Reducing Federal Aid, Not Changing Bankruptcy Laws, Key to College Affordability

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"The Looming Student Debt Crisis: Providing Fairness for Struggling Students"

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Chairman Durbin, members of the committee, thank you for inviting me to speak with you today. My name is Neal McCluskey and I am the associate director of the Center for Educational Freedom at the Cato Institute, a nonprofit, non-partisan public policy research organization. My comments are my own, and do not represent any position of the institute.

As a result of decades of college price increases that have eclipsed normal inflation and growth of household income, the nation has rightly begun to focus on the extraordinary cost of postsecondary education. And the federal government, as the primary supplier of aid to students, has a critical role to play in restoring sanity to college pricing: it must greatly reduce student aid. Unfortunately, what this committee is contemplating – changing bankruptcy law concerning private student loans – will do almost nothing to address the root cause of rampant tuition inflation.

The logic behind seeing federal aid as a primary cause of inflation is straightforward. First, subsidies drive increased demand, which increases prices. Second, and more important, colleges raise their prices if they know students will be able to pay them, and federal aid ensures that they can. You might know this as the "Bennett Hypothesis," put forth by U.S. Secretary of Education William Bennett in 1987. It is perhaps best captured, however, by former Harvard University President Derek Bok, who wrote that "universities share one characteristic with compulsive gamblers and exiled royalty: there is never enough money to satisfy their desires."[1]

The basic facts clearly support the Bennett Hypothesis. According to data from the College Board, between the 1981-82 and 2010-11 school years, inflation-adjusted aid per full-time equivalent student – the bulk of which came through the federal government – rose from $4,418 to $13,914, a 215 percent increase.[2] Meanwhile, real tuition and fee costs at four-year colleges grew roughly apace. At four-year public institutions prices expanded from $2,242 in 1981-82 to $8,244 in 2011-12, a 268 percent ballooning. At four-year, nonprofit private institutions prices rose from $10,144 to $28,500, a 181 percent leap.[3]

It is, of course, difficult to conclude definitively from simple aid and price comparisons that aid fuels price increases. But a growing body of research controlling for variables outside of aid supports the hypothesis that aid has an appreciable inflationary effect, though study results vary by type of aid and institution.[4] And there is a limit to what empirical research can reveal because aid automatically increases with higher prices, creating a major endogeneity problem.

Perhaps, though, price increases are not fueled by aid, but necessitated by state and local funding cuts to public colleges and universities. This is a frequently offered argument, and there is no question that state and local governments have faced tough economic times over the last few years. This is, however, an inadequate explanation for rampant tuition inflation.

For one thing, private colleges would not fall under this as they receive only a tiny fraction of their funding from state and local governments. Nonetheless, their prices have ballooned at almost the same rate as public schools.

More directly, state and local taxpayers have not become increasingly tightfisted with colleges. According to data from the State Higher Education Executive Officers, inflation-adjusted state and local outlays to colleges for general operations rose from $57.7 billion in 1986 to $74.2 billion in 2011, a 29 percent increase.[5]

Where it appears that state and local taxpayers have become less generous is expenditures on a per-pupil basis. Again using SHEEO numbers, real appropriations per full-time equivalent student declined from $8,025 in 1986 to $6,290 in 2011, a 22 percent drop. But this has to be taken with a sizable grain of salt. First, state and local appropriations tend to rise and fall with the business cycle, and the overall trend is pretty flat. More importantly, fitting trend lines to appropriations per-pupil and net tuition revenue per-pupil shows that for the past quarter century public schools have raised tuition revenue by about two dollars for every dollar lost in cuts. The appropriations trend line drops about $43 per year, while tuition revenue increases $83 per annum.

The "cheap states" theory doesn't wash: It doesn't explain private colleges' inflation at all; real state and local appropriations have not fallen; and on a per-pupil basis, public institutions have been raising revenue through tuition much faster than they've been losing it in appropriations.

Which brings us to the biggest problem: Based on students' demonstrated ability to complete college work; the limited amount of learning signified by a college degree; and workplace realities, it appears far too many people are enrolled in college. As much as Congress wants to help all people by giving them money to go to college, it is in fact doing few people any real favors. That is, other than the colleges and their employees, which are profiting mightily whether they are for-profit or putatively not-for-profit institutions.[6]

Start with completion rates. According to the latest data from the federal *Digest of Education of Education Statistics*, only 55 percent of first-time, full-time bachelor's degree seekers at public institutions finish their degree within six years – 150 percent of the expected time. At private, nonprofit four-year institutions the rate is just a little bit better: 64 percent. At for-profit four-year

schools the rate is much worse: 22 percent. And that is not the absolute rock-bottom rate: At public, two-year institutions the three-year completion rate is a puny 21 percent.[7]

If you factor in transfers and part-time students these numbers likely get a little better, but the ultimate story is clear: We are paying billions for a whole lot of people to undertake education they will never complete.

What about those who do finish? Isn't it clear that a degree confers major new earning ability?

