AN ECONOMIC ANALYSIS OF THE MARKET FOR TEXTBOOKS: CURRENT CONDITIONS, NEW DEVELOPMENTS AND POLICY OPTIONS

The Future of the Textbook

University of Georgia Center for Continuing Education

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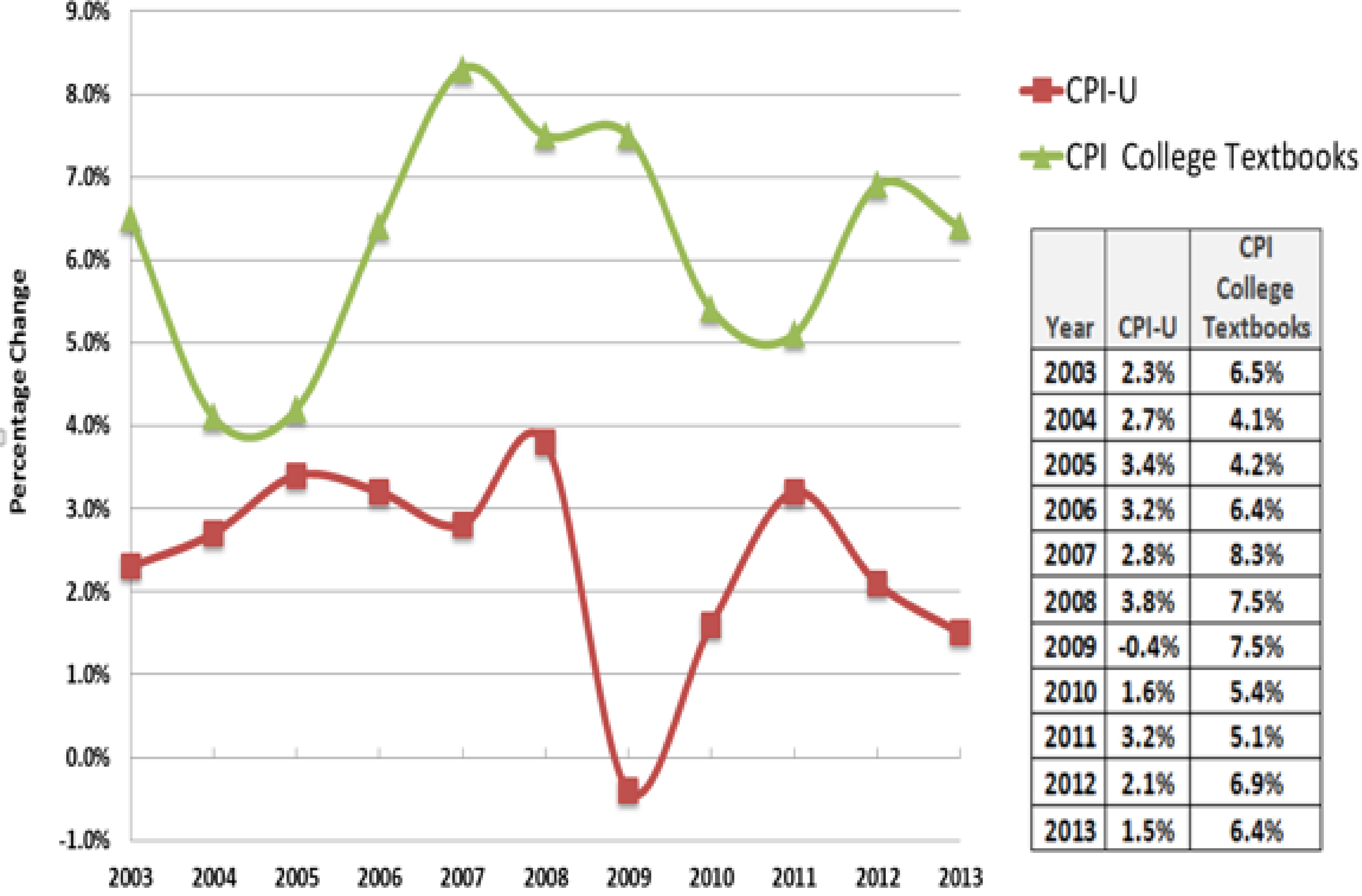
- **In September 2006, I completed a study of college textbook pricing and textbook markets for the Advisory Committee on Student Financial Assistance of the U.S. Congress.**

- **Then, in May 2013, I completed a study of textbook pricing for the Lumina Foundation entitled *"Turning the Page,"* *http://www.luminafoundation.org/publications/Turning_the_page.pdf*.**

- **Significant changes have occurred in textbook markets since 2006 and there has been a flurry of activity since Spring 2013.**

CPI-U vs. CPI for *New* College Textbooks, 2003-2013



Year	CPI-U	CPI College Textbooks
2003	2.3%	6.5%
2004	2.7%	4.1%
2005	3.4%	4.2%
2006	3.2%	6.4%
2007	2.8%	8.3%
2008	3.8%	7.5%
2009	-0.4%	7.5%
2010	1.6%	5.4%
2011	3.2%	5.1%
2012	2.1%	6.9%
2013	1.5%	6.4%

Why Have the Prices of New Textbooks Been Rising So Rapidly?

- **Student demand for textbooks historically has been insensitive to price changes (*"inelastic"*).**

- **Historically, textbooks markets have been a *"trust market"* in which students buy textbooks because their trusted faculty members tell them to do so.**

- **Other *"trust markets"*: pharmaceuticals, auto repairs, plumbing.**

- **A major problem in "*trust markets*" is that the person who tells you to buy something is not the person who has to pay for it. You are.**

- **In textbook markets, the "*trust*" persons are faculty members and unfortunately few faculty know the price of the textbooks they tell their students to purchase. After all, they're not paying for them.**

- **In 40 years in academe, never once have I ever had a textbook sales person voluntarily tell me the price of a textbook. They talk only about topical coverage, new material, DVDs, YouTube segments, test question banks, workbooks, etc.**

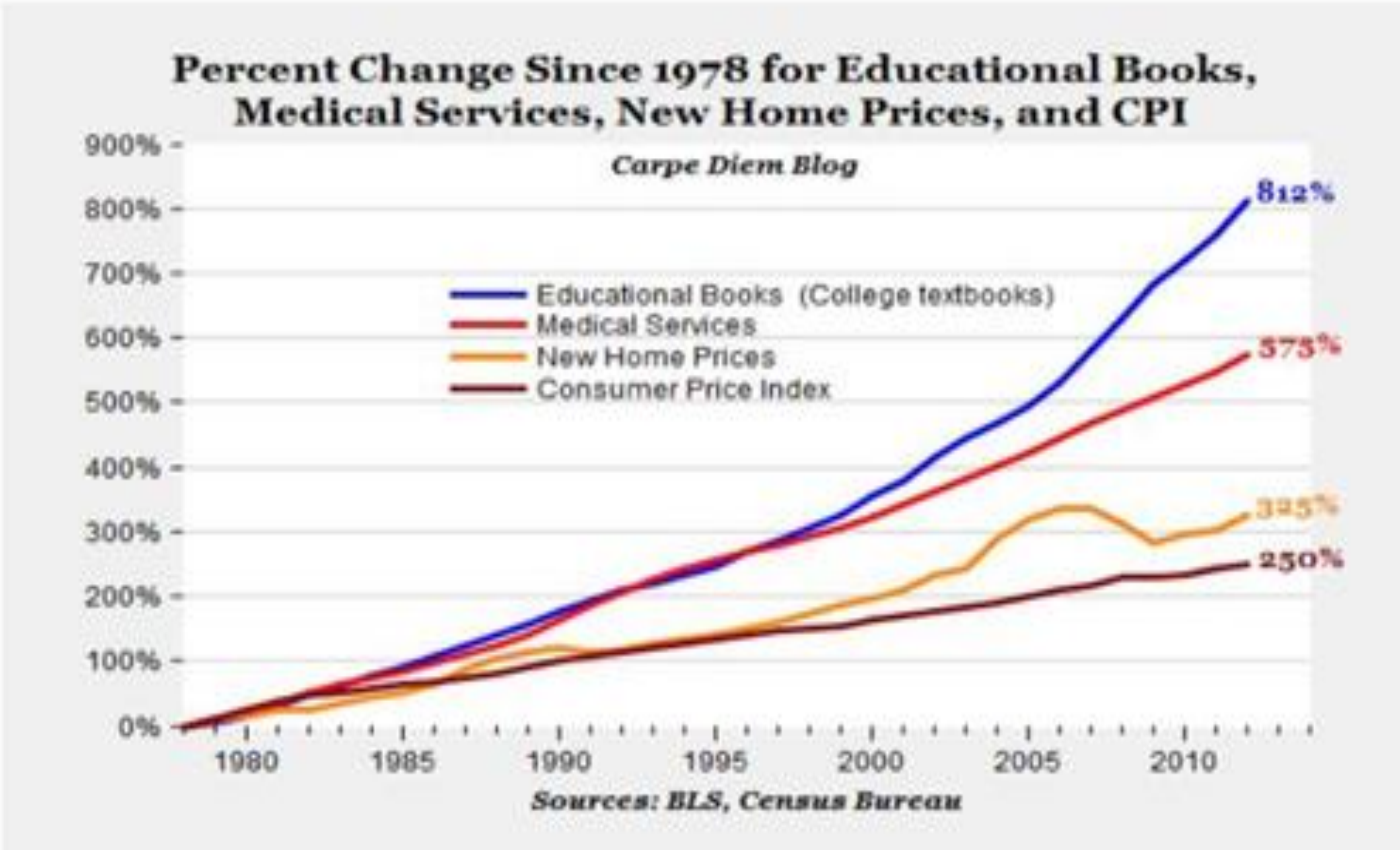
- Also, in the past, students had little or no way to find alternatives. There was no Internet and used book markets were limited. Therefore, student ignorance about textbook prices and alternatives was very high.

