

Policy Analysis

No. 678

June 15, 2011

Federal Higher Education Policy and the Profitable Nonprofits

by Vance H. Fried

Executive Summary

Undergraduate education is a highly profitable business for nonprofit colleges and universities. They do not show profits on their books, but instead take their profits in the form of spending on some combination of research, graduate education, low-demand majors, low faculty teaching loads, excess compensation, and featherbedding. The industry's high profits come at the expense of students and taxpayer.

To lower the cost of education, federal government policies should encourage competition. Regulations should not favor nonprofits over for-profits. Further, the accreditation process should be reformed so that any qualified institution can easily enter the industry. The financial-aid process should be redesigned to remove the bargaining advantage that colleges currently hold over prospective students.

The higher-education industry is heavily sub-

sidized by the federal government. These subsidies play a significant role in the high profitability of the industry and represent a massive transfer of wealth from the taxpayer to the industry. This should change. All tax credits and deductions should be eliminated immediately, as should all direct subsidies. The federal loan program should be restructured to eliminate the government subsidy and ensure that any deserving student can graduate from college without excessive debt, and eligibility for Pell grants should be tightened significantly. The net result of these changes would be greater efficiency and annual savings of \$50 to \$60 billion. To the extent that the federal government continues to play any role in higher education, its goal should be to ensure that all deserving students have access to higher education, not to maintain high industry profits.

*Vance H. Fried is Riata Professor of Entrepreneurship at Oklahoma State University and author of *Better/Cheaper College: An Entrepreneur's Guide to Rescuing Undergraduate Education*. His research focuses on higher education, entrepreneurship and public policy, the venture capital industry, and management of rapid-growth firms. Fried previously was a private-practice attorney, an oil company executive, and an investment banker.*

Comparing the costs of educating undergraduate students to per-pupil revenue, nonprofit schools have higher “profit” margins than for-profits.

Introduction

As a result of rapid increases in the amount of federal financial aid and other federal student assistance programs going to for-profit schools, Tom Harkin has launched a broad-based oversight effort to better understand how well for-profit schools, many of which are highly profitable publicly traded corporations, are serving the students attending the schools and the taxpayers who commit approximately \$24 billion to the schools each year.¹

So reads the website of Sen. Tom Harkin (D-IA), chairman of the Senate Health, Education, Labor, and Pensions Committee. The senator’s interest in oversight of federal student-assistance programs is laudable, but should not be limited to for-profit colleges. Federal aid to nonprofit colleges should also be a matter of great concern. Indeed, taxpayers’ annual commitment to nonprofit schools is much higher than it is to for-profit institutions.

So why are nonprofit institutions not getting the same scrutiny as for-profit schools? The inattention is perhaps unsurprising, given that many of the for-profits are not just profitable, they are *highly* profitable. For example, Apollo Group, owners of the University of Phoenix, reported a 30 percent operating profit margin in the first quarter of 2011.² However, comparing the actual cost of educating undergraduate students to per-pupil revenue, it appears that the “profit” margins of nonprofit schools are in fact higher than for-profit colleges.

Identifying Nonprofit Profits

How can a nonprofit have profits? Simply put, it happens when the revenue the nonprofit derives from providing a service

exceeds the cost of providing that service. This might seem obvious, but it is often assumed that putatively “nonprofit” schools, by virtue of their designation, never make a profit from providing a particular service. In addition, such schools never report that they have realized profits, even when the profits happen to be large. Why? Because profits are reported as expenses. Nonprofit schools take their profits from undergraduate education (which is typically the main focus of policymakers who are seeking greater affordability, access, etc.) in the form of spending on some combination of research, graduate education, low-demand majors, low faculty teaching loads, excess compensation, and featherbedding.

Profits from undergraduate education are of two types: economic rents and subsidies for other missions. Economic rents are payments made to college insiders that do not increase college outputs. Excess compensation (e.g., a small-college president making over \$1 million) and featherbedding (e.g., a 10:1 student faculty ratio) are economic rents. Subsidy for other missions is the spending on missions that are unrelated to undergraduate education but are funded partially by revenue generated through undergrads, such as graduate education and research. Unlike economic rents, this spending does increase the colleges’ outputs, and applying the term profits to it is not making a value judgment as to whether it is good for society and/or appropriate for the school. Rather, the point is that it is spending beyond what is necessary to provide an undergraduate student with a high-quality education. It is spending coming, in part, from undergraduates’ tuition payments that provides no benefits to undergraduate students. From a public policy standpoint the high profits earned by nonprofit colleges do not justify punitive regulation of the industry any more than do the high profits earned by for-profit colleges. Rather, as will be discussed in depth, the federal public-policy problem is that various government actions benefit the higher education industry at the expense of the undergraduate student and the taxpayer.

