CHAPTER 5: ADDRESSING HIGHER EDUCATION

- Taxpayers—many of whom never attended college—would carry the financial burden of policy proposals like *America's College Promise*, discussed in the *Report*.
- The problem is not insufficient credit for students to attend college, but that credit is too easily available, motivating irresponsible borrowing.
- When the economy is weak, jobs are scarce including for recent college graduates.
- Pouring billions of additional taxpayer dollars into failing PreK-12 schools is not benefitting children or taxpayers.

POLICY LESSONS ON HIGHER EDUCATION

The *Report* states that, on average, individuals with a higher level of education earn more money, are more likely to be in the labor force, and are less likely to be unemployed. It presents predictable data on earnings, labor force participation, and unemployment for various levels of educational attainment. Furthermore, the Obama Administration argues that, since there are benefits to the individual and the nation and so-called "market failures" in higher education financing, an economic rationale exists for Federal support of higher education. None of this is surprising.

However, the arguments for strong Federal involvement expose a misunderstanding of financial markets, ignore regional differences, overlook the root cause of the challenges, and fail to demonstrate the necessity for a Federal monopoly of student loans. Additionally, as distressing as it is to say this, recent policies by the Obama Administration stand to reduce the benefits associated with higher educational attainment, making it more difficult for Americans to justify spending time and money attending college.

America's College Promise

The *Report* states that it is "…committed to ensuring all students, regardless of their background, have access to a college education that prepares them for success in the workplace and life."[i] Arguably, this has already been achieved in America with community colleges and need-based financial aid. Community colleges are located in all 50 states, have no entrance requirement beyond high school completion, and Pell grants are available to cover costs for low-income individuals.[ii] If students wish to pursue education beyond an associate's degree, they can seek the advice of the community college's guidance counselor and admission personnel at four-year state and private colleges and universities. While many problems do exist in America's education system, affordable access to an associate's degree is not among them.

However, the Obama Administration believes more money should be redistributed from working Americans to college students. President Obama argued that community college should be "free" to everyone—including high-income students and families—and in 2015 he unveiled America's College Promise (ACP), "…two years of community college free for hard-working students."[iii] The problems with ACP are threefold. First, nothing is free because costs are always borne by someone; second, potential beneficiaries of the program tend to be higher earners who are capable of taking financial responsibility for their education; and third, beneficiaries of the program would no longer have skin in the game—money of their own invested—and, consequently, there is no financial cost to the student for academic failure.

For decades, Federal aid has been available so students with financial need can attain education beyond a high school diploma.[iv] These grants are available to undergraduate students attending two- and four-year colleges and universities. The state and Federally funded ACP would apply exclusively to community colleges and simply shift the financial burden of college from the

student to taxpayers. The beneficiaries of the taxpayer-funded program are students whose family earnings are too high to qualify for need-based Pell grants.

The implications of the program are that students from families with high income could attend community college at the taxpayer's expense. Some of these students would be low-performing students, and if they fail to complete the program, there are minimal costs to the student. Others will be high-performing students—those who would have attended either community college or a four-year college at their own expense. These students would now be able to earn an associate's degree at the taxpayer's expense. ACP would do nothing to increase accessibility to college for low-income Americans and should not be implemented.

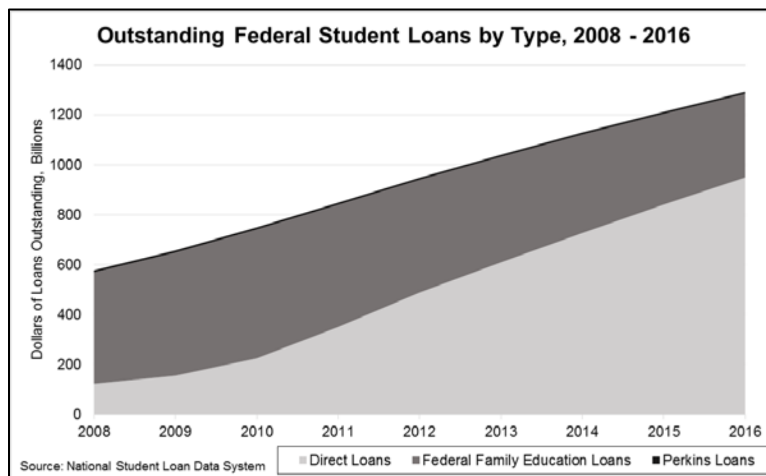
Financial Markets and Student Loans

The *Report* discusses the challenges that students face in acquiring student loans. However, the analysis reveals a lack of understanding of financial market behavior that leads to a misdiagnosis of the issues. The result is a government-run system where students have few choices, and all of the risk falls onto taxpayers.

