The Dilemma of Higher Education Financing

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Let me present you with a counterfactual proposition. Suppose that the federal government had never enacted the Higher Education Act, and that they had not entered into the business of providing financial assistance to college students. In other words, suppose we had no federal guaranteed student loans, no Pell Grants, no federal work study programs, no higher education tax credits or any other program designed to ostensibly aid students pay for college. Given the limited focus of this session, I will ignore other federal encroachments into higher education, such as federal research grants.

What would higher education be like today? While no one can answer that question with any absolute certainty, I expect the following would have happened. First, there would be a somewhat lower proportion of adult Americans today with college degrees, but in both absolute numbers and as a percent of the adult population, we would today still be at an all-time high. Higher education enrollments would have grown, but not quite as much.

Second, I suspect tuition fees of universities would be significantly lower than they are today. My guess is that sticker prices at colleges or universities would conservatively be 20 percent lower than they in fact are, and probably even lower than that. Similarly, fees at state universities would also be lower.

Third, I would predict the proportion of recent college graduates from the bottom quartile of the income distribution would be greater than it actually is today. In other words, the substantial variation of college participation by income would be at least modestly less than today, and higher education would have a somewhat less elitist character to it.

Fourth, I would predict that the strong disconnect between labor market realities and the output of college graduates would be significantly less. We would not have over 115,000 janitors with bachelor's degrees, nor over one million retail sales clerks.

Fifth, we would have significantly better academic outcomes than in fact we have today. We would have fewer college dropouts, for example, and a larger proportion of those who graduate would have done so in the traditional four years. We would probably have less grade inflation. We would have fewer climbing walls and luxury dormitories, but a larger portion of students showing they acquired meaningful increments to their knowledge about our civilization or to their critical thinking skills while in college.

Sixth, we would have a much smaller army of collegiate bureaucrats, what Johns Hopkins' Bemjamin Ginsburg calls "deanlets," probably very modestly lower salaries for faculty, possibly greater emphasis on teaching, and fewer, maybe no, million dollar university presidents. Universities and colleges would have smaller budgets, and the total resources devoted to higher education would be tens or scores of billions of dollars less than we in fact spend today. The actual productivity decline in higher education would have not occurred. There would be no talk of a higher education bubble, no U.S. presidents making speeches denouncing university fiscal behavior, or the like. The American Council on Education and other higher education trade groups would have fewer lobbyists at 1 DuPont Circle trying to collect economic rents from the federal government. In short, the face of higher education would be dramatically different than it in fact is.

Let me briefly elaborate on these necessarily somewhat speculative assertions. I do think the provision of grants and subsidized loans has increased the demand for education from what it otherwise would have been. It probably also increased the supply of educational services too, but to a lesser extent since many higher education institutions do not try to maximize enrollments, believing they derive prestige by turning customers away. McDonald's does not have an Admissions Office, but Harvard does. The government induced expansion of demand and to a lesser extent supply means total enrollments, and probably the number of graduates, is higher than it would have been otherwise. The government programs *have* succeeded in getting more kids through college, even though I suspect the six year graduation rate of Pell Grant recipients, which is a state secret that even the National Security Agency probably does not know anything about, is somewhere in the order of one third –for every Pell recipient who graduates, two do not.

Since these financial aid programs raise demand, they lead to higher tuition fees. Then Education Secretary Bill Bennett posited that hypothesis in 1987, and I think he was right then and right now. The possible offset of rising demand by rising supply has not occurred for a variety of reasons, including the aforementioned aversion of many colleges to enrollment expansion as it detracts from maximizing prestige, but also because accrediting agencies impose barriers to entry into the higher education business, and no doubt other reasons.

Federal data suggest that around 1970, before Pell Grants and when federal student loans were very modest in number and size, around 12 percent of recent college graduates came from the bottom quartile of the income distribution, compared with barely 7 percent today. Despite federal financial assistance programs that have multiplied more than ten-fold even after allowing for inflation, a smaller proportion of poor persons are college graduates, suggesting that these programs have abysmally failed at achieving their ostensible goal of expanding educational opportunity to the economically less advantaged.

Lower income persons are more price sensitive than more affluent ones, and high sticker prices have led more lower income persons than higher income ones to say no to college, or pick less expensive options like community colleges. The FAFSA form required because of the federal programs has been historically a highly complicated and intrusive way of getting financial information. Kids from affluent families complained about the forms but filled them out, but many from lower income environments just gave up rather than answer over 100 questions, many demanding highly personal information that if asked by any other type business might have led to their facing potential criminal charges.

In 1970, less than one percent of taxi drivers had college degrees. People did not work their way through college to take a job requiring less than a high school education to perform. By 2010, the proportion of taxi drivers with bachelor's degrees or more exceeded 15 percent. College graduates expect their degree means a ticket to a comfortable, moderately affluent middle class life in a managerial, technical or professional job. Yet almost half of graduates are in occupations that the Labor Department tells us typically requires less than a college education to perform well. To the extent the enrollment explosions in recent decades have been fueled by federal student financial assistance programs, it has aggravated this problem, which is NOT merely a consequence of the slowdown in employment growth reflecting the financial crisis and the anti-work public policies of the government.

The connection between university student performance and federal student financial aid is arguably more indirect and subtle, but in my judgment is nonetheless real. The amount of time students spend on academics has declined in tandem with increases in federal student aid programs. Grades have risen with increased student aid –and reduced student academic effort. The Civics Literacy Test of the Intercollegiate Studies Institute and the decennial Adult Literacy Survey of the U.S. Department of Education show that core knowledge and literacy amongst college students are falling. Arum and Roksa compellingly argue that critical thinking and writing skills are not substantially advanced during the college years. I don't think this is coincidental. Despite rampant grade inflation, college dropout rates remain stubbornly high.