The profligacy of nonprofit colleges is well known. As long-time Harvard president Derek Bok once quipped, “universities share one characteristic with compulsive gamblers and exiled royalty: there is never enough money to satisfy their desires.”³

Why do nonprofit colleges behave this way? Thirty years ago, Howard R. Bowen, an economist and president of three different colleges, proposed what is known in education circles as Bowen’s Law.⁴ It can be summarized as “colleges raise all the money they can, and spend all the money they can raise.” Bowen’s Law is well-accepted by scholars of higher education economics.⁵

But don’t colleges try their best to keep costs low in order to keep tuition down? No! As Bowen points out:

The question of what *ought* higher education to cost—what is the minimal amount needed to provide services of acceptable quality—does not enter the process except as it is imposed from the outside. The higher educational system itself provides no guidance of a kind that weighs costs and benefits in terms of the public interest. The duty of setting limits thus falls, by default, upon those who provide the money, mostly legislators and students and their families.⁶

This isn’t to say that most college insiders necessarily realize they are spending excessively. Rather, spending for just about anything is justifiable to them in the name of reputation and the pursuit of knowledge.⁷ Further, the culture of academia tends to see practical financial concerns as anathema to the scholarly ideal.

Robert E. Martin, an economics professor with substantial experience as a faculty member at both a large state research university and a small liberal arts college, recently expanded on Bowen’s Law. He concluded:

... as the Bowen hypothesis suggests, higher education finance is a black

hole that cannot be filled. The relationship between revenues and subsequent costs has a dynamic feedback effect. Higher education responds to higher costs by raising tuition and fees or initiating fundraising campaigns. But because costs in higher education are capped only by total revenues, there is no incentive to minimize costs. The costs go up in tandem with revenues. The next year, the cycle begins again because the higher costs mean that the new programs must be financed by additional revenues. There is thus a never-ending spiral effect between revenues and cost.

As revenues increase, faculty, administrators, and board members extract more surplus from the cash flows in the form of higher costs and then use those higher costs as justification for more revenue. *Imagine the consumer’s response if for-profit firms argued they had to raise prices because the surplus that they extracted during the last period (i.e., profit) increased* [italics added].⁸

But why wouldn’t for-profit schools also just do more—regardless of its value—as revenues increased? Largely because their goal is to maximize the return to investors, which requires doing as efficiently as possible those things that customers want and are willing to pay for.

High Industry Profits

The profits of nonprofit colleges are not readily visible from publicly reported financial data. Colleges directly report their revenues, but not their real costs, so the profits are invisible from a financial accounting standpoint. To know profits, one needs to know real costs.

There are two viable approaches to identifying real costs. One is to use a build-up method to determine costs at a college that utilized best practices to provide an under-

Higher education finance is a black hole that cannot be filled.

The average private undergraduate school makes \$12,800 in profits per student, based on tuition, donations, and endowments.

graduate education. This approach eliminates both economic rents and other mission subsidies. The problem is that it is based on a hypothetical college.

One published study by this author has used the build-up method for a hypothetical college.⁹ It created a business model for a hypothetical College of Entrepreneurship and Leadership in Society (CELS) and then determined its cost by developing a detailed pro forma statement of operating costs. The basic design premise was simple: maximize value to the student. Determine what package of benefits (primarily learning) and price is attractive to them. If an activity has a high cost but provides a substantial benefit, do it, but do it as efficiently as possible. If an activity adds significant cost but only minor benefits, don't do it. CELS was designed as a high-quality residential college. It didn't cut any corners on spending, but it did not spend profits.

The CELS pro forma statement takes a detailed look at the cost side of providing education. In 21 pages it presents individual cost items down to the number of clerical staff needed in the registrar's office and photocopying costs for class handouts. The biggest cost item, faculty salaries, was determined by first creating a curriculum for general education and nine broad majors, including business and engineering science; second, by determining the number of courses to be offered in a year, given the curriculum and enrollment; and third, by determining the size and makeup of faculty staffing necessary to teach those courses. Faculty salaries were at the national average for small doctorate-granting institutions. Minimal use was made of adjunct faculty. Depreciation assumed a new campus in the Dallas, Texas area with per-foot construction costs 20 percent higher than the regional average.

The College of Entrepreneurship and Leadership in Society's operating costs were \$6,705 per pupil for a college with 3,200 students. Because of some loss due to economies of scale, costs went up to \$9,200 per student for a small college with 1,200 students. On

the other hand, a commuter college could realize about \$1,700 in savings by eliminating student life activities, such as athletics, concerts, and student organizations.

The second approach to identifying real costs is to use actual cost data from real colleges. Publicly available data on college costs do a poor job of allocating costs to various missions. Costs for graduate instruction are lumped in with undergraduate instruction, and many research costs are allocated to instruction, not research. However, some states perform internal studies that more accurately allocate spending by mission for their state-owned colleges, producing data that do not lump costs of other missions in with undergraduate instruction.

Florida, Illinois, and Ohio make their actual cost data available in this manner in a report published by the State Higher Education Executive Officers (SHEEO).¹⁰ Actual costs for undergraduate education were \$7,080 in Florida, \$11,040 in Ohio, and \$7,980 in Illinois. The drawback of the SHEEO study is that it does not eliminate economic rents tied to undergraduate education.

Based upon the CELS and SHEEO studies, the real cost of undergraduate education could vary from \$5,000 to \$9,000 per year, depending on institutional characteristics.¹¹ For simplicity of presentation, assume \$8,000 is the real cost of providing a quality undergraduate college in a residential setting.

As itemized in Table 1, the average private undergraduate college has net tuition revenues—sticker-price tuition and academic fees minus tuition discounts (often called institutional scholarships)—of \$13,515 per student per year, plus \$7,292 per student per year in donations and endowment income.¹² Based on tuition revenues alone, the average private undergraduate school makes about \$5,500 per student. When donations and endowment income are added, profits jump to \$12,800 per student. That's more than a 60 percent net profit margin per student—double the margin of for-profit Phoenix—and that's just the average. Many private colleges are much more profitable from tuition alone.