The *Report* states that private markets—presumably banks and other financial intermediaries—are often unwilling to provide loans because there is no collateral in the event of default, additionally claiming that this is a market failure.[v] This assertion is incorrect. Private markets are willing to provide loans, so long as lenders receive a rate of return that is consistent with the level of risk. In other words, the rate of return that lenders require on any investment is based on the characteristics of that investment. One of the most important characteristics is the level of default risk—the risk of not receiving payment of principal or interest. The greater the risk, the higher the required rate of return. Lending money to a college student, with no collateral and no assurance

that the student will graduate and have sufficient earnings to repay the loan, is extremely risky. However, investors are willing to take that risk if the rate of return is appropriate for that risk. If Federal regulations set the rate of return too low, private lenders will avoid the high-risk investments.

Figure 5-1



Additionally, the *Report* refers to banks' risk aversion as a market failure. However, risk-averse lending is the market functioning efficiently through financial institutions acting responsibly with depositors' money. Alternatively, when government mandates are imposed on financial markets, the markets cease operating efficiently. For example, the financial crisis of 2008-2009 largely resulted from government-sponsored enterprises (GSE) Fannie Mae and Freddie Mac encouraging private institutions to act irresponsibly with depositors' money.[vi] GSEs, in an effort to meet Federally mandated homeownership goals, encouraged private institutions to issue low-interest, high-risk, subprime mortgages by agreeing to purchase those loans once issued.[vii] This led to the housing bubble, subsequent price collapse, and recession.[viii] In the context of student loans, banks' risk-aversion—requiring a higher rate of return for lending to students—protects depositors' money. This contrasts with the GSEs' pursuit of homeownership goals,

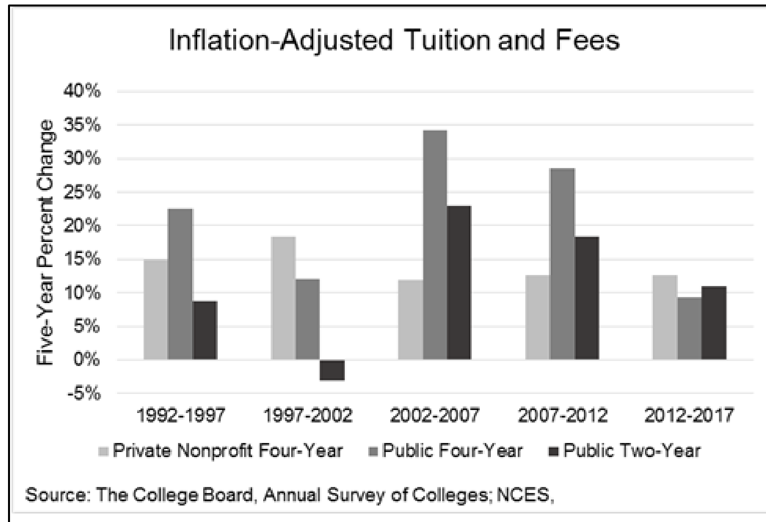
which resulted in large-scale defaults, bank failures, and a taxpayer-funded Federal bailout. Chapter 6 of this *Response* discusses the financial crisis in detail.

In 2010, the *Health Care and Education Reconciliation Act* was signed into law, removing private financial intermediaries from the student loan process. This created a true market failure—a Federal monopoly for student loans. Today, there are nearly $1.3 trillion in outstanding high-risk student loans provided by taxpayers—double the amount in 2008 (Figure 5-1).[ix] CBO projects an additional $1.4 trillion student loan debt from 2013 to 2023.[x] This debt earns a very low rate of return or zero, in the case of subsidized student loans.[xi] These fall well below the rate appropriate for the risk and put taxpayer money in jeopardy. A better student loan program would be locally managed and include competing private lenders.

Rising Tuition

The *Report* focuses on a number of issues but overlooks the root cause of the college education financing problem, which stems from rising tuition and fees. For decades, the cost of attending college has risen far faster than other prices. In the 114th Congress, Mitchell E. Daniels, President of Purdue University, testified before the Committee that tuition prices have increased by "… 225 percent over the last 30 years, after inflation."[xii]

Figure 5-2



The root cause of runaway college costs is not that there is too little credit available to college students; but rather, that credit is too easily available. The availability of subsidized-credit to nearly all college students allows colleges and universities to easily increase their tuition (Figure 5-2). This phenomenon was famously presented in a 1987 *New York Times* op-ed titled, “Our Greedy Colleges,” by William Bennett, then-Secretary of Education.[xiii] In the article he stated, “If anything, increases in financial aid in recent years have enabled colleges and universities blithely to raise their tuitions, confident that Federal loan subsidies would help cushion the increase.”

