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The Real Costs of Federal Aid to Higher Education

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I want to make five short observations about financial assistance for American college students. I'm an economic historian, and a historical perspective, I think, helps in an intelligent evaluation of public policy.

My first observation is that the increase in access to higher education in America largely came before massive federal involvement in student financial aid programs. Second, I would argue that the incremental or marginal students that we have gained through substantial federal programs likely have extremely poor records with respect to college completion, and probably shouldn't have been in college in the first place.

Third, I suspect that a student financial aid Laffer curve phenomenon is at work, whereby modest provision of financial assistance serves to increase the proportion of college graduates in society, but that a vast financial aid effort such as we've had in recent years has actually had a negative impact on that ratio. Fourth, and closely related to the third point, some of these financial aid programs have contributed mightily to the explosion in tuition fees in modern times. Finally, I echo the Spellings Commission's charge that the current system is confusing and dysfunctional, with programs often working at cross-purposes. Then I will turn very briefly to a more general assessment as to why university costs have been rising and discuss how I believe governmental funding should change.

Growth Without Government

Now, let me elaborate a little. The rationale for government financial aid for students and higher educa-

Talking Points

- New federal spending on student aid is unlikely to improve college access. The increase in access in higher education in America largely came before massive federal involvement in student financial aid programs.
- Evidence suggests that federal subsidies for student aid may be counterproductive. Modest provision of financial assistance serves to increase the proportion of college graduates in society, but a vast financial aid effort such as we have had in recent years has actually had a negative impact on that ratio. Importantly, evidence suggests that increasing subsidies for higher education has contributed to inflation of college costs.
- As a long-term objective, the federal government should largely exit the higher education business. Shorter-term, lawmakers should oppose vast increases in student-aid programs.

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tion revolves around the argument that America is an egalitarian society that favors high social and economic mobility and promotes equal educational opportunity as a means to that end. Yet the large majority of the rise in higher education participation in America occurred *before* there was a major federal financial involvement. For example, in 1900, 23 out of every 1,000 Americans between the ages of 18 and 24 went to college. Compare it with 324 in 1970. While the GI Bill did impact enrollments for awhile after World War II, in 1970, total federal financial aid programs, including grants and loans, amounted to less than \$1.6 billion, or less than \$200 per student enrolled. A fourteen-fold increase in college participation occurred without a major federal financial involvement, excepting for a brief period after World War II when the GI Bill assistance was quantitatively an important factor.

It is worth noting that this is exactly what has happened throughout primary and secondary education as well. The vast rise of literacy in Great Britain before the Industrial Revolution and during the Industrial Revolution occurred without a pence of governmental financial support. And similarly, in our history, literacy was high in the United States in 1850 even though the majority of schooling was still privately funded. The notion that government funding was somehow necessary to promote high levels of educational access is simply historically untrue. To be sure, the vast growth in college enrollment in the first two-thirds of the last century does coincide with the rise in state governmental institutional support, and that no doubt had a positive enrollment impact. But the notion that the government must provide funds to students to promote college attendance was not widely accepted before 1970, the era of greatest university growth.

In the 1990s, the proportion of the American population going to college fell by one measure for the first time in well over a century, and by another measure showed the smallest increase in modern times—smaller even than during the Great Depression. There was an extremely sharp slowdown in the growth in higher education participation. Yet the federal financial aid programs for college students grew dramatically during this period; finan-

cial aid went from \$19 billion in 1990 to \$63 billion in 2000. Aid for students more than doubled even after adjusting for inflation. We were in a period of sharply rising federal assistance, but a slowdown in enrollment growth.

Moreover, the rise in enrollment says little about learning. There is a growing body of evidence showing that college graduates are less literate than previously. The National Survey of Student Engagement says that the average senior at an American university studies 13 hours a week, which when added to classroom hours, suggests work of 1,000 to 1,200 hours yearly—one-third to one-half less than the typical American worker. College students are inadequately challenged and grade inflation has reduced consequences of poor performance. Compounding all of this, nearly one-half the students entering college full-time fail to graduate within six years. College dropouts are a huge problem. We probably are over-invested in higher education, with the incremental students financed by increases in student aid largely ill equipped for college-level study.