Table 1
Private Bachelor's Colleges, Average Annual Revenue per Student

	Without donations (\$)	With donations (\$)
Net Tuition	13,515	13,515
Donations/Endowments	0	7,292
Revenues	13,515	20,807
Costs	8,000	8,000
Profits	5,515	12,807

Source: The Delta Project on Postsecondary Education Costs, Productivity, and Accountability. Figures are for a private bachelor's college in 2008.

Table 2
Public Research Universities, Average Annual Revenue per Student

	Without subsidy (\$)	With subsidy (\$)
Net Tuition	10,000	10,000
State Subsidy	0	9,000
Revenues	10,000	19,000
Costs	8,000	8,000
Profits	2,000	11,000

Public colleges are also highly profitable, as illustrated in Table 2. Take a typical public research university that charges in-state tuition of \$10,000 per student (see Table 3 for a list of such schools and their prices) and receives a state subsidy of \$12,000 per student. The difference between out-of-state and in-state tuition is a good proxy for the subsidy for in-state students.¹³ Assume that \$3,000 of the subsidy is earmarked for research and public service, leaving \$9,000 to subsidize undergraduate education. The university has a 20 percent margin simply from in-state tuition. Margins jump to 58 percent when the state subsidy for undergraduate education is included.

Undergraduate Education as a Commercial Enterprise

Nonprofit colleges, whether private or

government owned, were originally designed to provide an education to students funded by a mix of commercial and donated funding. The commercial funding came in the form of tuition paid by students for their education. The donations came in the form of charitable giving and state subsidies. These donations were used to reduce the need for commercial funding. In other words, the donation benefited the student by reducing tuition. This is how most nonprofits were funded until the 1980s.

Over the last 30 years the amount of non-tuition funding has increased substantially. In 1980, states were the primary donors to higher education through the subsidy they provided to state-owned colleges. States have continued to generously fund higher education. While in some years there have been cuts because of downturns in state tax revenues, historically the subsidy has gone back up as

Until the 1980s, nonprofit colleges used their donations to benefit the students by reducing tuition.

Table 3
In-State Tuition and Fees, Public Research Universities, 1980 and 2010

University	2010 (\$)	1980 (in 2010 \$)
Pennsylvania State University	17,344	4,272
University of Illinois–Urbana-Champaign	15,144	2,561
University of Michigan–Ann Arbor	14,168	3,822
University of California–Berkeley	12,461	1,994
University of Colorado at Boulder	11,960	2,590
University of Kansas	11,780	2,007
University of Virginia–Main Campus	10,906	2,712
University of Connecticut	10,416	2,780
University of Kentucky	9,813	1,775
Texas A & M University	9,606	1,273
University of Iowa	9,220	2,160
The University of Texas at Austin	8,930	1,176
Ohio State University–Main Campus	8,679	2,890
Indiana University–Bloomington	8,613	2,637
University of Wisconsin–Madison	8,310	2,619
University of California–Los Angeles	8,266	1,976
University of Maryland–College Park	8,053	2,301
University of Alabama	7,900	1,991
University of North Carolina–Chapel Hill	6,666	1,556
University of Florida	5,381	1,931

Sources: Tuition and fees for 1980 were taken from the Integrated Postsecondary Education Data System (<http://nces.ed.gov/ipeds/datacenter>) and converted to 2010 dollars using the Consumer Price Index. Tuition and fees for 2010 were taken from the universities' own websites. Many colleges vary their tuition and fees based upon the number of credit hours taken, course level, and subject matter. The figures shown assume that a student is taking 32 hours (16 per semester) of upper-division business courses.

Given the large inflow of government funds, what have colleges done with their prices? Aggressively raised them.

the state's financial position improved. In fact, between 1987 and 2009, per capita state spending on higher education increased by 31 percent in real terms.¹⁴

At the same time, the federal government radically increased funding for higher education. From 2000 to 2010, annual student lending went from \$42 billion to \$96 billion and Pell grants increased from \$9 billion to \$28 billion.¹⁵ Congress also created federal tax deductions and credits.¹⁶ For example, in 2010, a married couple with an income under \$160,000 could receive a \$2,500 credit for their child's college tuition. Total federal tax

benefits for higher education in 2009 totaled \$18.2 billion.¹⁷

Given this large flow of government funds, what have colleges done with their prices? They have aggressively raised them. For example, see the following table showing inflation-adjusted, in-state tuition at several large state-owned research universities.

The funding model for higher education has changed at both public and private colleges. Today, tuition not only covers the full cost of providing an undergraduate education, it generates profits. Even at state-subsidized colleges, most undergraduate

students now pay the full cost of their education, with state subsidies going toward profits—particularly subsidies of other missions such as graduate education and research. Undergraduate education is clearly a profit-generating commercial activity at nonprofit colleges. A major driver of this appears to be the federal government, which by greatly increasing subsidies has allowed schools to earn increasingly larger profits.