Since 1987, there has been a number of studies to test the “Bennett Hypothesis.”[xiv] A 2016 study by the Federal Reserve Bank of New York found that for every dollar of subsidized student loan received by the college, the tuition increased by 60 cents, and for every Pell grant dollar received, tuition increased by 40 cents.[xv] A better policy would require colleges and universities to share the risk associated with student loans, incentivizing the accurate

identification of students who are likely to succeed in college versus those who are not.

Flexible Repayment

Historically, most student loans had to be repaid in equal monthly installments over ten years. Graduates were required to meet their loan obligations to taxpayers irrespective of their income level. However, in 1987, President Ronald Reagan signed into law a pilot program that included "income-contingent loans" to allow students to repay their student loan over a period of time in excess of ten years, in order to lessen the burden for new graduates and reduce defaults. The loans were unsubsidized—interest accrued while the student remained in school, removing a costly Federal subsidy. In addition, colleges had to contribute 10 percent of the loan, and annual repayment could never exceed 15 percent of the graduate's income.[xvi]

Although the pilot program was discontinued, elements of it survived and were implemented in more recent programs, including among those of the Obama Administration.[xvii] Regretfully, the Obama Administration's programs, while similar on the surface, are poorly designed and incentivize irresponsible borrowing by passing the cost to taxpayers. Reagan's plan was developed to increase the likelihood that students will repay the full amount of their student loan. In comparison, the Obama Administration's plan ensures that many students will have a portion of their student debt burden passed on to taxpayers.

The *Report* touts the benefits to the borrower of the extended payoff period for income-driven repayment plans while ignoring the cost to taxpayers.[xviii] The Obama Administration's versions of these plans were implemented in the 2012 *Pay as You Earn* (PAYE), the 2015 *Revised Pay as You Earn* (REPAYE)—both plans cap payments at 10 percent of graduates' discretionary income—and the 2009 and 2014 Income Based Repayment (IBR) plans that cap payments at 10 or 15 percent of discretionary

income. All of the plans forgive outstanding debt after 20 years of payments.[xix] While appealing to borrowers, taxpayers bear a substantial cost.

Figure 5-3

Repayment Plan	Initial Payment	Final Payment	Payment Years	Total Paid By Borrower	Total Paid By Taxpayers
A. REPAYE	$60	$296	20	$32,358	$24,253
B. PAYE & IBR	$60	$296	20	$39,517	$27,823
C. PAYE & IBR	$185	$612	20	$97,705	$41,814

With the recognition that loan repayments will never exceed 10 or 15 percent of earnings and that payments end after 20 years, there is no additional cost to students for borrowing additional dollars—assuming students expect to have an unpaid balance after 20 years. Figure 5-3 presents three scenarios. Scenarios A and B assume a $30,000 loan and a starting salary of $25,000, and scenario C assumes a $60,000 loan and starting salary of $40,000.[xx] If the students borrowed more than the $30,000 or $60,000, their payments, and the total paid by borrower, would not change. The only change from a greater amount of debt is an increase in the portion of their education expense borne by taxpayers—the last column in the table. Thus, the Obama Administration's loan policies incentivize students to maximize debt—borrowing irresponsibly and exacerbating the problem of high student debt—leaving taxpayers responsible for the unpaid portion after 20 years. A better program would require full loan repayment by the student to taxpayers.

The President's Recovery

It is not surprising that, on average, the greater the educational attainment achieved, the higher the salary earned.[xxi] When the economy is strong—high growth and a tight labor market—there are more opportunities for college graduates. However, when the economy is weak and jobs are scarce, all Americans, including recent graduates, suffer. The current economic recovery is the weakest in decades, falling far short of past recoveries.[xxii] Annual real GDP growth under the Obama Administration never reached 3 percent.[xxiii] No other Administration since 1933 has failed to attain this level of growth, including Presidents that presided over the Great Depression and the economic malaise of the 1970s.[xxiv]

Today, college graduates face a weak economy, high college debt, and the responsibility of servicing the nearly $20 trillion gross Federal debt—an amount that doubled under the Obama Administration and is forecast to grow indefinitely.[xxv] Federal debt interest payments alone are forecast to nearly triple from 2017 to 2027, a cost that taxpayers must bear.[xxvi] Chapter 2 of this *Response* presents a thorough discussion on the weak economy of the past eight years. A better strategy would be to pursue pro-growth policies that benefit all Americans—regardless of educational attainment—rather than burdensome redistribution policies that benefit some at others' expense.