- Most students (myself included) trusted our faculty members to make the best decision for us, just as we trust M.D.s and auto repair technicians to tell us what we need.

- **Alas, there is a tendency in many *"trust markets"* for consumers to end up with the short end of the stick. Rates of price inflation in these markets far exceed the growth of the CPI and this has been true for many years.**

- **Though things now are changing for the better, for the most part student consumers have not fared well in the textbook version of a *"trust market."***

Here is the problem in a nutshell.



Source: Mark J. Perry's Carpe Diem Blog, December 24, 2012, www.aei-ideas.org/channel/carpe-diem.

- **Let's focus for a moment on the supply side of the market.** Historically, colleges either have owned their own book stores and earned profit from textbook sales, or they have invited a firm such as *Barnes & Noble* or *Follett* on campus and subsequently have received both a fixed annual payment plus a percentage of sales from that firm. As a consequence, many colleges have had an incentive *not* to change the current system.

- George Washington University took this seriously earlier this year when it told its faculty that they had a *"contractual obligation"* to do business with Follett, which runs their campus bookstore. GWU subsequently backed away from this. *Inside Higher Education*, 082214.

- **It is fair to say that the textbook publishing market is *“highly concentrated”*---just a few sellers control most of the market.**
- **At Indiana University, the largest three publishers accounted for 64 percent of all dollars spent on required textbook materials in 2012.**
- **The national four-firm concentration ratio in 2008 was 87.5, ranking textbook publishing as one of the more concentrated manufacturing markets in the United States---along with highly visible markets such as health insurance, search engines, wireless telecommunications, and soft drink production.**

So What?

- **The preferred seller concentration measure of the U.S. Department of Justice (USDOJ)---the *Herfindahl Index*---was 2,522 for the textbook publishing market in 2008.**

- **The USDOJ considers any *Herfindahl Index* above 2,500 to signal a *"highly concentrated"* market where anti-competitive behavior is more likely to occur. According to the USDOJ, this behavior might include high prices, reduced output and diminished innovation.**

- **In recent years, there has been substantial consolidation of college textbook publishers. *The Big Five* (*Cengage, Pearson, McGraw-Hill, Worth,* and *Wiley*) now appear to control more than 90% of the *new* textbook market.**

- **However---Only *Pearson* and *McGraw-Hill* are publicly traded companies such that we can easily obtain data about their operations.**

Supply Side Selling Strategies

- **Bundling:** Packaging the textbook, a workbook, DVDs, etc., together and sell them as *"all or nothing."* (Think of how cable television companies sell and price their products.)

- However, Federal law now requires publishers and bookstores to offer students the opportunity to *unbundle* textbook packages and to have the opportunity to purchase *a la carte* any item they wish.

- Nevertheless, forms of bundling assuredly still exist because some publishers and bookstores assign unique ISBN numbers to bundles. Whatever their intent, this makes it much more difficult for students to comparison shop.

- Publishers also are aggressively promoting book technology packages such as *McGraw-Hill's* *"Smart Book"* that promise a personalized learning experience and enable students to do periodic assessments of their learning. *MGH* says it is an *"active"* learning experience rather than a *"passive"* one.

Mc Graw Hill Education | LEARNSMART™ ADVANTAGE

- *Pearson's* *"My Lab"* is in the same general vein.

PEARSON

MyLab™ & Mastering™

- **New Editions**: **Every three to four years, produce a new edition and expect bookstores not to buy back the older edition. This is a version of the *"artificial obsolescence"* often imposed by software suppliers such as *Microsoft* and *Apple*.**

- **Reimportation Bans: Historically, publishers forced bookstores and distributors to sign contracts that prohibit the re-importation of technically similar---but less expensive---books from abroad and/or the purchase of international editions. (The same book frequently is sold at a much lower price in countries such as Poland or India.)**

- However, in March 2013, a U.S. Supreme Court decision extending the doctrine of *"first sale"* to textbooks purchased outside of the United States. This means that entrepreneurial individuals now can purchase less expensive international editions outside of the U.S., send them to the U.S., and undercut the U.S. edition prices.

- Widespread international arbitraging of textbook prices already is underway.

- **In sum, since WW II, textbook markets have not generated results that are as favorable to consumers as those we have observed in many other markets (e.g., PCs, smart phones, etc).**

- **However, as we have seen, change is in the air and student consumers are faring much better recently.**

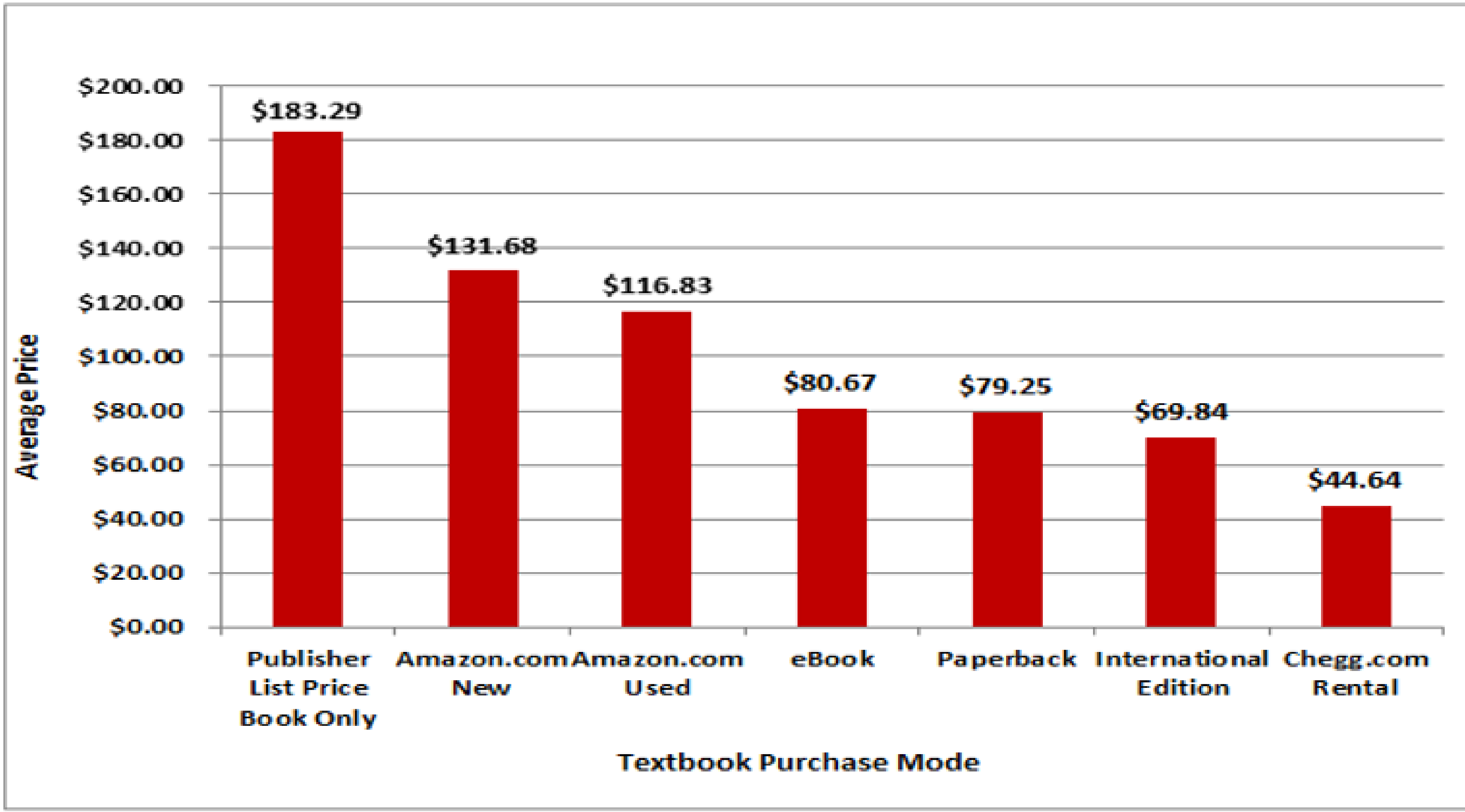
- **Why? Textbook markets are being disrupted by a variety of forces, most of which are connected to the Internet and digitization. One immediate result: today, there are about 3,000 bookstores in the U.S., while in 1990 there were about 10,000.**