My eyeballing of the historical data leads me to conclude that we may well have overdone financial aid, even if our only goal is to maximize the proportion of adults who are college graduates. High levels of aid have contributed to higher tuition prices, forcing away some students. The recent trend towards shifting aid from a need to a merit base may have meant that most incremental funds have gone to students who would have attended college with or without aid. Moreover, some students getting aid stick around universities longer and often do not complete degrees. The rapid rise in student aid has occurred simultaneously with a slowdown in the growth of the proportion of Americans who are college graduates.

More Aid, Higher Tuition

When someone else is paying the bills, people want to buy more of the good or service in question at prevailing prices than when the customer pays the bills. This means a higher demand for higher education, and other things being equal, higher tuition costs. Some in the Academy deny this, of course, and people are writing studies trying to deny it. However, I believe that is simply wrong.

There is little doubt in my mind—and I’ve run regressions to verify it—that the soaring financial aid, in part federally financed, has contributed somewhat to the escalation in college tuition costs—which have been going up since Aristotle, by the way. One estimate I did suggests that each one dollar in grant aid leads to tuition fees somewhere around 35 cents higher than would otherwise be the case. Just as third-party payments in medicine have led to escalating health care costs, so increased student financial payments have contributed to soaring tuition costs. When the feds created tuition tax credits in the late 1990s, I called it the “faculty salary enhancement act,” since colleges could capture much of the tax break by raising tuition fees and then used some of the money to reward their staff. Money moved as much from taxpayers to university staff members as to the pockets of student consumers.

The Spellings Commission got it right when it said that the financial aid system was dysfunctional—actually, I picked that word out in my capacity as a member of that commission—although it recommended little in the way of changing it. There are close to 20 programs that help pay for college, and some are at cross-purposes to others. Compounding everything, the FAFSA (Free Application for Federal Student Aid) form that parents must complete is confusing beyond belief, more complicated than the dastardly federal income tax form 1040.

As Judge Richard Posner put it well in his blog with Gary Becker the other day, the intellectual justification for expanded federal student loan programs is extremely weak. It is not clear that higher education has major positive spillover effects that justify government subsidies in the first place, and the private loan market that can handle anything from automobile loans to billion-dollar government bond sales can handle providing financial assistance to students if necessary.¹ Indeed, colleges might consider using some of their own endowments for this purpose, going into the business themselves. It is striking how government programs often are at cross-purposes with one another.

For example, 529 savings plans that get favorable tax treatment increase the demand for pricey private education among upper-middle class persons, almost certainly leading to tuition increases. This offsets some of the benefits from the modest annual increases in the Pell Grant program for lower-income persons. The professed goal of increasing college access may be thwarted by the interaction between seemingly unrelated programs. In short, I have a skeptical view of Democratic proposals to go on a spending spree for student financial aid. There is little or no evidence that this will do much of anything to improve college graduation rates, and will simply perpetuate a complex system that exists on dubious intellectual foundations.

Causes of Tuition Explosion

Now the so-called student debt crisis would not exist if the federal government had not made it easy for 18-year-old students to borrow. But it would also not exist if the cost of college rose at the same rate that other things have. The tuition explosion reflects a multitude of things. Let me mention 12 words or phrases that encompass most of its causes:

- Third-party payments
- Non-profit
- Price discrimination
- Bottom line
- Public support
- Ownership
- Cross-subsidization
- Rent-seeking
- Governance
- Resource rigidities
- Barriers to entry and restraints on competition
- Information

Using only one sentence for each point, let me now elaborate. I have a longer paper on this if you would like to read it. Third-party payments from governments and philanthropic individuals mean that customers are less sensitive to costs since oth-

1. Richard Posner, “Student Loans-Posner’s Comments.” The Becker-Posner Blog, December 3, 2006, at www.becker-posner-blog.com/archives/2006/12/student_loanspo.html (January 9, 2007).

ers are paying the bills. The non-profit nature of most institutions means that there are few incentives to cut costs or improve product quality. Price discrimination means that universities set high sticker prices, and then discount them a lot to favored customers, hurting those not favored. There is no bottom line in higher education, no metric like profits to determine whether easily understood goals are being met. High public support means artificially increased demand for higher education has increased prices. Ownership means that many persons claim that they own the universities, and governance and consequences of bad management are murky.

Cross-subsidization means that at many institutions, graduate instruction, research and/or athletics are highly subsidized by undergraduate programs. Rent-seeking means that some people, especially senior administrators and faculty, have had huge compensation increases that increase costs. Governance means that it is unclear who really runs the universities: the president, the trustees, the faculty, rich alums, etc. Resource rigidities such as tenure make it difficult to redeploy resources to more efficient uses. Barriers to entry imposed by accrediting associations and others restrict competition and hurt needed and efficient for-profit providers, while, at the same time, schools seek prestige by denying students access. Information means that people have no idea whether universities are doing a good or bad job of adding value to student consumers, as there is no bottom line, rendering markets less efficient because the customers are in the dark far more than necessary.