Federal Policy Implications

The federal government has done nothing to restrain price increases, but rather has played a significant role in increased tuition prices, higher overall school profits, and significant transfers of wealth from students, parents, and taxpayers to colleges.¹⁸ It has also helped the industry gull naïve citizens into believing that college is always a good investment, that price doesn't matter when deciding which college to attend, and that high student debt won't cause long-term economic hardship. This is in the face of a staggering 35 percent underemployment rate for college graduates and high student-loan default rates.¹⁹ The net impact of federal policy is that college is less affordable for everyone, including lower-income students.

In light of this, one can seriously question why the federal government should be involved in higher education at all. Even if one ignores the constitutional argument against a federal role,²⁰ the results of federal involvement are not supportive of the wisdom of using top-down decisionmaking in higher education. Rather than trying to correct federal policy, it might be best to simply eliminate the federal role.²¹ However, if there is to be a federal role, there are several areas for improvement.

Don't Discriminate against For-Profits

As suggested by Senator Harkin's recent hearings, many people within the government want federal programs to favor nonprofit colleges over for-profit colleges, per-

haps in part because for-profit schools are forthright about wanting to make money from their services to undergraduate students. Yet nonprofit schools often extract more profits from students and society than do for-profit schools. If it is to be concerned about anything in higher education, the federal government should be concerned about a college's instructional quality and cost, not its form of ownership.

Decrease Funding to the Industry

Rather than putting more money into the industry, the federal government should put in less and get the same output. Less federal money would force higher college productivity and, of course, lower government spending. And, as the following discussion of federal higher-education subsidies will illustrate, ensuring that all qualified students, regardless of their economic status, can get a college education requires little in the way of federal funding.

Direct Payments. Last year individual colleges received over \$2.3 billion in direct payments from the federal government. By far, the biggest recipient was Howard University. Howard is a private university that has historically received 50 percent of its revenues directly through the Department of Education budget. This amounted to \$206 million for general support in 2010.²² While Howard University receives more than \$19,000 per student directly from the government, it still charges students \$17,000 a year for tuition.²³

Direct payments to most colleges are not in the department budget. Instead, they come through earmarks.²⁴ With an average grant of \$500,000, most colleges receive much less than Howard through regular appropriations. However, many more colleges receive earmarks, which in total amounted to almost \$2 billion in 2010. Many of these earmarks were for research, but some were for education.

The Republican caucuses in both the House and Senate have recently adopted rules eliminating earmarking. Education-related earmarks can be easily eliminated, as well as other direct payments to colleges. The only

Rather than putting more money into the higher education industry, the federal government should put in less.

The current federal loan programs are not only costly to the taxpayer, they can be very harmful to borrowers.

adverse impact will be on the profit margins of colleges. Colleges justify many of their earmarks on the grounds that they are necessary to provide an education.²⁵ However, colleges already have revenues far in excess of educational costs. Colleges use these earmarks to pay costs, but they do not reduce tuition accordingly. In effect, earmarks increase profits. They aren't justifiable, even if there were no federal deficit.

Loans. The current federal loan programs are not only costly to taxpayers, they can be very harmful to borrowers. Take the case of Kelli Space, a first-generation college student from New Jersey who graduated from Northeastern University with a BA in sociology and almost \$200,000 of student loans.²⁶ The student-loan programs encourage students like Space to spend excessively on college without paying serious attention to its costs and benefits. Further, excessive borrowing can put a student in a very poor financial situation after graduation. A student can struggle all his life to pay off a loan for an overpriced college degree, and unlike most consumer debt, student loans are non-dischargeable in bankruptcy.

In the long run students would benefit from reducing the amount of money they can borrow from the government and capping the amount of student debt that is non-dischargeable in bankruptcy. The goal should not be to do away with a student's ability to borrow for reasonable college costs, but rather to avoid excessive debt and costs. Given this goal, how high should the cap be? Let's look at the question in two ways. First, let's consider what amount is repayable, and second, what amount is needed.

The rule of thumb among financial counselors is that the total student debt should not exceed the first year's earnings.²⁷ At that level, the graduate can live comfortably and still repay debt. Some argue this is overly conservative, since it assumes that the debtor's income will not rise beyond entry level. Of course, earnings vary significantly by individual and major—young engineering graduates get paid a lot more than young so-

ciology graduates. So, let's assume the maximum loan is set at \$40,000. Would this be enough money to finance a student's college education?

Take the extreme case of a student with no savings and no family support. At a minimum-wage job, the student needs to work about 30 hours per week to live a modest but comfortable student lifestyle (e.g., low-end shared dorm room, old car, basic cell phone, no spring-break trips to Vail or Cancun). With this amount of work, most students should be able to graduate in four years if they take a reduced per-semester load but go to school year round. So, students do not need to borrow money for living expenses. Particularly frugal students (e.g., the ramen noodle diet and inexpensive student housing), those with above-minimum-wage jobs, or those living at home could actually have excess from their earnings that could be used to pay for tuition. But if the student only made enough money to cover living costs with none left over, she would need to finance her tuition through a student loan.

In most states you can get a degree from the public flagship university for \$40,000 or less in tuition. A student who instead combines two years at a community college with two years at a regional college might pay under \$20,000 total. So, even at today's high tuition levels, a student could comfortably borrow enough to pay for college if there were a \$40,000 cap. In fact, students at lower-cost institutions could afford to borrow all their tuition plus about \$5,000 a year for their living expenses.