- **In contrast to my 2006 and 2013 studies, virtually all students now have the ability to comparison shop for textbooks via the Internet. (*University Business* reported on 080314 that 85% of all students purchase some of their textbooks online. Sellers are actively *"disintermediating"* faculty.)**

- **And, as we have just seen, some of the marketing tactics traditionally used by publishers and bookstores have become less common.**

Example: The Textbook Choices Students Now Enjoy

Average Textbook Price by Purchase Mode for Seven Textbook Sample, December 28, 2012

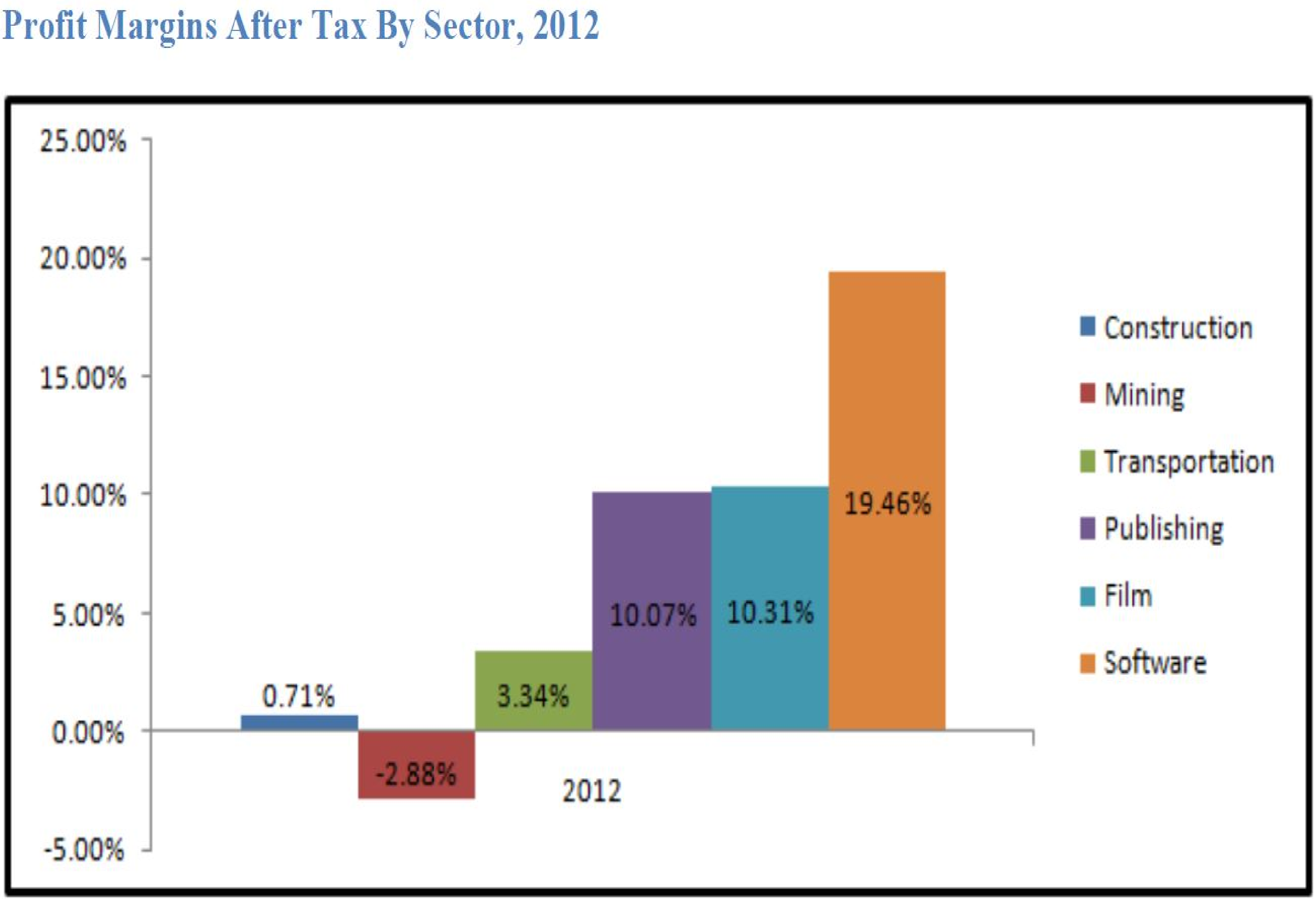


Source: Internet Sample Taken by James V. Koch, December 28, 2012.

- **What about the publishers?** **How are they doing? Overall, publishers seem to be doing reasonably well financially, though a few are encountering problems. *Cengage*, for example, declared bankruptcy, though primarily because it was saddled with crushing levels of debt due to an acquisition and not because it was unprofitable in an operating sense.**

- **What profit rate evidence do we have?**

Comparing Profit Margins on Sales (Source: *Publishers Lunch*)

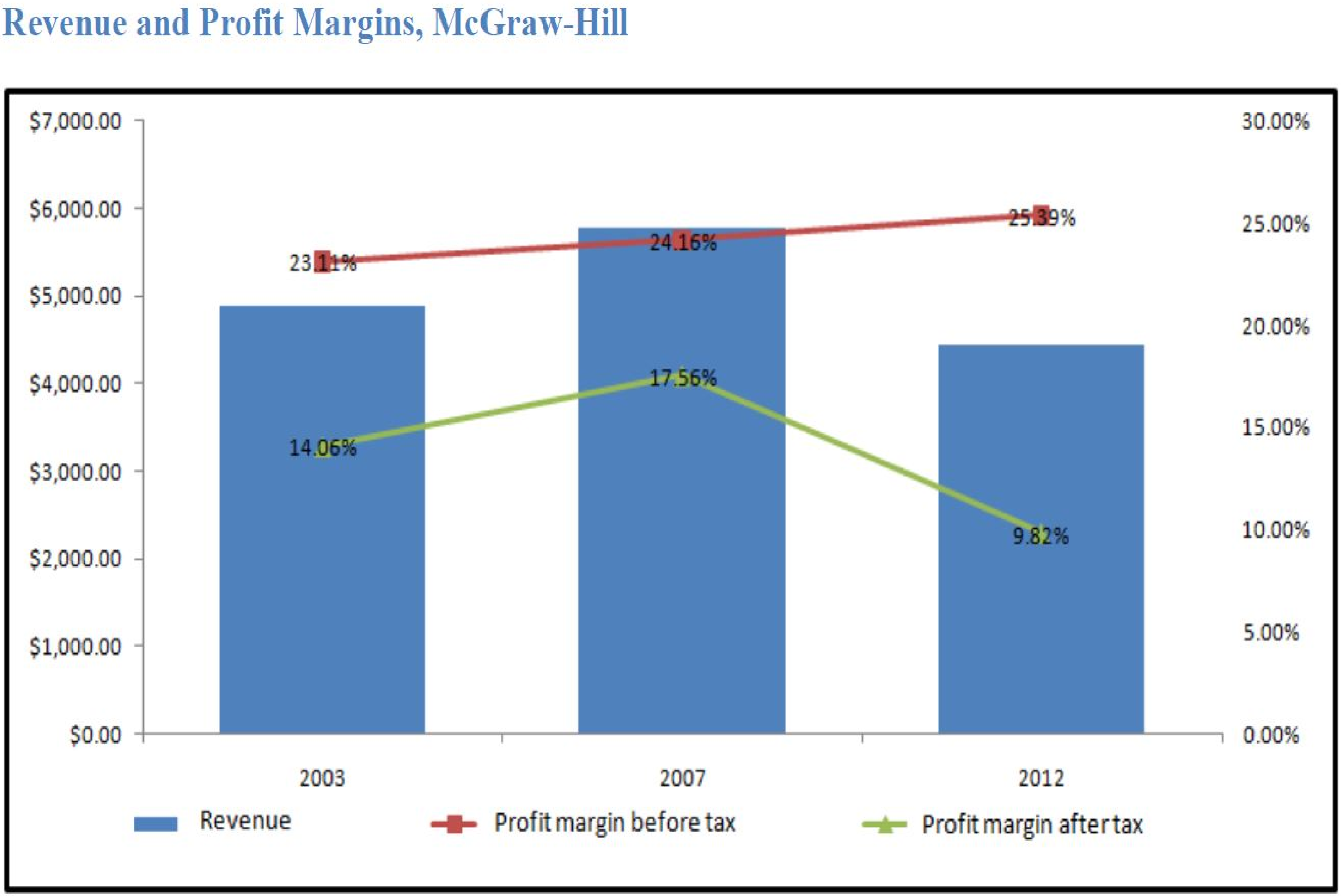


How Profit Margins on Sales Changed, 2002-2012 (Source: *Publishers Lunch*)