That is the case on average, though how much additional earning potential is a matter of serious dispute, with estimates ranging from $1 million over a lifetime to just about $100,000.[8] And those are averages: Many graduates will likely not gain even that $100,000 premium, depending on their major.

So the college earnings premium almost certainly does not reach the $1 million we so often hear about. In addition, there is significant evidence that the value of a bachelor's degree is shrinking. Essentially, degrees are becoming more widespread and easier to obtain, and signify less and less that the possessor has valuable skills and knowledge.

According to Bureau of Labor Statistics' data, the weekly earnings for people whose maximum educational attainment is a BA have dropped over the last decade, by about 4 percent. Only people possessing advanced degrees saw an increase, something missed when, as is often the case, people with bachelor's degrees and advanced degrees are all lumped into one category.[9]

Is this drop a function of credential inflation, or the economy increasingly demanding advanced skills?

It is hard to tell definitively because we have no comprehensive measure of what students are learning in college. One longitudinal assessment, however, suggests that the problem is credential inflation. The National Assessment of Adult Literacy was conducted in 1992 and 2003, and revealed a shocking decrease in literacy among college graduates. For instance, the percentage of bachelor's holders proficient in prose literacy dropped from 40 to 31 percent between 1992 and 2003, and in document literacy from 37 to 25 percent. Among adults with at least some graduate education, there were proficiency drops from 51 to 41 percent in prose, and from 45 to 31 percent in reading documents.[10] In other words, a college degree appears to represent significantly decreased abilities.

Recent research illustrates why this might be: students simply aren't learning much in college, at least as measured by the Collegiate Learning Assessment. According to research by Richard Arum and Josipa Roksa, 45 percent of students in their sample, drawn from a variety of school types, demonstrated no significant learning in their first two years of college, and 36 percent demonstrated no learning in four years.[11]

Finally, it is assumed that almost everyone will need some sort of postsecondary training to get a job in the new economy. And perhaps they will – but not necessarily from colleges or universities. According to BLS projections, the large majority of the 30 occupations expected to

see the largest employment growth this decade will require no more than a high school diploma and involve on-the-job training.[12] By pushing everyone into outside-the-job, postsecondary education, we are setting them up for expensive failure. Indeed, currently about one-third of people with bachelor's degrees are in jobs that do not require them.[13]

The solution to these problems is clear: Reduce student aid, which encourages millions of people to pursue studies they are not prepared to complete, and decreases their sensitivity to prices.

Some of this could be relatively painless, such as phasing out tax benefit programs that are biased toward those wealthy enough to hire accountants or financial advisors to help them minimize their tax liability. Similarly, federal loan programs that have no income cap could be eliminated.

Such changes would begin to restore sanity to college pricing by better focusing eligibility on truly lower-income students. But that will not be sufficient: It is clear that many students of all income levels simply aren't prepared or inclined to do college work, yet they can easily get federal student aid to attend school. It is a waste of their time and money, as well as taxpayers' dollars.

To deal with this Washington could peg aid to strong evidence of an ability to benefit from college; perhaps some combination of high standardized test scores and grade point averages. But these are imperfect measures, and would no doubt weed out some students who could handle college work while allowing others in who could not.

To avoid this problem – and the rightful objection many will have that if they pay taxes, they should be eligible for aid – the best solution is for the federal government to get out of the student aid business entirely. If you look at the numbers there is no logical reason to remain in it, nor is there authority to be involved if you examine the specific, enumerated powers given to the federal government in Article I, Section 8 of the Constitution. Quite simply, the aid self-defeatingly spurs price inflation as colleges capture the money while likely encouraging many people to spend time and treasure on an education for which they are either unprepared or under-motivated.

Critically, students would be able to afford college were aid phased out: Prices would have to come back to Earth as students were required to pay with their own money or with funds voluntarily received from others. Meanwhile, even the lowest-income student would be able to attain a loan if she had a strong, demonstrated ability to do college-level work and attain a well-paying job as a result. Both lender and borrower would benefit as the degree would translate into substantial earnings.

Unfortunately, what this committee is considering – making private student loans dischargeable in bankruptcy – ignores the gigantic root problem underlying college pricing insanity and would at best nibble around the edges. At worst, it would encourage students to over-consume even more.

A little perspective. According to College Board data, in 2010-11 around $6 billion was originated in private student loans. In that same year, total federal loans equaled almost $104 billion, or an amount roughly seventeen times larger. Throw in grants, tax benefits, and work study, and federal aid exceeded $169 billion.[14] $6 billion is just the proverbial drop in the bucket.

What would changing bankruptcy laws for private loans do for college affordability? It is difficult to predict: If lenders know that borrowers can escape repayment through bankruptcy they would likely raise interest rates to account for that risk and lend to fewer people, discouraging use of such loans. However, students might be more apt to take such loans – and pay still higher college prices – if they think that they will be able to unload their debt without repaying it.