In addition to these problems, there is a lot of neglect of students going on in universities as an unintended consequence of all this. The reduced teaching loads of faculty, the five- and six-year graduation rates, partly reflect—not entirely, but partly—closed classes, students not able to get into courses they want. There is evidence that resources have been declining in some relative sense for community colleges and for liberal arts colleges, relative to the high research institutions.

Is this serving the needs of students in America? Are we using students as sort of a means to another end, namely getting money for research and so

forth? I think these stories need to be told. At a recent meeting, the members of my department voted to lower their teaching load by almost 20 percent. I think they got around to telling the dean eventually. They just did it; no one stopped them. Who are making decisions in higher education? The people have lost control of higher education. So part of the answer to all these things is that people need to take control.

And yes, we need to get third parties out. There is becoming a critical shortage of people in skilled occupations that do not require a college education—mechanics, electricians, and construction people. Plumbers make more than PhDs in history. And frankly, they should, if you read the typical new book published in history these days. Fixing a toilet is socially useful.

One reason why college costs have gone up so much is that the differential between high school earnings and college earnings has expanded. In the 1960s—these numbers aren't precisely correct; it depends on what group you're talking about—let's say there was a 50 percent differential between high school graduates and college graduates. Now it's closer to 80, 90, or even 100 percent. The differential has widened. The credentialing role of colleges has grown. By the way, I don't think those differentials reflect what colleges are teaching the kids. I think many of the kids going to college are innately superior to begin with, so the differential may have very little to do with what the college is doing.

But those differentials have grown. There is some evidence in the past five years that those differentials may have leveled off, and maybe even are tailing off a little bit, because of this over-investment in higher education, this over-subsidization of universities. As a consequence of this, as the cost of higher education goes up, but the vocational benefits are leveling off and maybe even starting to decline in some places, the vocational dimension argument for borrowing money to go to college and all may decline. This may be a factor in this equation that we need to look at very carefully.

Finally, the very purpose of federal aid has been subverted recently as more and more wealthy students are receiving it. It's not only true of federal aid, it's particularly true even with institutional aid.

Danette Gerald and Kati Haycock have done a marvelous study that shows in the last decade, if you look at institutional spending, that is the money that the colleges themselves are giving students, and you look at different income classes, the low-income people are getting actually less money today in real terms than 10 years ago, and kids from families of \$80,000 or \$100,000 income are getting far more because colleges are trying to buy high SAT scores to do well in the *U.S. News & World Report* ranking, because that seems to be the only reliable metric that people seem to accept as a measure of quality of higher education.² Which means, among other things that we need to have alternatives to the *U.S. News* rankings that really reflect excellence in teaching and nurturing students. Harvard has good students graduating because they have good students coming in—but do they really gain a lot while at Harvard?

Toward a Government Exit

There are no easy solutions. The evidence shows no positive association between state government spending on public universities and economic growth, suggesting the positive externalities claimed

for higher education are overblown. As a long-term public policy objective, I think government should largely exit the higher education business. Shorter-term, we should oppose vast increases in aid programs and demand higher levels of transparency and measurements of results from schools accepting federal funds. We should reduce barriers to entry imposed by accrediting bodies; we should end all subsidies to students beyond four years of college attendance; we should force schools taking federal money to be less restrictive in inter-institutional transfers; and we should do a host of other things that time does not permit me to talk about that would make universities more efficient, more accountable, and better. Including making professors teach more, by the way.

—Richard Vedder, Ph.D. is Director of the Center on College Affordability and Productivity and author of *Going Broke by Degree: Why College Costs Too Much* (AEI Press, 2004). These remarks are drawn from a panel discussion that included Heritage Foundation Bradley Fellow Eugene Hickok and Hillsdale College president Larry Arnn.

2. Danette Gerald and Kati Haycock, “Engines of Inequality: Diminishing Equity in the Nation’s Premier Universities,” The Education Trust, 2006, at www2.edtrust.org/NR/rdonlyres/F755E80E-9431-45AF-B28E-653C612D503D/0/EnginesofInequality.pdf (January 9, 2007).