Change in After Tax Profit Margins—2003-2012

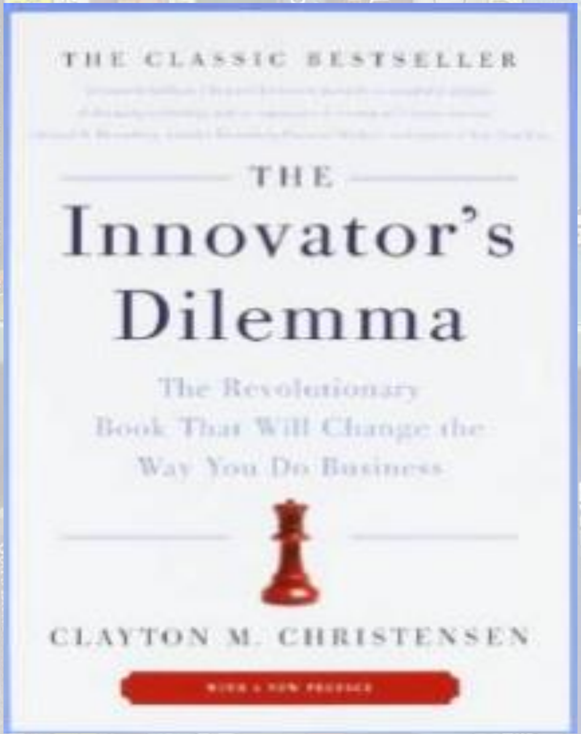
Transportation	-0.44%
Mining	-3.77%
Construction	0.96%
Film	3.05%
Publishing	2.49%
Software	2.73%
Other Industry Average	-1.08%
Copyright Industry Average	2.76%

A Look at McGraw-Hill (Source: *Publishers Lunch*)



Even So, Textbook Markets Are Being Disrupted

- **Clayton Christensen's notion of "*disruptive innovations*" applies to the market for textbooks. New ways of buying and selling textbooks are forcing change.**



- **Approximately two-thirds of all textbook units used by students now are purchased used, rented, borrowed, shared, or copied. The Book Industry Study Group found that 25% of students in 2012 photocopied or scanned some textbooks and 19% acquired their book from a pirate website. (**See Josh Mitchell, "A Tough Lesson for College Textbook Publishers," *WSJ*, 264, 082714**).**

- ***Student Monitor's* just released 1,200 student survey revealed that the average full-time undergraduate student downloaded 1.2 textbooks per semester from possibly illegal file-sharing sites.**

Illegal Downloads? Many Students Don't Care (*Student Monitor*, 2014)

Agreement With Statements About Illegal Downloads Q. 278

Students are ambivalent about illegally downloading eTextbooks

- **Student Monitor says that 40%+ of all student textbook *purchases* now are *used* books and that eBooks now account for about eight percent. However, this latter segment of the market is growing more rapidly than other segments.**

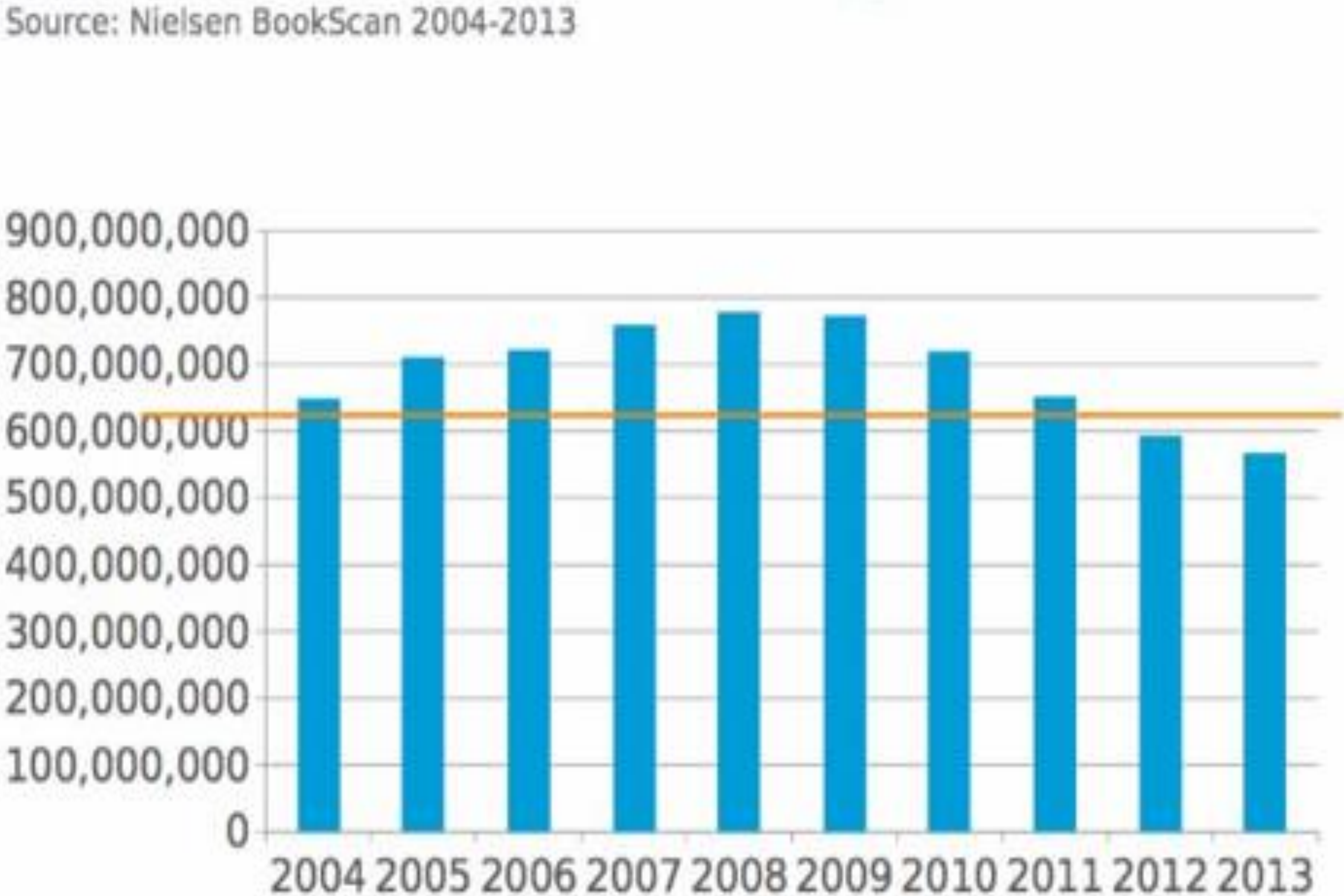
- **But, 10% to 30% of students don’t purchase any book, depending upon the source one chooses to believe.**

Why don't students purchase a textbook? (*Student Monitor*, 2014)