Both possible outcomes have concerning aspects, but the change would still have a negligible effect on affordability because private loans are such a small piece of the pie. Ultimately there is simply too much aid, and most of it comes from Washington.

Thank you, and I look forward to your comments and questions.

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[1] Derek Bok, *Universities in the Marketplace: The Commercialization of Higher Education* (Princeton, NJ: Princeton University Press, 2003), p. 9.

[2] College Board, Trends in Student Aid 2011, Table 3, http://trends.collegeboard.org/student_aid/report_findings/indicator/Aid_Per_Student_All_Students, accessed March 15, 2012.

[3] College Board, Trends in College Pricing 2011, Table 4, http://trends.collegeboard.org/college_pricing/report_findings/indicator/Tuition_Fees_Over_Time, accessed March 15, 2012.

[4] See, for instance, Stephanie R. Cellini and Claudia Goldin, "Does Federal Student Aid Raise Tuition? New Evidence on For-profit Colleges," National Bureau of Economic Research Working Paper 17827, February 2012; Bradley A. Curs and Luciana Dar, "Do Institutions Respond Asymmetrically to Changes in State Need- and Merit-Based Aid?" Working Paper, November 1, 2010; John D. Singell, Jr., and Joe A. Stone, "For Whom the Pell Tolls: The Response of University Tuition to Federal Grants-in-Aid," *Economics of Education Review* 26, no. 3 (2006): 285-95; Bridget Terry Long, "How Do Financial Aid Policies Affect Colleges? The Institutional Impact of Georgia Hope Scholarships," *Journal of Human Resources* 30, no. 4 (2004): 1045-66; Michael Rizzo and Ronald G. Ehrenberg, "Resident and Nonresident Tuition and Enrollment at Flagship State Universities," in *College Choices: The Economics of Where to Go, When to Go, and How to Pay for It*, edited by Caroline M. Hoxby, (Chicago, IL: University of Chicago Press, 2004); Rebecca J. Acosta, "How Do Colleges Respond to Changes in Federal Student Aid," Working Paper no. 808, Department of Economics, University of California, Los Angeles, October 2001.

[5] State Higher Education Executive Officers, Supplemental SHEF Data Tables and Figures, "1986-2011 All States and National" Excel file, http://www.sheeo.org/finance/shef/shef_data11.htm, accessed March 16, 2012.

[6] Vance Fried estimates that the average private research university makes between $5,515 and $12,807 in profit, depending on whether donation revenue is included, on the average undergraduate. Public research universities make between $2,000 and $11,000, depending on whether state subsidies are included. These profit margins exceed even those of the for-profit Apollo Group. See Vance H. Fried, "Federal Higher Education Policy and the Profitable Nonprofitables," *Cato Policy Analysis* no. 678, http://www.cato.org/pubs/pas/PA678.pdf, June 15, 2011.

[7] U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics*, Table 341, http://nces.ed.gov/programs/digest/d10/tables/dt10_341.asp, accessed March 15, 2012.

[8] The $1 million figure has appeared in many places, and most recently can be calculated using earnings data from Tiffany Julian and Robert Kominski, "Education and Synthetic Work-Life Earnings Estimates," U.S. Census Bureau, http://www.census.gov/prod/2011pubs/acs-14.pdf, September 2011. In contrast, the Association of Public and Land-grant Universities estimates that the average graduate of a public research university will realize just a $120,000 earnings increase after including the cost of her education. See Peter McPherson and David Shulenburger, "University Tuition, Consumer Choice and College Affordability: Strategies for Assessing a Higher Education Affordability Challenge," http://www.aplu.org/document.doc?id=1296, November 2008.

[9] Calculated using median weekly earnings data from Current Population Survey, U.S. Bureau of Labor Statistics, http://www.bls.gov/webapps/legacy/cpswktab5.htm.

[10] National Assessment of Adult Literacy, "A First Look at the Literacy of American Adults in the 21st Century," 2006, p. 15, http://nces.ed.gov/NAAL/PDF/2006470.PDF.

[11] Richard Arum and Josipa Roksa, "Are Undergraduates Actually Learning Anything?" *The Chronicle of Higher Education*, http://chronicle.com/article/Are- Undergraduates-Actually/125979/, January 18, 2011,

[12] U.S. Department of Labor, Bureau of Labor Statistics, "Table 6. The 30 occupations with the largest projected employment growth, 2010-20," http://www.bls.gov/news.release/ecopro.t06.htm, accessed March 15, 2012.

[13] Anthony P. Carnevale and Stephen J. Rose, "The Undereducated American," Georgetown University Center on Education and the Workforce, http://www9.georgetown.edu/grad /gppi/hpi/cew/pdfs/undereducatedamerican.pdf, June 27, 2011.

[14] College Board, *Trends in Student Aid 2011*, Table 1, http://trends.collegeboard.org/student_aid/report_findings/indicator/Total_Aid_Adjusted_for_Inflation, accessed March 15, 2012.