Students in a few states, such as Pennsylvania and Illinois, whose public colleges operate with well-above-average prices, will have some trouble fully financing tuition with a \$40,000 cap. That problem could be resolved by those colleges reducing their prices to the already high average price. However, even at the extremely high prices these colleges currently charge, staying under a \$40,000 cap is still possible if the student works full-time and uses her earnings to pay both living expenses and part of her tuition. For most

students, working full time means going to school part time. As a result, the time to graduation might go up to 6 years for a low-income student in states with particularly high-priced state colleges.

Private colleges will complain about a lower cap because it will make it harder for low-income students to attend their colleges instead of state schools. This is particularly a problem for for-profit colleges that heavily serve low-income students. State colleges are at a major advantage in competing for students because of state subsidies, which enable them to price tuition lower. Private colleges, both for-profit and nonprofit, correctly argue that this gives an unfair advantage to the state colleges. The existence of the subsidy means that public colleges, if they desire, can easily undercut a private college on price. As a result, private colleges avoid price competition with publics.

All students—not just low-income ones—would benefit from a system where a state provided its subsidy to students attending any in-state college, rather than requiring the student to attend a state-owned college.²⁸ This would increase competition between public and private schools, leading to lower prices. For instance, if a private nonprofit college priced its tuition at cost, it would only need to charge \$8,000. If a state subsidy of \$6,000 could be applied to private-college tuition, then tuition net of the state subsidy would be \$2,000 a year. The public college would then lose students to the private college unless it lowered its own tuition to match. However, the allocation of state education funds is a state issue, not a federal issue.

No matter the state's policy on subsidies, a lower borrowing cap will be better for students because it will direct them to institutions they can afford and blunt the ability of schools to raise prices. It will also be highly beneficial for taxpayers. On federal loans, taxpayers are stuck with the bill for any defaults. According to the Congressional Budget Office, the federal direct-loan program costs taxpayers 12 percent of the amount lent.²⁹ With the 2009–2010 direct loans amounting

to \$97 billion, the cost to the taxpayer is close to \$12 billion.

Lowering the cap will reduce the cost of the federal loan program since less money will be lent. It will also lower the cost by improving loan quality: low-balance loans have lower default rates than high-balance loans.

The cost of the loan program can also be reduced by increasing interest rates. For example, the National Commission on Fiscal Responsibility and Reform recently recommended eliminating the current subsidized interest rate, but not the deferral of interest payments, while a student is in college.³⁰ Going a step further, the CBO estimates that the federal loan program would break even if interest rates were increased by an average of 2 percent.³¹ On a \$40,000 loan, this means additional interest of \$67 a month. An increase in payments of this limited magnitude wouldn't make college much less accessible to low-income students, but would save taxpayers \$12 billion a year.

Pell Grants. In 1978, two million students received Pell grants. This number doubled by 1992, then remained flat until 2000. In 2000, it began to grow rapidly, reaching six million by 2008, and eight million in 2010.³² This huge increase in the number of students receiving Pell grants is not justifiable. If our hypothetical student with no savings and no outside support can borrow enough money to pay for college, why does he need a Pell grant, which is money he never has to return to taxpayers? And if such a relatively strapped student does not need a grant, then who does? Perhaps those who cannot work much and go to school, such as the single parent without child support or the physically disabled may need grants, but the current eight million Pell recipients (or even the two million from 1978) certainly do not.

Tax credits/tax deductions. If most low-income students do not need a federal subsidy to attend college, upper-middle-class students certainly do not. In addition, these credits do not appear large enough to have much influence on the behavior of the people receiving the credit. They should be eliminated.

If most low-income students do not need a federal subsidy to attend college, upper-middle-class students certainly do not.

A used-car buyer is in a much better bargaining position than a potential student at many private colleges.

Lower the Barriers to Entry

The federal government has anointed various private accrediting groups as the gatekeepers for federal student aid. Since these accrediting groups are run by their constituent colleges, there is potential for the member colleges to engage in collusive behavior to maximize profits at the expense of their students. This can be seen in the current process a college must go through to gain initial accreditation.

The current process makes it very difficult for new colleges to enter the market, thus limiting competition. The most flagrant example of this behavior is accrediting agencies' refusal to approve colleges because they are organized as for-profits. The barriers for a new nonprofit are also high, if not absolute. Gaining accreditation is a slow process that has been known to take up to 10 years.³³

This time frame is totally unreasonable. Basically, all the new college needs to show is that it has qualified faculty and management in place, written basic operating procedures and academic policies, and is adequately financed. A competent accrediting agency should be able to conduct an in-depth analysis of these issues for a new applicant in a matter of months, not years.

The current accreditation system has many other problems in addition to initial accreditation. Several solutions have been proposed, including eliminating mandatory accreditation altogether.³⁴ Whether or not any of these global solutions is adopted, the barrier-to-entry problem should be solved as soon as possible. Within the existing system this can be done by requiring that any federally recognized accrediting agency runs a clean, open, and timely process for initial accreditation.

Don't Take the Colleges' Side on Pricing

Many colleges, particularly private colleges, haggle with students over tuition. They set a high sticker price and then lower it through institutional "scholarships," which are actually individual price discounts. They are allowed to coordinate their pricing pro-

cess with the federal student aid decision-making process.³⁵ In January of his senior year in high school, the potential college student seeking financial aid provides the Department of Education with extensive information about his family's finances. Based on this information, the department computes the student's Expected Family Contribution. The EFC is the amount that the department has determined that the student and his family are capable of paying for college. This information is used by the department to determine eligibility for federal financial aid.