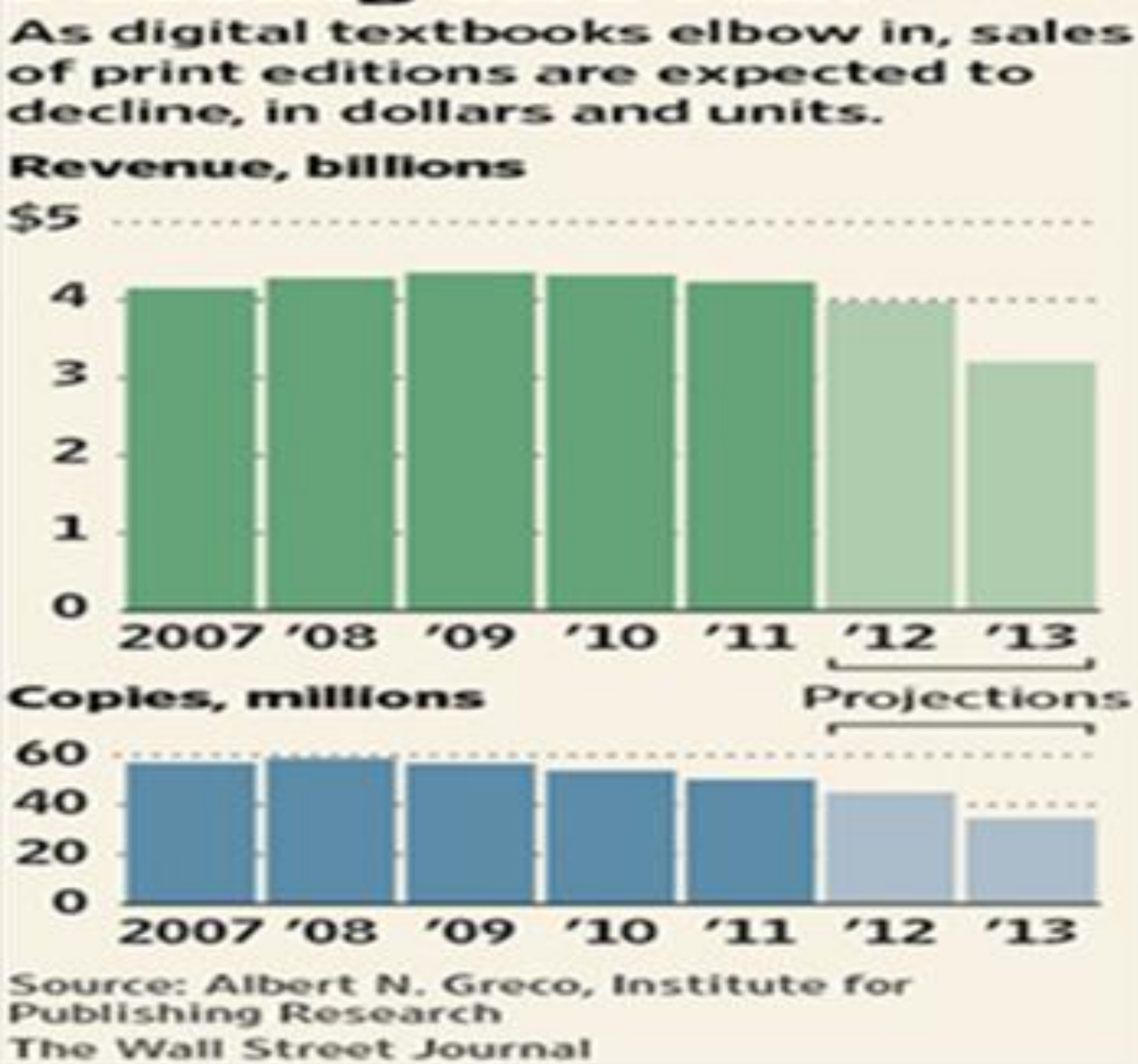
Reasons For Purchasing Less Than All Required Textbooks Q. 288

"Can't afford the cost of a new textbook" (31%) and "Shared the book with someone else" (27%) are the most commonly reported reasons for purchasing less than all required textbooks

Print Book Unit Sales are Declining (Source: *Nielsen Book Scan*)

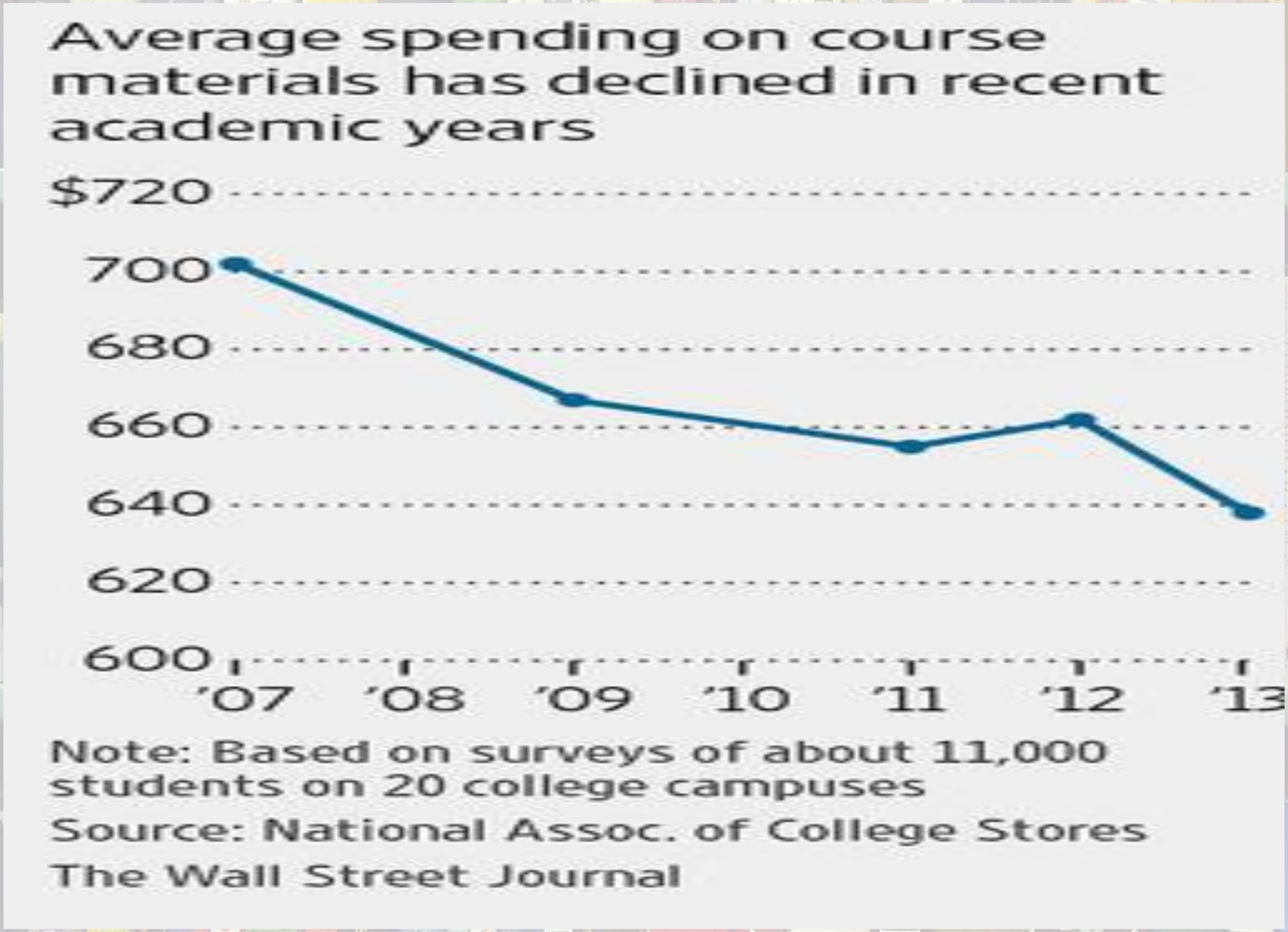


Print Textbook Sales Also Are Declining



Source: Jessica E. Vascelaro, Shara Tibken and Jeffrey Trachtenberg, "Apple Jumps Into Textbooks," *Wall Street Journal*, 258 (January 20, 2012), B8.

Students Are Spending Less on Course Materials



Source: **Josh Mitchell, "A Tough Lesson for College Textbook Producers,"** ***WSJ*****, 263 (082714).**

- **Meanwhile, Apple and Amazon have announced that they intend to create a resale market for e-Books.**

- **If they do this for college textbooks, and they permit e-Books to be resold several times, and don't rigidly control prices, then this will place tremendous downward pressure on eBook prices. Who would ever be willing to pay the full price for a new e-Book if it is possible to purchase a less expensive used version?** ***"Race to the bottom"*** **pricing?**

- **The Indiana University System e-Book initiative holds great promise.**

- **<u>IU has negotiated sharp price discounts</u> with major publishers for digitized versions of textbooks and related materials. Students pay the equivalent of a laboratory fee, are able to print paper copies if they wish, and retain ownership as long as they are students. (However! Discounts from what? What is the *"real"* price of a textbook? The marginal cost of producing an additional copy is rather small.)**

- **And, IU successfully separated the material (e-Books and digitized materials) from its chosen delivery platform (*CourseLoad*).**

- **Publishers want to control both content and the delivery platform. In the words of IU Vice President Brad Wheeler, *"They wanted to control the mixing bowl."* This, however, would have provided publishers with considerable future negotiating and pricing leverage.**

- **Now, institutions can independently decide on the material they desire and then how they wish to deliver that material.**

- **Nevertheless, publishers usually like the IU arrangement because it guarantees them a steady flow of sales and 100 percent sell through.**
- **Authors don't experience a drop off in sales after the first year.**
- **Students pay lower prices.**
- **Faculty can be assured that all students in a course have the required book.**
- **Materials can be updated on a real time basis.**

- **Of course, there have been some teething problems. Among them are:**

<u>Faculty</u> (especially at research institutions) often lack the incentive either to use eBooks at all, or to learn how to use them efficiently.