Challenges for those from Disadvantaged Backgrounds

The *Report* states that the challenges to access quality post-secondary education are especially high for low-income families, first-generation college families, and other disadvantaged groups.[xxvii] Additionally, it states that loan default rates are highest for students with a low amount of debt because they are more likely to have dropped out of college prior to completing the program.[xxviii] These two phenomena are linked in that public PreK-12 schools often fail to prepare low-income and/or first-generation college students for a successful college career;[xxix] and

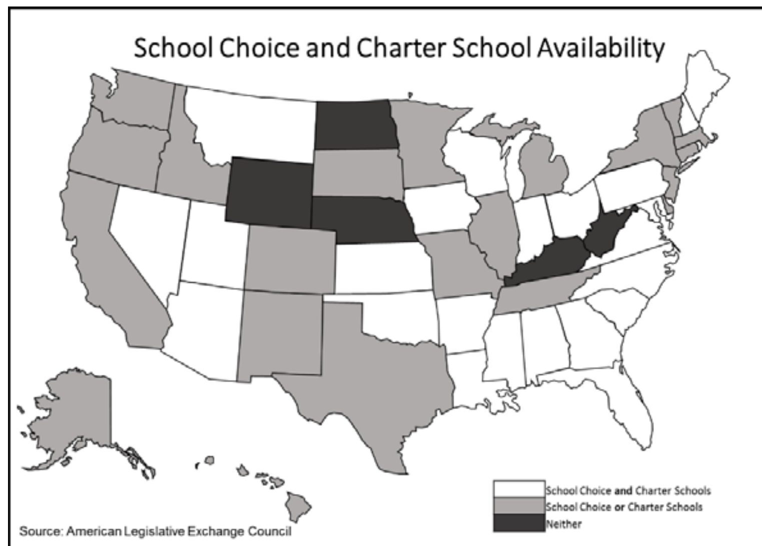
a large portion of these students fail to complete a post-secondary program, ultimately defaulting on their student loan.[xxx]

These issues are far from new. In 2008, the Pell Institute conducted a thorough analysis on the experiences of low-income first-generation college students.[xxxi] The study recommends substantial improvement for middle schools, high schools and community colleges. Middle schools need to better counsel students about completing gateway courses well before high school. High schools need to offer study-skill support, encourage student participation in college preparatory courses, assure teachers are equipped to offer challenging college-preparatory and advanced-placement courses, and assure that counselors have more comprehensive knowledge about the college access process. Community colleges need to help high school students develop a comprehensive long-term education plan, including steps for high school, two-year, and four-year colleges. Additionally, community colleges need to ensure students take courses that address academic shortcomings—especially in math—and offer strong transfer counseling with an emphasis on financial aid.

Over the past eight years, little has changed to better prepare these students for a successful college career. The Obama Administration spent billions through the School Improvement Grants (SIG) program to fix underperforming schools. A Department of Education review of the program found, "…no significant impacts of SIG-funded models overall on math or reading test scores, high school graduation, or college enrollment…"[xxxii] Many American parents continue to be forced to place their children in government-assigned public schools based on their zip code rather than the parents' opinion regarding what is the best school for their child. In some cases, these schools fail to provide even basic education and safety, and often these children have no alternatives because their state fails to offer any education choices.[xxxiii] While twenty-five states have some form of

school choice and charter schools, the others lack either one or both of these options as shown in Figure 5-4.[xxxiv]

Figure 5-4



Continuing to pour billions of taxpayer dollars into the same failing schools is not serving our children or taxpayers well. While progress must be made at the Federal level, state and local governments must also improve. Better policies would include school voucher programs that encourage parent choice and innovation, unleashing the drive and creativity of the free-market system, and ultimately putting pressure on public schools to improve.[xxxv] A market-based approach would reward those schools that create value for their stakeholders while weeding out schools that fail to create value. This will allow children to attend better schools, facilitate school improvement, and address students' specific needs, ultimately better preparing them for the academic demands of college or whatever path they choose.

Income Inequality and the Incentives

Most students invest time and money into college to gain skills so they can work in the career of their choice, earning a higher

income than they would be able to earn with solely a high school diploma. In other words, it is the existence of income inequality that partly motivates and financially justifies investing in post-secondary education. The *Report* correctly states that there is a 70 percent earnings premium for a bachelor's degree over a high school diploma. However, the Obama Administration has aggressively moved to reduce the reward for pursuing higher education by implementing policies that reduce income for high earners.