In addition to assessing a student's eligibility for federal aid, the department sends a summary of the student's family information with the EFC to every college to which the student has applied. The result is a significant increase in the bargaining power of the college over the potential student. Many colleges try to limit the amount of discount to the college's sticker price less the applicant's EFC. In other words, they try to charge full sticker price if the student's EFC is higher than that amount. Students may be given the impression by colleges that the government has determined that this approach to pricing results in a fair price to the student. In effect, however, the government is giving its blessing to existing high prices. Even more shocking is that the government provides the college with confidential financial information about the student that the college can use to its benefit in price negotiations. A used-car buyer is in a much better bargaining position than a potential student at many private colleges.

The department should immediately cease sharing any student financial data with colleges. This doesn't just protect students who are middle-income and above with high EFCs. As the Center for College Affordability and Profitability argues:

... by no longer giving the colleges students' financial information, one of the vilest practices in higher education will cease: "need-aware" admissions. This practice deliberately restricts the

The federal government's goal should be to ensure that students have access to higher education, not to maximize industry profits.

number of needy students admitted by using the information provided by the SARs [student-aid reports] when deciding which applicants to accept. Poorer students who would be accepted on merit are rejected because they would require more aid. Many, including us, view it as “deceitful and wounding to reject a student without saying that the reason was financial rather than academic.” For many schools, the alternative is “admit-deny,” where students are admitted on a need-blind basis, but there is no guarantee that enough aid will be available to enable low-income students to attend. While this is also unfortunate, at least it is not deceitful, gives the student the final choice, and frames the decision in a familiar “can you afford to enroll here?” rather than the deceitful “you’re not good enough to enroll here.”³⁶

Conclusion

The higher-education industry is highly profitable, and the nonprofit sector, both private and state-owned, has higher profit margins than the for-profit sector. The industry’s high profits come at the expense of students, and federal policy has increased industry profits by driving up prices.

The higher-education industry receives massive federal subsidy payments, both directly from the government and indirectly through subsidies to students. These subsidies play a significant role in the high profitability of the industry and represent a massive transfer of wealth from the taxpayer to the industry. This should change. All tax credits and deductions should be eliminated immediately, as should all direct subsidies. The federal loan program should be restructured so as to eliminate the government subsidy and ensure that any deserving student can graduate from college without excessive debt. Eligibility for Pell grants should be tightened significantly. The net result of

these changes would be greater efficiency, and annual savings of \$50 to \$60 billion.³⁷ To the extent that the federal government continues to play any role in higher education, its goal should be to ensure that all deserving students have access to higher education—not, as it has been doing, to maximize industry profits.

Notes

1. Office of Senator Tom Harkin, “Harkin Oversight Investigation of Federal Dollars Going to For-Profit Schools,” December 15, 2010, <http://harkin.senate.gov/forprofitcolleges.cfm>.
2. Apollo Group Inc., Form 10-Q, filed March 29, 2011.
3. Derek E. Bok, *Universities in the Marketplace: The Commercialization of Higher Education* (Princeton: Princeton University Press, 2003).
4. Howard Bowen, *The Costs of Higher Education* (San Francisco: Jossey-Bass, 1980).
5. For example, see Ronald G. Ehrenberg, *Tuition Rising: Why College Costs So Much* (Cambridge: Harvard University Press, 2002); Robert E. Martin, “The Revenue-to-Cost Spiral in Higher Education,” The John William Pope Center for Higher Education Policy, September 2010, <http://www.popecenter.org/acrobat/revenue-to-cost-spiral.pdf>; and Robert Zemsky, Gregory R. Wegner, and William F. Massy, *Remaking the American University: Market-Smart and Mission-Centered* (Piscataway, NJ: Rutgers University Press, 2005).
6. Bowen, p. 20.
7. See Vance H. Fried, “Culture” and “Ownership” in *Better/Cheaper College: An Entrepreneur’s Guide to Restructuring the Higher Education Industry* (Washington: Center for College Affordability and Productivity, 2010), pp. 9–24.
8. Robert E. Martin, “The Revenue-to-Cost Spiral in Higher Education,” The John William Pope Center for Higher Education Policy, September 2010, <http://www.popecenter.org/acrobat/revenue-to-cost-spiral.pdf>.
9. Vance H. Fried, “The \$7,376 ‘Ivies’: Value Designed Models of Higher Education,” Center for College Affordability and Productivity, August 2008.
10. Sharmila Basu Conger, Ali Bell, and Jeff

Stanley, "Four State Cost Study," State Higher Education Executive Officers, September 2010. Annual costs were calculated by multiplying undergraduate cost per student credit hour (Table 4) by 32 credit hours for a year. While data from New York is provided in the SHEEO report, it is excluded from this paper because unlike the other three states, New York did not charge institutional overhead to the various missions. If it had, New York's costs would likely be somewhat lower than those of Florida and Illinois.

11. Ohio costs were ignored since they are an outlier. It is not apparent from the SHEEO study why Ohio costs are substantially higher than those of the other three states.