"Cutting Costs and Quality?" *Inside Higher Education*, 090214, re University of Colorado Boulder faculty complaints.

<u>Students</u> often are unenthusiastic about e-Books because they involve different ways of doing things. Hence, *"learning by doing"* is important for student eBook usage (and this may be even more true for faculty).

- **Student surveys concerning eBooks reveal that most are only lukewarm about eBooks. This is an interesting result given the visual, digitized inclinations of students today.**

- **However, as just noted, there is "*learning by doing*" and repeated use does improve their reactions to eBooks.**

- **And, the *Chronicle of Higher Education* (082214) recently reported that 10% of all materials held by *academic libraries* now are eBooks. Like it or not, we appear to be headed in this direction.**

- **A major initiative similar to IU exists in the 426,000 student California State University system** and several other campuses and systems have taken steps down this path (*Affordable Learning Georgia* and *Maryland's Open Source Project* provide examples).

- IU, however, leads the pack and has invited other campuses to *"free ride"* on its software, policies, procedures and experience. This is an amazingly generous offer that should accelerate the use of eBooks, which at IU never are priced above 35% of the publisher's list price (a price in any case that IU regards as rather illusive and *"made up"*). The more, the better, since there are significant economies of scale in eBook production (high fixed costs, very low variable costs).

- **Publishers have not been sitting still.** **The Big 5 publishers founded *CourseSmart* in 2007 and its stated aim is to create the world's largest library of eTexts and digitized learning materials. It is now owned by *Vital Source*, which says it is the *"world's leading digital text platform."***
- ***Vital Source* says its catalog now includes 30,000 textbooks representing 90 percent of all textbooks currently in use and that it currently represents 350 publishers.**
- ***Vital Source* is interested in institutional-wide licenses at set subscription fees. But, it does not appear to have made a major indentation in the market thus far.**

- **In addition, there are intriguing eBook and digitized materials initiatives involving *Apple, Saylor.org*, the *Open Library, Boundless Learning* ($20 per student per course for customized books), *Flooved* (free lecture notes, etc.), *OpenStax College* (sponsored by Rice University with 500,000 reported book downloads).**

- **There is increased ability to share accessible eTexts among institutions through resources like *AccessTexxtNetwork* and *Bookshare.***

- **And, *Flatworld Knowledge*, a pioneer in providing digitized textbooks, says its books have been used by 300,000 distinct students.**

- ***Flatworld,* like most other innovators, has diversified into software and learning platforms.**

- **Nearly all innovators are searching for a viable business model (often unsuccessfully) that will enable them to attract and retain authors and to be able to pay for the resources they use. Grants from the Gates Foundation, etc., are not a permanent solution.**

- <u>The salient question</u>: **Are the changes I've just mentioned really fundamentally altering the economics of the textbook business? Yes, it already is happening.**

- **The college textbook market is in ferment. The changes in process now among both students/consumers and publishers/sellers are unprecedented.**

We are in the midst of one of Schumpeter's *"Perennial Waves of Creative Destruction"* in the textbook industry such that we won't recognize it ten years from today.

- ***Let do a quick quiz.*** **What do these well-known firms all have in common?**

Texaco, Bethlehem Steel, LTV, Colt,

Kaiser Aluminum, Kodak, Polaroid,

Owens Corning, Lionel, Delphi, Braniff,

the Milwaukee Road, and Wheeling Pittsburgh.

- <u>The Answer</u>: **They have all disappeared. In some cases, not even a vestige of the former firm exists.**

- ***"Creative Destruction"* also appears to be at work in the textbook industry.**

- **New technologies, new delivery systems, new firms, new shopping techniques---all are the engines of change.**

- **The most persuasive evidence is that today's students aren't spending as much on textbooks as they used to spend (~$1,200 per year has declined to $600-$800 per year).**

- **This is what *Student Monitor* data tell us and also is consistent with college bookstore financial reports.**

So, What Are Students Doing Instead of Buying New Editions of Print Textbooks?

(1) **They purchase *used* books from Internet-based firms such as *Chegg*.** (~30%). Used book prices average 50-60% less than new books. *Chegg,* however, has found this market challenging and has branched out into homework and tutoring (*"Uber for tutoring"*) as well as internship and job placement.

Chegg

eCampus.com Textbooks Easy. Fast. Cheap!

textbooks.com Used textbooks waiting for new owners.

BARNES&NOBLE

amazon Try Prime

VALOREBOOKS

(2) <u>They *rent* books</u> **from their own institutions (EIU, SEMO, many in the University of Wisconsin System), or they can do so for as little as $5 per day electronically from *Packback,* which lists 5,000+ titles. (~10%).**

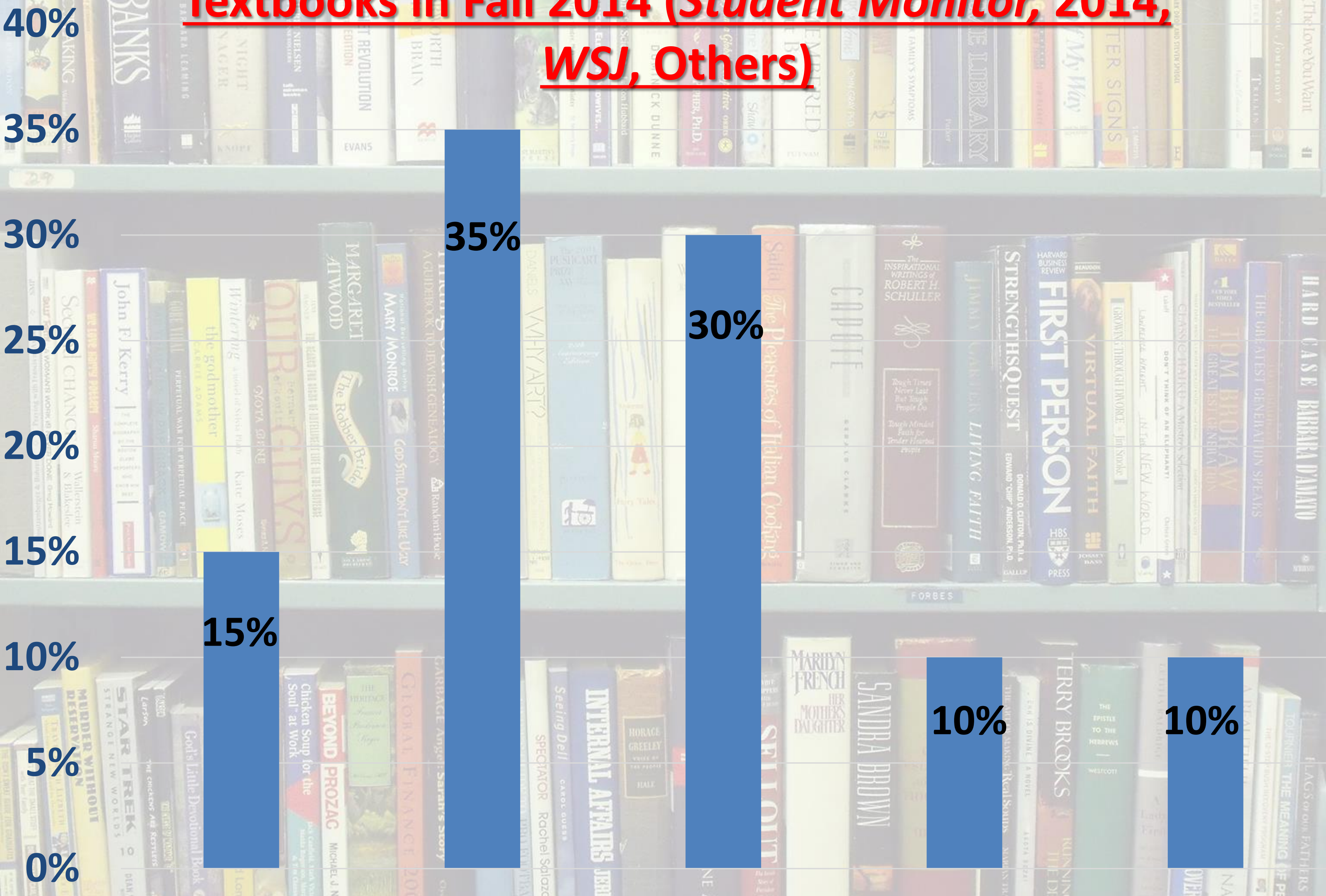
Institutionally sponsored textbook rental systems reduce student textbook costs by approximately 75% (compared to purchasing new versions), but are expensive to mount and often displease faculty because they require that the same edition be used three to five years consecutively in order to be economically viable.

