

# WebMemo



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## Assessing the President's Proposals on Higher Education Costs

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President Obama is right to draw attention to the soaring cost of a college education in America. However, his proposed solution will not only fail to fix the problem but is also likely to compound it by blunting the competition that is needed to shake up the world of higher education.

### **Tuition and Costs Rising.**

It is important to focus on the cost of higher education, because gaining post-high school skills and credentials of competency is increasingly necessary for Americans to move up the economic ladder. For example, Americans with a bachelor's degree earn about 70 percent more each year than those with only a high school diploma—nearly double the differential of a generation ago.<sup>1</sup>

For those young Americans who seek a college education as the means of gaining needed skills, the rising cost of college is making it less and less affordable, especially for those from modest-income households, and many can complete it only by incurring heavy debt. Over the past 25 years, the inflation-adjusted cost of college has almost tripled, while the median inflation-adjusted family income has risen by only about 10 percent.

In 2009, more than half of those students who graduated from public colleges were in debt, with an average loan burden of \$19,800. For private college graduates, the percentage in debt and the amount were even greater. Fees keep rising rapidly, soaring 8.3 percent last year at public universities

and 4.5 percent at private institutions. Meanwhile, the number of administrators per 100 students at some of the top universities across the country has increased 39 percent since 1993, contributing to soaring college costs.<sup>2</sup>

President Obama proposes to slow tuition growth by conditioning the amount of federal campus-based aid to colleges. He also wants to create a “college scorecard” for every institution as a measure of quality. The scorecard would include such indicators as tuition, graduation rates, and earnings upon graduation.

### **Problems with the Aid-Tuition Linkage Proposal.**

While the President was cheered by students when he presented his proposals at the University of Michigan, the students should have paused to consider the implications of his approach.

**Double whammy for state universities.** Rising tuition in recent years is not due only to inefficiency and bloated administrations at the nation's colleges, although these are significant long-term factors.

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Most state universities are raising tuition sharply to compensate for cutbacks in budget support from their financially strapped state governments. Among the hardest hit, in-state tuition in California soared 21 percent last year, and the University of California system expects to raise tuition at double-digit rates over the next few years to make up for cuts in its allotment from the state.

Moreover, the extensive and expensive system of federal aid for college has actually exacerbated increases in the total cost of college. This is because colleges can boost tuition when such assistance enables students to offset part of their costs. To be sure, better-targeted student aid can help specific groups of students afford college, but increasing total aid, as the President proposes, will tend to increase—not decrease—the sticker price of college.

### The Outdated College Business Model

Still, ever-increasing federal subsidies are but one culprit contributing to the high cost of college. Traditional higher education is a classic example of an industry that has grown bloated and inefficient over many decades and is ripe for a major transformation. The business model of most colleges and universities has changed little over time. When college tuition and expenses were a smaller part of the typical household budget, the costs of tenured professors teaching few classes, large administrative bureaucracies, or elegant buildings that added little tangible value could be passed on to students. But as these costs consistently increased faster than household income, it was only a matter of time before many customers were priced out of the market. That is now beginning to happen.<sup>3</sup>

The antidote to this trend is not for the federal government to tweak college assistance. It is to encourage the mounting competition to the current cozy system coming from new and far less expensive higher education business models. Competi-

tion—not further involvement from the Department of Education—will transform higher education and sharply reduce costs in the future.

### New Forms of Competition

The most obvious direct challenge comes from online education. Online course enrollments have been growing much faster than overall university enrollments, and the range and technological sophistication of online education is increasing rapidly while the cost of delivering a course is falling. Some leading institutions, like MIT and Harvard, are experimenting with online courses that could revolutionize higher education while bringing costs down sharply.

Meanwhile, other smaller colleges and “virtual” colleges are exploring very different ways to organize education, using online courses and other innovations. For example, the nonprofit Western Governors University, created by the governors of 19 western states, focuses on developing core competencies in key areas of knowledge and licenses the study material from other sources. Its annual tuition is about \$6,000.

These innovative alternatives are an existential challenge to the traditional higher education business model, and they are the key to forcing transformation and cost reduction in that industry. Just as the innovations of Steve Jobs and Bill Gates forever changed the world of mainframe computers and bloggers and online news disrupted the seemingly impervious newspaper business, higher education appears to be on the brink of fundamental change.