12. The Delta Cost Project. "Trends in College Spending," *The Delta Project on Postsecondary Education Costs, Productivity, and Accountability*, <http://www.deltacostproject.org/resources/pdf/Trends-in-College-Spending-98-08.pdf>, pp. 16, 29. Figures are for a private bachelor's college in 2008.

13. Commonly reported data showing subsidy per student includes both in-state and out-of-state students in the denominator even though the subsidy (numerator) is only for in-state students. As a result, the subsidy is understated in this data. The use of the in-state/out-of-state tuition differential may slightly overstate the state subsidy depending on the state system's specific techniques for allocating donated income and other non-subsidy items, as well as tuition discounts. It does not, however, include interest charges borne by the state to finance college buildings. Overall, the differential makes for a reasonable, readily available proxy for the subsidy. Indeed, some state college systems explicitly price by setting out-of-state tuition at actual cost and then deducting state subsidy to arrive at in-state tuition.

14. Matthew Mitchell, "Growth in Real per Capita State Spending 1987–2009," Mercatus Center at George Mason University, December 14, 2010.

15. College Board, "Trends in Student Aid 2010" (Washington: The College Board, 2010), p.10.

16. Internal Revenue Service, *Tax Benefits for Education*, no. 970, January 25, 2010.

17. U.S. Department of the Treasury, *The American Opportunity Tax Credit*, October 12, 2010.

18. Gary Wolfram, "Making College More Expensive: The Unintended Consequences of Federal Tuition Aid," Cato Institute Policy Analysis no. 531, January 25, 2005.

19. Charles Murray, *Real Education: Four Simple*

Truths for Brining America's Schools Back to Reality (New York: Crown Forum, 2008); Richard Vedder et al., "From Wall Street to Wal-Mart: Why College Graduates Are Not Getting Good Jobs," Center for College Affordability and Productivity, December 16, 2010; and Edward N. Wolf, *Does Education Really Help? Skill, Work and Inequality* (New York: Oxford University Press, 2006).

20. Neal McCluskey, "Higher Education Policy," *Cato Handbook for Policymakers*, 7th. ed. (Washington: Cato Institute, 2009).

21. Diane Ravitch, "The GOP's Education Dilemma," *Wall Street Journal*, November 28, 2010.

22. U.S. Office of Management and Budget. "Office of Postsecondary Education" in *Fiscal Year 2010 Budget of the United States Government* (Washington: GPO, 2010), pp. 372–99.

23. Howard University, "Cost of Attendance," December 21, 2010, <http://www.howard.edu/studentfinancialservices/accounts/tuitionandfee.htm>.

24. Doug Lederman, "The Academic Pork Barrel, 2010," *Inside Higher Education*, April 29, 2010; "Congressional Earmarks: Grants to Higher Education Institutions in 2010," *Inside Higher Education*, December 17, 2010, <http://www.insidehighered.com/news/2010/04/29/earmark>.

25. Many of the earmarks are targeted to research projects. Supporters of earmarks argue this is necessary because the executive branch often discriminates in favor of a small group of colleges when awarding research grants. Whether or not this true, research grants have nothing to do with providing college education. It is a separate mission.

26. Kelli Space, "My Very Costly College Education," *Clarion Call*, January 4, 2011.

27. Mark Kantrowitz, "What is Gainful Employment? What is Affordable Debt?" December 17, 2010, <http://www.finaid.org/educators/20100301gainfulemployment.pdf>, p. 11.

28. Vance H. Fried, *Better/Cheaper College*, pp. 107–11.

29. Congressional Budget Office, "Costs and Policy Options for Federal Student Loan Programs," March 2010.

30. National Commission on Fiscal Responsibility and Reform, "The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform, December 2010, p. 45.

31. Congressional Budget Office, "Costs and Policy Options for Federal Student Loan Programs," March 2010.
32. College Board.
33. Michael Clifford, quoted in Daniel Golden, "Your Taxes Support For-Profits as They Buy Colleges," *Bloomberg*, March 4, 2010, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aYqphCvYXAaI>.
34. For example, see Andrew Gillen, Daniel L. Bennett, and Richard Vedder, "The Inmates Running the Asylum?" Center for College Affordability and Productivity Policy Paper, October 2010; and George C. Leef and Roxana D. Burris, *Can College Accreditation Live Up to Its Promise?* (Washington: American Council of Trustees and Alumni, 2002).
35. For an analysis of aid programs, see Richard Vedder et al., *25 Ways to Reduce the Cost of College* (Washington: Center for College Affordability and Productivity, 2010).
36. *Ibid.*, p. 190.
37. The savings include \$21-\$28 billion in Pell grants, \$18 billion in tax credits, \$12 billion in student loans, and \$1-2 billion in direct payments.