(3) <u>They purchase less expensive *eBooks*</u> that are less expensive, but cannot be sold back and whose content typically expires at the end of the semester (~8%-10%).

(4) <u>They *share or borrow* textbooks</u> (10%-15%).

(5) <u>They *don't purchase* any form of textbook</u> (10%-30%). <u>Example</u>: My Economics 301 (Managerial Economics) class at Old Dominion University this past spring. 12% of 230 students confessed they had not purchased any form of a textbook. Instead, they relied on my very extensive Blackboard site.

How Undergraduate Students Acquired Their Textbooks in Fall 2014 (*Student Monitor,* 2014, *WSJ*, Others)



Issues Worthy of Note

Issue One: Does the Bureau of Labor Statistics textbook price index presented as a part of the Consumer Price Index tell us what we need to know about textbook prices?

- **Not really. The problem/challenge is that the BLS college textbook price index *does not include used books or rented books,* but these two categories account for almost one-half of all unit purchases and nearly always are sold at lower prices than new books.**

- **The BLS textbook price index has become increasingly irrelevant. Perhaps only 35% of all undergraduate students purchase a new print copy of a textbook. The BLS textbook price index misses this evolution in habits.**

- **In BLS's defense, however, historically it almost never has tracked the prices of used goods because of obvious problems related to the measurement of the quality of individual units. How does one compare a used textbook that has been trashed with one that hardly has been used? And, how should one count a one-day textbook rental?**

- Textbook rental systems were rather common 50 years ago, then faded into the background, but now have experienced a rebirth.

- They typically cut student expenditures for textbooks by about 75% because in effect they constitute a guaranteed sale and resell mechanism.

- **But, textbook rental systems are expensive to mount, don't work well when the number of sales is small, and more than a few faculty resist being told what textbook they must use for three or four years in a row (the time period necessary for a campus to avoid high costs). For some faculty, there are both academic freedom and quality issues.**

Issue Three: Do students learn more or less when they use e-Books?

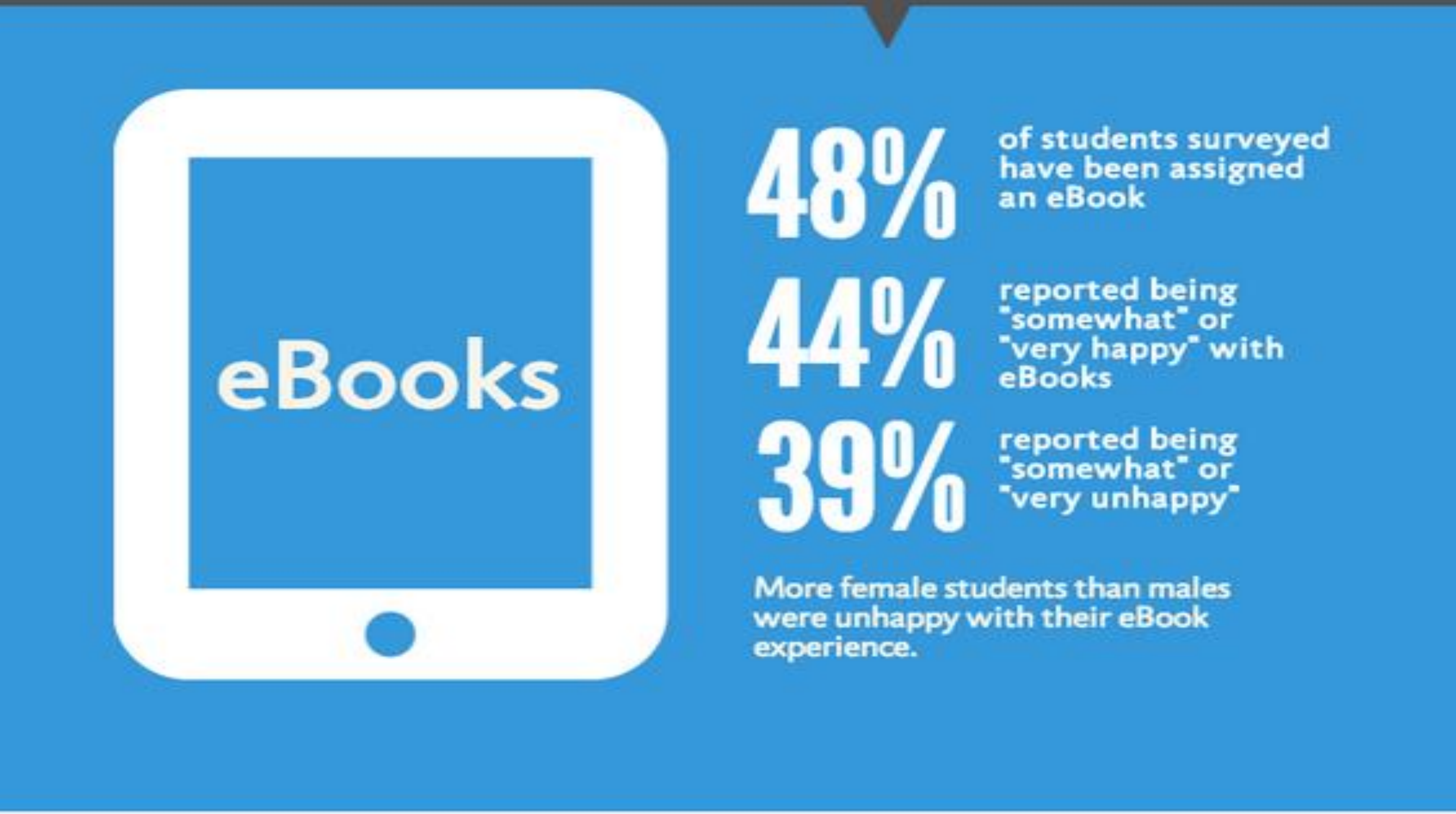
- We're still in the infancy of determining the academic impact of e-Books on students (and faculty), but the evidence is not encouraging.
- We need rigorous, control group studies of the impact of e-Books on learning, content coverage, student retention, connection to additional course registrations, graduation, etc. And, we need to know how e-Books impact how and what faculty teach, if they change how faculty use their time, and how they are rewarded.

Now, for some Predictions!

(1) <u>Adjusted for inflation, the average student will spend less on textbooks in this decade than he/she did in the last decade</u>

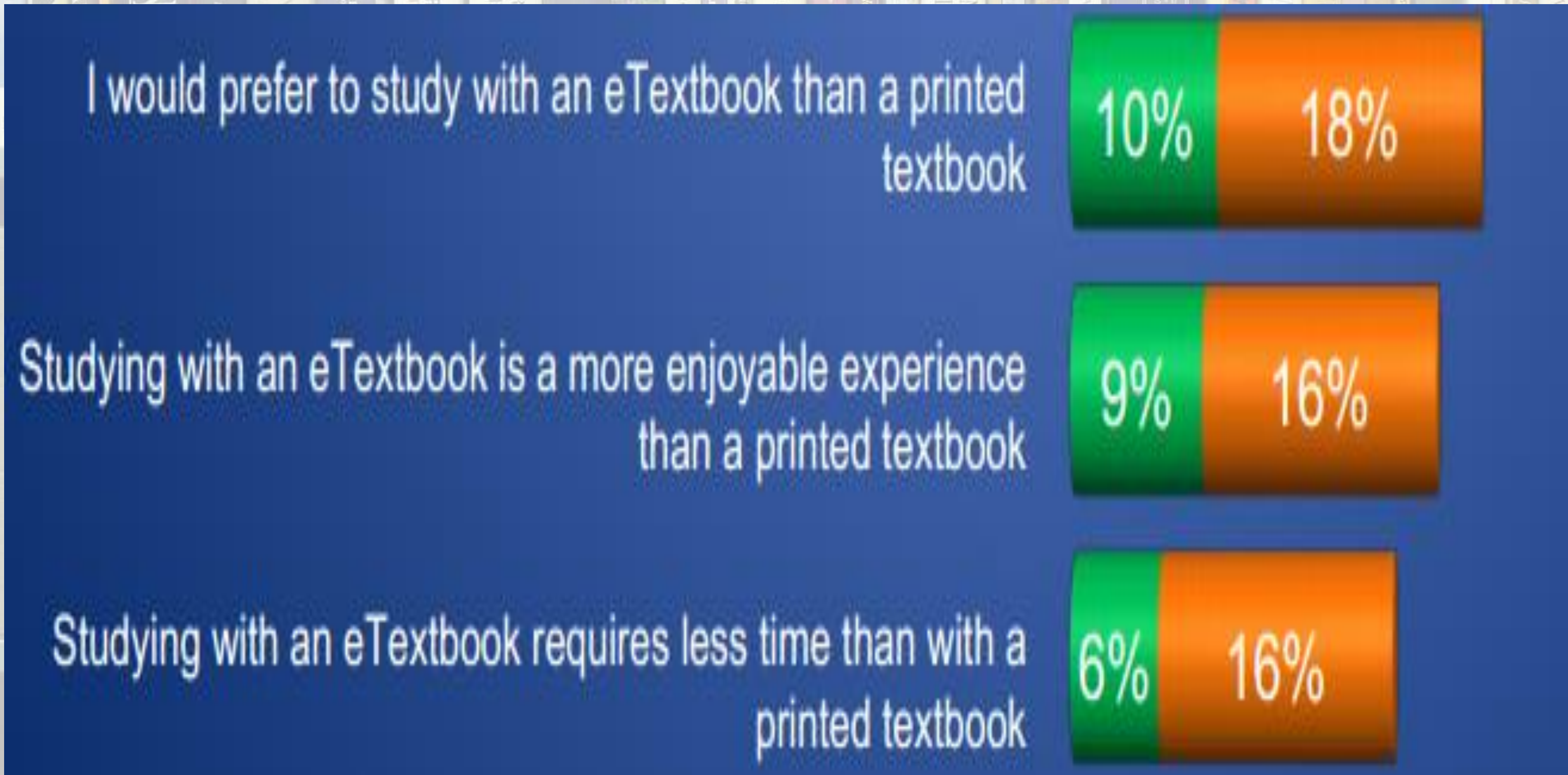
(2) <u>eBooks will not replace printed books</u>, but as students and faculty become more comfortable with eBooks and learn how to use them, they will become more popular and in ten years might account for as much as one-third of all *unit* textbook purchases, especially on large enrollment campuses.

