

# A sustainable model for business schools?

**Kai Peters and Howard Thomas** argue that the current business model of business schools is financially unstable and probably unsustainable

**At the core of each business school, a dialectic takes place between two distinct purposes – the goal of producing knowledge and the goal of educating students. Individual institutions have different views.**

At one end of the spectrum there are research-intensive institutions while at the other there are teaching-led or even research-less schools. Most schools are somewhere in between, leaving them with a dual system of purposes and corresponding metrics that are all too often contradictory and confusing rather than cohesive.

The choices that individual institutions have made broadly share one common element. They are, the authors believe, financially unstable and probably unsustainable. This article therefore seeks to explore the financial drivers of business schools on both the income and expenditure sides of the equation and highlight areas of distinct concern for business school finances.

Where does the money come from?

£1k

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£9k

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### The state

Not all schools are dependent on government funding but many more are than are willing to admit. State funding means that schools are directly funded to educate students and additionally to produce research. Education is seen as a public good that produces an educated workforce, which in turn generates returns to the nation through higher productivity and taxes. Research generates innovation that also creates long-term public benefit.

While this traditional mode of funding is still strongly represented in continental Europe, it is increasingly being questioned on philosophical and financial grounds. In many nations, and especially in Asia and Latin America, education is viewed as largely a private rather than a public benefit and funding is being adjusted accordingly.

Whatever the merits of this debate, it is clear that it serves the purpose of governments to reduce education funding since they are facing intense competition for societal financial resources. Consequently, direct grants for education are being reduced and students are increasingly responsible for funding their own education.

Direct grants have thus become indirect grants via loans to students. In Britain this process has been underway for some time. While education was free for the user until 1997, fees have been increasing ever since.

In 1998 annual undergraduate fees of £1,000 were introduced. This increased to £3,000 in 2004 and will almost certainly rise to £9,000 at a majority of institutions in 2012.

At the same time as student debt increases, direct grants to universities for business education of approximately £3,500 per student will be removed in 2012. Graduates will be required to repay their loans over a lengthy period once they reach an annual income above £21,000.

The government is assuming that two-thirds of students will repay their loans. The university sector as a whole is expecting only one-third to repay. The truth will eventually become clear but perhaps not for as long as 30 years. Ironically, if eventual total repayments are less than 50% of the loans given out, the new system will be more expensive than the one it replaces.

Reliance on government is also the key driver where one would least expect to find it: in the American for-profit educational sector. The vast majority of students use federal loans to pay for their programmes.

For-profits are actually the largest users of federal funding. Without this funding, which is presently being challenged in Congress because of poor completion rates of between 10% and 15% of students in some cases, the business model of the for-profits will certainly be less attractive in the future.

Underlying these Anglo-American examples is the question of what proportion of a society ought to attend university. There are two different models for modern universities.

The Anglo-American model seeks broad participation. Approximately 50% of all secondary school graduates continue on to university. In the Humboldt university model, which is common in continental Europe, universities aim for a narrower intellectual elite in the range of 20% of high school graduates. In countries using the Humboldt model financing universities is less onerous.

In middle-income and developing countries, university attendance rates are more aligned with the Humboldt model, averaging, according to UNESCO, a UN agency, around 20%. The role of government funding is also more modest than in the west. Public funding accounts for 54% of university budgets whereas in OECD countries, approximately 76% of university funding originates from governments.

### Student tuition

If the government is unwilling to pay, then the burden falls on the user of services. Undergraduate tuition fees are now beginning to rise steadily in many countries. Postgraduate fees, on the other hand, have for some time been largely free from constraints in terms of programme pricing and are seen as a key source of funding for many institutions.

The demand for postgraduate business education has increased dramatically over the last 20 years. Because of the imbalance between demand and supply, fees have increased rapidly. The cost of MBA tuition in Western Europe in the 1990s rarely surpassed €10,000; two decades later fees of €60,000 for full-time programmes are common, with some EMBA now having price tags of over €100,000.

Tuition fees in America have reached extremely high levels. Presently, over 100 institutions charge over \$50,000 a year for fees, room and board. On this basis and extrapolating from present trends, fees for four-year undergraduate degree programmes in America are likely to reach \$330,000 by 2020. The top 20 MBA programmes in the US all ask tuition fees of around \$100,000 while EMBA programmes cost up to \$172,200.

Although historically students may have thought that the return on investment was not unreasonable, the increasing costs of tuition and living expenses combined with potential loss of income during the course may well lead to numerous candidates concluding that a tipping point will soon be reached where the costs outweigh the benefits.



### Other sources of funding

Once government funding has decreased, business schools turn to two more sources of funding: executive education and fund raising. Both can be tremendously lucrative but are not necessarily easy to establish nor guaranteed to be successful. Executive education requires a different infrastructure and faculty composition than that of degree programmes.

Even when established, executive education is very volatile as illustrated by the impact of the current recession. Revenues reduced significantly within a matter of months. Unicon, a consortium of schools involved in executive education, reported that on average, revenues generated by executive education shrank by 30% in 2009 compared to 2008.