**RECENT STUDIES IN THE
CATO INSTITUTE POLICY ANALYSIS SERIES**

- 677. **The Other Lottery: Are Philanthropists Backing the Best Charter Schools?**
by Andrew J. Coulson (June 6, 2011)
- 676. **Crony Capitalism and Social Engineering: The Case against Tax-Increment Financing** by Randal O'Toole (May 18, 2011)
- 675. **Leashing the Surveillance State: How to Reform Patriot Act Surveillance Authorities** by Julian Sanchez (May 16, 2011)
- 674. **Fannie Mae, Freddie Mac, and the Future of Federal Housing Finance Policy: A Study of Regulatory Privilege** by David Reiss (April 18, 2011)
- 673. **Bankrupt: Entitlements and the Federal Budget** by Michael D. Tanner (March 28, 2011)
- 672. **The Case for Gridlock** by Marcus E. Ethridge (January 27, 2011)
- 671. **Marriage against the State: Toward a New View of Civil Marriage** by Jason Kuznicki (January 12, 2011)
- 670. **Fixing Transit: The Case for Privatization** by Randal O'Toole (November 10, 2010)
- 669. **Congress Should Account for the Excess Burden of Taxation** by Christopher J. Conover (October 13, 2010)
- 668. **Fiscal Policy Report Card on America's Governors: 2010** by Chris Edwards (September 30, 2010)
- 667. **Budgetary Savings from Military Restraint** by Benjamin H. Friedman and Christopher Preble (September 23, 2010)
- 666. **Reforming Indigent Defense: How Free Market Principles Can Help to Fix a Broken System** by Stephen J. Schulhofer and David D. Friedman (September 1, 2010)
- 665. **The Inefficiency of Clearing Mandates** by Craig Pirrong (July 21, 2010)
- 664. **The DISCLOSE Act, Deliberation, and the First Amendment** by John Samples (June 28, 2010)
- 663. **Defining Success: The Case against Rail Transit** by Randal O'Toole (March 24, 2010)

662. **They Spend WHAT? The Real Cost of Public Schools** by Adam Schaeffer (March 10, 2010)
661. **Behind the Curtain: Assessing the Case for National Curriculum Standards** by Neal McCluskey (February 17, 2010)
660. **Lawless Policy: TARP as Congressional Failure** by John Samples (February 4, 2010)
659. **Globalization: Curse or Cure? Policies to Harness Global Economic Integration to Solve Our Economic Challenge** by Jagadeesh Gokhale (February 1, 2010)
658. **The Libertarian Vote in the Age of Obama** by David Kirby and David Boaz (January 21, 2010)
657. **The Massachusetts Health Plan: Much Pain, Little Gain** by Aaron Yelowitz and Michael F. Cannon (January 20, 2010)
656. **Obama's Prescription for Low-Wage Workers: High Implicit Taxes, Higher Premiums** by Michael F. Cannon (January 13, 2010)
655. **Three Decades of Politics and Failed Policies at HUD** by Tad DeHaven (November 23, 2009)
654. **Bending the Productivity Curve: Why America Leads the World in Medical Innovation** by Glen Whitman and Raymond Raad (November 18, 2009)
653. **The Myth of the Compact City: Why Compact Development Is Not the Way to Reduce Carbon Dioxide Emissions** by Randal O'Toole (November 18, 2009)
652. **Attack of the Utility Monsters: The New Threats to Free Speech** by Jason Kuznicki (November 16, 2009)
651. **Fairness 2.0: Media Content Regulation in the 21st Century** by Robert Corn-Revere (November 10, 2009)
650. **Yes, Mr President: A Free Market Can Fix Health Care** by Michael F. Cannon (October 21, 2009)
649. **Somalia, Redux: A More Hands-Off Approach** by David Axe (October 12, 2009)
648. **Would a Stricter Fed Policy and Financial Regulation Have Averted the Financial Crisis?** by Jagadeesh Gokhale and Peter Van Doren (October 8, 2009)
647. **Why Sustainability Standards for Biofuel Production Make Little Economic Sense** by Harry de Gorter and David R. Just (October 7, 2009)

646. **How Urban Planners Caused the Housing Bubble** by Randal O'Toole (October 1, 2009)
645. **Vallejo Con Dios: Why Public Sector Unionism Is a Bad Deal for Taxpayers and Representative Government** by Don Bellante, David Denholm, and Ivan Osorio (September 28, 2009)
644. **Getting What You Paid For—Paying For What You Get: Proposals for the Next Transportation Reauthorization** by Randal O'Toole (September 15, 2009)
643. **Halfway to Where? Answering the Key Questions of Health Care Reform** by Michael Tanner (September 9, 2009)
642. **Fannie Med? Why a “Public Option” Is Hazardous to Your Health** by Michael F. Cannon (July 27, 2009)
641. **The Poverty of Preschool Promises: Saving Children and Money with the Early Education Tax Credit** by Adam B. Schaeffer (August 3, 2009)
640. **Thinking Clearly about Economic Inequality** by Will Wilkinson (July 14, 2009)
639. **Broadcast Localism and the Lessons of the Fairness Doctrine** by John Samples (May 27, 2009)
638. **Obamacare to Come: Seven Bad Ideas for Health Care Reform** by Michael Tanner (May 21, 2009)
637. **Bright Lines and Bailouts: To Bail or Not To Bail, That Is the Question** by Vern McKinley and Gary Gegenheimer (April 21, 2009)
636. **Pakistan and the Future of U.S. Policy** by Malou Innocent (April 13, 2009)
635. **NATO at 60: A Hollow Alliance** by Ted Galen Carpenter (March 30, 2009)
634. **Financial Crisis and Public Policy** by Jagadeesh Gokhale (March 23, 2009)
633. **Health-Status Insurance: How Markets Can Provide Health Security** by John H. Cochrane (February 18, 2009)
632. **A Better Way to Generate and Use Comparative-Effectiveness Research** by Michael F. Cannon (February 6, 2009)