I think a major reason for deteriorating academic standards amidst rising federal student aid is that there is absolutely no performance expectation associated with receiving this aid. Indeed, I suspect on average mediocre students get more Pell Grant money than good students, since good students are likely to take four years to graduate while the mediocre ones take longer. Colleges have no skin in the game, so they accept and promote federal student borrowing for those who they know have low probability of academic success. All of this contributes to a dumbing down of the curriculum and standards.

If colleges have raised tuition fees more because of federal student aid, this has added to their revenues. Where have these incremental funds gone? A look at changes in college staffing and spending suggests that a large portion has gone for non-instructional purposes. Particularly noteworthy in the period since the student financial aid explosion began is the huge growth in non-instructional professional staff at universities, roughly speaking, administrators. Rising university revenues have probably also stimulated the collegiate Edifice Complex –expensive buildings, many of them for not academic purposes. The federal student financial aid programs are helping fund a costly and academically dubious academic arms race.

The Dilemma: Changing the System

My remarks have emphasized that the current federal financial aid program is dysfunctional – costly, not achieving its initial goals, worsening the rise in tuition fees, and so forth. Obviously, getting rid or at least significantly downsizing the program is highly desirable. Ideally, it should be eliminated, not reformed. The dilemma, however, is that an immediate elimination of the program would have significant disruptive effects and arguably be unfair to individuals expecting these programs for college financing. In other words, there are significant transitional issues involved in moving away from the status quo. Moreover, given the huge political constituency that has received or anticipates receiving federal student financial aid, it is probably politically impossible to eliminate the program overnight. But I think there may be politically feasible ways to move to mitigate its negative impact.

Here are seven actions that would dramatically reduce the burden to taxpayers and inefficiencies and pathologies associated with the current system. First, return the program to its roots: helping poor persons attend college. Right now, over 17 percent of students from families with incomes from $60,000 to $80,000 a year get Pell Grants—these individuals have above median incomes. Over a few years we should tighten eligibility significantly, reducing the number of Pell recipients by perhaps 50 percent. Similarly, PLUS loans to parents of high income kids should end. Tuition tax credits benefit families whose kids would go to college in the absence of the credit, mostly from above average incomes. Go to a single grant program and a single loan program.

Second, impose academic performance standards to continue receiving grants. Reward students who graduate in less than four years, and cut off aid for, say, students who are in their sixth year of full-time attendance.

Third, get the federal government out of the business of making loans, confining their role to guaranteeing loans made by private lenders. The Feds have to borrow to pay their own bills, so implicitly they borrow from, say, Chinese bond purchasers in order to lend money to college kids. Not only return lending to private lenders, but strengthen the tie between interest rates charged students and market rates.

Fourth, make participating colleges have some skin in the game. If colleges accept students and promise them Pell grants or guaranteed loans, make them share in the burden of high levels of defaults on loans, or the failure associated with Pell recipients not graduating. This would lead to a needed reduction in lending to persons who lack the aptitude, background, or discipline for college level learning.

Fifth, view federal aid as assisting students obtain a basic college education from a relatively low cost university. Limit the assistance to a few thousand dollars a year, and do not subsidize a Harvard education more than one at a relatively lower cost state university. This implicitly involves reviewing limits on aid per student. Right now there is a vicious circle. Colleges raise tuition fees so the Feds make larger loans to students, leading the colleges to raise their tuition fees still more. Cap per student federal assistance expansion to the rate of increase in inflation. In other words, allow all students to borrow, say, $5,000 a year on a federal guaranteed loan regardless of the school attended, with the amount rising annually only with the rate of inflation.

Sixth, convert the Pell Grant program into an educational voucher. Right now, Pell money is managed and distributed by school financial aid offices. The college offers government money to students, as if it were the college's money. Why not give the money to the student directly and let them use it wherever they want, empowering them more and make the institutions more attentive to student needs? Moreover, such educational vouchers could be issued only to very low income students, and made progressive, with the voucher size diminishing with need. Similarly, receipt of the voucher could be tied to academic progress, with a merit dimension included. Top students could be paid extra for superior academic performance. If 5 million of these grants were made at an average amount of $4,000, some $20 billion would be paid out – more than 40 percent less than currently, and virtually all Americans attending college who were truly "poor" would be accommodated.

Seventh, encourage private investors to begin human capital equity funds, where students sell equity in themselves rather than debt. The investor would pay the cost of college upfront, with the graduate paying the investor a portion of his or her income for a specific time period. The seller of equity gets college financing and knows in advance what the post-graduation burden of college repayment for college will be. Markets would adjust to favor students with better prospects for graduation and greater post-graduate productivity. A graduate from M.I.T.

majoring in electrical engineering might have to pay 8 percent of his income for 12 years, while a graduate in anthropology from Central Michigan University might have to pay 15 percent for 20 years. These market signals would be useful in reallocating resources within higher education. The mechanics of encouraging such funds need resolution, but the idea of students paying for college with equity rather than debt commitments is an appealing one.

To reiterate, in a perfect world I think the federal government should get out of the financing business. America has suffered, not benefited, from the existence of a Byzantine number of federal loan, grant, work study and tax credit plans. But if the government presence is going to continue, at least rationalize the system by downsizing and redirecting it. Getting out of the student financial aid morass is going to require imagination, political will and even political entrepreneurship. The current system is dysfunctional and not sustainable. The time for reform is now.

Thank you.