### A Role for Government?

**A scorecard?** What should the government do, if anything? It might seem that President Obama’s idea of a federal college scorecard would speed up transformation by providing student customers with objective information to better assess value

1. Stuart M. Butler, William W. Beach, and Paul L. Winfree, *Pathways to Economic Mobility* (Washington, D.C.: Pew Charitable Trust, 2008), p. 22, at [http://www.economicmobility.org/assets/pdfs/PEW\\_EMP\\_PATHWAYS.pdf](http://www.economicmobility.org/assets/pdfs/PEW_EMP_PATHWAYS.pdf) (February 1, 2012).
2. Jay Greene, Brian Kisida, and Jonathan Mills, “Administrative Bloat at American Universities,” Goldwater Institute Policy Report, August 17, 2010, at <http://goldwaterinstitute.org/sites/default/files/Administrative%20Bloat.pdf> (February 1, 2012).
3. Stuart M. Butler, “The Coming Higher-Ed Revolution,” *National Affairs*, No. 10 (Winter 2012), at <http://www.nationalaffairs.com/publications/detail/the-coming-higher-ed-revolution> (February 1, 2012).

for money. But there are key drawbacks with that proposal.

- Scorecards are already developing in the private sector. *US News & World Report*, *Forbes*, and *Kiplinger's* already provide cost-benefit information, and they are continuously improving their competing methodologies. Meanwhile, the American Council of Trustees and Alumni (ACTA) focuses on comparing the academic content of college courses.
- If the federal government seeks to tie financial aid to its own monopoly measure of quality, there will be a strong incentive for existing institutions, threatened by new forms of competition, to lobby hard to structure the quality measures to favor their business model. The federal government is very prone, in part because of provider pressure, to focus on inputs rather than outputs as supposedly a measure of quality.
- Measuring quality and value for money in education is, in any case, technically difficult. There are many legitimate ways to weight factors, which is why the private scorecards rank colleges differently, and different customers prefer different scorecards depending on their goals and preferences. Thus, rather than conditioning student aid on its own (likely defective) scorecard, a better approach would perhaps be to provide a neutral clearinghouse for existing and new scorecards, so that students and their parents can identify the best value for money based on their own criteria, including tuition costs.

**More federal support?** The President proposes to provide \$1 billion to states that curb education costs and to expand the Perkins loan program from \$1 billion to \$8 billion. Unfortunately, the unintended effect of adding more federal assistance, even though it would defray the costs for some students, would be a lack of incentive for colleges to reduce costs.

## Fostering Competition and New Business Models

The President wants \$55 million to fund a competition for start-up funding for institutions that devise innovative ways to boost productivity. But the way to foster innovation in higher education is not for the federal government to try to become a venture capital fund. It has a dismal track record in picking winners and losers. For one thing, federal officials are far less likely to perceive truly innovative ventures than are private investors or foundations. For another, the recent Solyndra scandal underscores the tendency of political factors to distort federal investment decisions.

There is no shortage of innovation in higher education. The best way to foster more creativity is to loosen accreditation requirements associated with federal assistance. Accreditation can easily become a barrier to entry for new approaches that conflict with the business model assumptions of the federal government. Existing institutions under pressure from new ventures invariably turn to licensing and other regulations to block competitors.

## Reducing Indebtedness

The federal government can also help improve the debt burden of graduating students and put downward pressure on tuition by encouraging a shift toward saving for college and away from debt financing. So rather than focusing on subsidizing college loans for modest-income and middle-income families, Congress should use appropriate tax reform to remove the double taxation of savings for college and other purposes.

Two steps are needed:

1. Direct spending on human capital—education—should actually be given the same tax preferences as physical capital, such as business equipment, since each generates future taxable income. The Heritage Foundation's tax reform

proposal in *Saving the American Dream* takes a big step in that direction by allowing all families to take a tax deduction for higher education costs, capped at the cost of four years in a state college.<sup>4</sup>

2. The limited tax benefits available for Section 529 college savings accounts should be extended by exempting all saved income until it is spent. This proposal is also included in *Saving the American Dream*.

The combination of these two steps means that saved income and the earnings on that saved money would not be taxed at all if the money is used for higher education (subject to the cap). This change in policy would be a strong incentive for families to save for a much larger proportion of college costs instead of relying on subsidized debt.

### **College Made Possible Through Savings and Competition, Not Government Spending**

The rising cost of college is a barrier to young Americans' acquiring skills they need to be success-

ful in the U.S. economy and move up the economic ladder. To tackle this problem, it is necessary to recognize that while federal assistance reduces the costs faced by families that qualify, unfortunately it also reduces the pressure on colleges to restrain tuition. The real antidote to tuition hikes at traditional public and private colleges is emerging competition from colleges that are pioneering new business models, online education, and other technologies that dramatically cut costs. The best way for Washington to foster this competition is to make sure that accreditation requirements and other regulations are loosened. And the best way to ease the student debt problem for future students is through tax reform that encourages saving.

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4. See Stuart M. Butler, Alison Acosta Fraser, and William W. Beach, eds., *Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity* (Washington, D.C.: The Heritage Foundation, 2011), at <http://www.savingthedream.org/about-the-plan/plan-details/SavAmerDream.pdf>.