally, IHEs will also have to scrutinize the expenditure side of their operations in the current environment to identify ways of bringing expenditures and revenues in line with each other. As noted earlier, per-student expenditures have historically grown at rates exceeding the rate of inflation. However, there are some factors that may limit an institution’s ability to meet their financial challenge in this way. First, IHEs are highly labor-intensive organizations. It is not uncommon to find that more than 70 percent of a college or university’s expenditures is allocated toward salary and benefits for employees. The wages of employees normally increase each year to some degree to compensate workers for changes in the cost of living. Even though some states have frozen salaries in response to financial challenges, these gains are often followed by above-average increases in subsequent years to remain attractive to workers. Some portion of employee compensation is also beyond the control of the institution. In particular, many institutions have been hit with substantial increases in the cost of providing medical benefits to their employees. The unionization of faculty at many institutions and the tenure system for faculty also inhibit the ability of many institutions to make dramatic changes in staffing and compensation levels in response to economic fluctuations.

A second mitigating factor for reducing expenditure growth is that enrollments are rising across the nation due to increases in the college participation rates of students and the demographic influence of the children of the baby boomers. As more students move on to postsecondary education, there will be a greater demand placed on IHEs to find and retain faculty and staff to serve their needs (Arnone, Hebel, and Schmidt, 2003). Freezing or eliminating positions in a time of growing enrollments would be a dangerous strategy.

What may emerge from this is that IHEs will have to take a careful look at their programmatic offerings and in some instances make strategic decisions about the types of programs that they will offer. The end result is that a sustained economic downturn could contribute to more specialization within the academy as institutions try to find ways to cut costs and still maintain the strength of their best programs.

References

Public universities located in states with systems that enhance political control and universities whose trustees are selected by nonacademic stakeholders charge significantly lower prices than universities located in states with decentralized systems and those whose trustees are selected by academic stakeholders.

Effects of State Postsecondary Education Structures on Public University Prices and Spending

Robert C. Lowry

Governance of public universities is a salient policy issue in many states. McGuinness (1997) notes that nine states enacted major changes in postsecondary education governance structures during 1991–1997, and other states have since made changes or continue to debate them (Ackerman, 1996; Oppel, 2000; Shannon, 1997). Nonetheless, there is no consensus regarding the relative merits of political control versus autonomy. Whereas university administrators typically seek greater autonomy (MacTaggart and Assoc., 1996, 1998), some analysts argue that universities in states with more political oversight are more responsive to the interests of those who are not professional academics. Part of this debate concerns the price paid by students to attend college. A recent study by the California Higher Education Policy Center concluded, for example, that families pay a lower share of total institutional operating costs in states that have a “systemwide mechanism for representing the public interest in budget decisions” than do families in states that lack such a mechanism (Bowen and others, 1997). This study did not attempt to control for all of the various cost and demand factors that might affect tuition and fees at individual university campuses,

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