eBooks Still Have a Steep Hill to Climb



Source: *Career College Central*, 082014

From *Student Monitor's* 2014 Survey



Green = "Strongly Agree" **Orange = "Agree"**

(3) **To the extent permitted by law, universities will band together and exercise *monopsony* (buyer) power to extract more favorable pricing arrangements from publishers.** The IU and CSU examples demonstrate the payoff.

(4) **The production of books outside of the U.S. and their subsequent reimportation will undercut publishers' current international price discrimination (and their profits).** As time passes and publishers are forced to modify their pricing habits, reimportation will once again decline in importance.

(5) **One or more significant U.S. textbook publishers will bite the dust in the next several years.** (**Primary reasons**: not being able to deal with digitization and their inability to experience economies of scale.)

It's not yet clear if this will increase or decrease seller concentration because new competitors are on the horizon.

And, almost needless to say, quite a few conventional bookstores will disappear.

(6) **If a major player such as Apple decides really to take seriously its stated intent to produce eTextbooks at low prices, then this will turn the industry upside down** by providing existing publishers with very strong competition.

(7) **If Apple and Amazon fulfill their commitment to develop a market for *used* eBooks, then this too bodes to turn the industry upside down** because it will exert downward pressure on book prices in general and eBooks in particular. Price competition will force the prices of eBooks down toward the rather low incremental cost of producing them. This also will make printed books less attractive.

(8) <u>It's clear that one of the major engines for change in textbook markets is Amazon</u>. **Amazon's pricing argument (and recent agreement) with Hachette and others has major implications for textbook pricing. Amazon wishes to set (low) prices for eBooks---prices sufficiently low that they will squeeze the margins of publishers and reduce author royalties.**

- **This is a model that can be extended to print books, etc.**

- **It would be a mistake to underestimate Amazon's ability to bring about change in textbook markets.**

- **Amazon has a 40% share of the U.S. new book market, sells 62% of all books sold online, and has 64% of the overall eBook market. Bottom line Amazon has the power to change things.** **(See Jeffrey A. Trachtenberg, "Amazon, Hachette Reach a Truce,"** ***Wall Street Journal*****, 264 (111414), B1-2.)**

- **Amazon is a ten-ton gorilla in room full of ordinary sized monkeys. For better or worse, Amazon will have a powerful influence over the future development of college textbook markets.**

Lower book prices are good for students, but…

- Will Amazon acquire substantial monopoly power that it later might use to dominate book markets?
- Will the financial squeeze on publishers drive some of them out of business?
- Will reduced incentives deter authors from writing textbooks?

“Amazon, Simon & Schuster Reach Book Contract,” *WSJ*, 264 (102114), B6.

Deal Could Put Pressure on Hachette Amid Dispute With Amazon

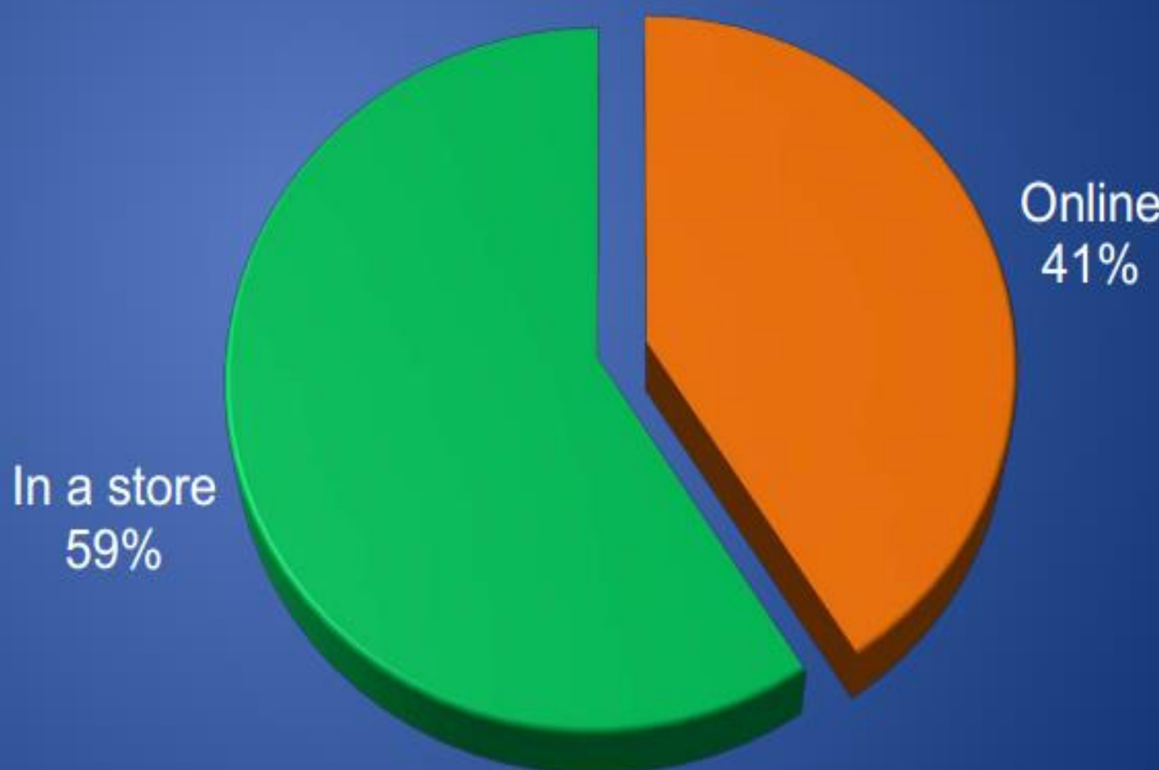
(9) <u>College bookstores will continue their evolution into convenience stores/computer stores/restaurants</u> **that make most of their money from selling things other than textbooks. Students with immediate book and supply needs, or who have technology problems may go to the bookstore; however, they may do all of their shopping digitally from their room or apartment. Purchases that can be anticipated or postponed likely will be purchased on the Internet and perhaps later be picked up at the bookstore, or delivered by the USPO, UPS, or FedEx.**

The old *"buy all your books at the campus store"* model is disappearing. This will put a crimp in the revenue streams of many colleges and universities, but in the process also diminish their financial conflict of interest.

But, All Is Not Lost for Bookstores (*Student Monitor*, 2014)

Share Of Textbooks Purchased/Rented Online
Q. 301

59% of the textbooks students purchased or rented were purchased or rented in a store



Bookstores Have Been Rather Resilient
Student Monitor, 2014)

Share Of Textbooks Purchased/Rented Online Tracking
Q. 301

Over the last seven semesters, on average, 37% the textbooks students purchased or rented were purchased or rented online (63% were purchased or rented in a store)

Finis