Fundraising is the other potentially large source of external funding and proud and satisfied alumni and friends of schools can be very generous. Certainly the endowments of the world's top ten universities are measured in billions rather than millions of euros.

However, expectations about amounts likely to be generated by endowments have had to be amended recently as funds have shrunk in real terms as have returns. Furthermore, the number of universities where fundraising makes a substantial impact on operating budgets is actually very small.

### Where does the money go?

#### Academics – Research

In recent debates about higher education, one subject that has received only limited attention must surely be the model through which business schools and universities manage their main asset: their faculty.

In most academic institutions, overall staffing costs, including faculty, can easily approach 75% of institutional expenditures. These faculty members have priorities – teaching and research – that are often in conflict. In research-intensive universities as well as in many research-focused business schools, faculty members' career paths are dependent on their research productivity measured in the quality of research journals and the number of high-quality publications. Metrics are clear and are, unsurprisingly, output measures.

Input measures do not exist on the research front. How long does it take to write a paper? For some, a lifetime. For others, a weekend. Some individuals are able to develop collaborative infrastructures that include colleagues, graduate students and research assistants and as a result are able to generate many papers a year.

The point here is a simple one: how much time should be devoted to research in contrast to other activities? How much and what types of research output should be expected? Ultimately, can more time be freed up for other purposes such as teaching, managing or working with executives?

In some cases, research is directly funded or financed by research grants from foundations or directly from governments. But in most cases, research is cross-subsidised from teaching income. That is, premium-priced programmes such as EMBA become the "cash cows" for the funding of the school.

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# €100k

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### Academics – Teaching

The economics of teaching time is fascinating. The core question, surely, is what does an hour of teaching time cost, and what does an hour of teaching time generate as revenue? These core calculations can then be scaled up to an annual calculation and be compared across the higher educational landscape and with related, knowledge-intensive businesses.

At a base level, there are three research models in higher education. The first, a research-only model, will by necessity be left aside except as a cost to the institution that must be borne somehow.

The second is a teaching-intensive model. In many of the newer universities in Britain and elsewhere, there is an anchor at about 300 teaching hours a year. Assuming a base faculty salary of €50,000 with typical on-costs for pensions, support staff and so on, one can model a fully loaded cost of something in the region of €80,000 per faculty member. The teaching cost is thus about €270/hour.

At the research-intensive end of the spectrum, fully loaded salaries can be double. The main factor, however, is the reduced teaching load. At 120 teaching hours a year, the hourly teaching cost is about €1,350 though there are schools where average fully loaded salaries approach €250,000 with similarly low teaching loads. This leads to an hourly teaching cost of €2,200. No doubt someone somewhere is even more expensive on an hourly basis.

In comparison, secondary school teachers in middle income and developing economies cost, on average, €8/hour and in the OECD €34/hour.

Consulting firms have a similarly bullish approach to costs per hour. Given that consultants can easily have a target of generating 200 billable days, one will be looking at an hourly cost of something in the region of €45 for a mid-level consultant.

Given the economic infrastructure in place in higher education, there are two ways in which teaching costs can be managed.

The first is what seems to be the trend. Simply teach less. At undergraduate levels, contact time can appear rather thin with suggestions that six to ten contact hours per week for 30 weeks a year is not unusual. A second lever is simply to increase the number of students in the classroom to drive costs per students down.

Perhaps there is another option which needs to be considered. Is it realistic for universities to continue to operate with only their present range of models and levers or is it ultimately necessary to consider the unthinkable – increasing teaching loads across the sector?

### Other

While overall staff proportions are actually quite stable across the higher education landscape, the proportion of academic to non-academic staff varies widely. Factors that have an impact include the product portfolio, the business school model, and in many cases the overall wealth and ambition of the institution. Marketing, for instance, will typically consume 8% to 12% of the MBA income stream.

### Adding it all up

While not all business schools will face financial challenges in the near term, fault lines are clearly visible. Traditional sources of income are less stable. Government, the primary source of funding in the OECD countries, will not continue to expand educational budgets for ever. Examples to the contrary are already evident in many countries.

Student tuitions cannot go on rising forever. Many MBA programme fees, we believe, have reached levels that are not sustainable and raise a real question of value and fairness. Income from executive education or from donations can be substantial but is not in the reach of all schools.

On the cost side, we posit that many institutions are using a faculty model that is very luxurious. No other industries that we can think of use their main human capital to directly generate income for less than 10% of their annual time at one end of the spectrum or only about 30% at the other.

There are plenty of other challenges in the global market for education. These include the role of for-profits, the welcomed growth of middle income and developing world countries' own educational infrastructure, the advent of recessions and cost pressures in the competitive environment.

The consequent strategic options, including part-time and on-line education, should encourage Deans and Directors of business schools to reflect genuinely on the long-term financial viability of their business models and focus on refreshing such models in the future. **gf**



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