Chapter 3 of the *Report* discusses how the Obama Administration has increased existing taxes on income—making the system more progressive—and imposed new taxes to fund Federal spending.[xxxvi] However, by reducing after-tax income, the earnings premium for attending college decreases, which in turn reduces the incentive and rationale for attending college. This harms both the individuals who then choose not to attend college and the nation by weakening additional skill acquisition of the labor force. A better strategy would promote policies that increase the reward for acquiring skills—college or otherwise—encouraging Americans to better themselves. This includes policies such as lowering marginal tax rates and removing onerous business regulations and barriers to entrepreneurship.

Moving Forward

To increase access and successful completion of college, America should move away from a top-down bureaucratic education system toward a more locally run system that includes private lenders. Additionally, policies that embrace choice and innovation would improve PreK-12 and better prepare students for college.

The current one-size-fits-all Federally-run program ignores regional differences, which precludes states and localities from creating the most suitable program for their residents. A higher education program that suits a rural state like Wyoming may be inappropriate for a state with a substantial urban and suburban

population, such as Maryland. In the *Report*, the Obama Administration cites the Knox Achieves and Kalamazoo Promise as successful examples of Promise programs stating that, "Evaluations of early local Promise programs show that these programs can significantly improve high school graduation, college enrollment, and college graduation rates."[xxxvii] However, both programs were initiated prior to the Obama Administration, and more importantly, neither was initiated nor managed by the Federal Government. Localities tailored these privately funded programs to meet the needs of their residents. Given the differences between the two programs—Knox Achieves covers two years of college while Kalamazoo Promise covers four—there is no reason to believe that these programs are best for other states.

The static Federally-run system lacks the dynamic nature of private financial markets and eliminates access to all of the lending products that private-sector financial institutions might generate. Unlike government at any level—Federal, state, or local—private-sector financial institutions can implement and test new forms of lending without risking taxpayer dollars. In an attempt to best serve their customers, financial intermediaries will generate various lending products. The products and firms that serve their customers well will expand and prosper; those firms that fail to produce valued products face the discipline of the market. This process of creative destruction works best when firms are permitted to enter markets freely and are not restricted by overly burdensome regulations or excluded by the presence of a government monopoly. For example, the 1994 *Riegle-Neal Interstate Banking and Branching Efficiency Act* provides evidence of the benefits of private lending and deregulation. The Act permitted banks to operate across state lines.[xxxviii] The result was expanded access to student loans and an increase in college enrollment of roughly 4.9 percent, with the largest effect on low- and middle-income families.[xxxix]

Today, the Federal student loan system passes all of the risk to taxpayers. A better system would distribute risk among various willing parties. Colleges and universities that receive the funds should bear some of the risk. They currently receive all of the money upfront irrespective of student qualifications upon entering the school, actual program completion, or eventual loan repayment. President Reagan's pilot program applied the concept of shared risk by requiring the educational institution to contribute 10 percent of the loan. This gives the institution a stake in the success of the student, alleviating part of the responsibility from the taxpayer. Private lenders should also bear some risk. If the pure Federal system of loans, created by the Obama Administration, can be replaced by a system including private financial intermediaries, then they should bear some of the risk. The Federal Government could guarantee a part of the loan rather than all of it—as they have done in the past—so they too have a stake in the students' success.

Other alternatives, beyond the traditional method of financing college through loans, warrant consideration. In his earlier referenced testimony before the Committee, Mitchell Daniels also recommended Income Share Agreements (ISA).[xl] ISA's are more like equity than debt; investors provide funding for students in exchange for a negotiated, freely chosen percentage of future income. There are several benefits to this structure. First, students are assured that their payments never become too onerous, since ISA payments remain a constant share of earnings rather than a fixed payment; second, investors have a new investment opportunity and stake in a student's success in completing a degree and in launching his or her career; and third, the risk is taken voluntarily by the investor and not forced on taxpayers.

IMPROVING PREK-12 EDUCATION

America must also improve PreK-12 education. State governments should expand school choice for students, especially those forced to attend failing government-assigned schools. There

is mounting evidence that school choice programs benefit students. School voucher programs create higher rates of youth entrepreneurship.[xli] Student exposure to schools in the voucher system is associated with higher graduation rates as well as enrollment and persistence in four-year colleges.[xlii] Evidence also suggests that school voucher programs benefit many disadvantaged student populations.[xliii] Globally, there is substantial evidence that private schools outperform public schools in the overwhelming majority of cases; thus, more access to private schools will benefit students.[xliv]

In addition to reforming higher education financing and PreK-12, new college graduates will benefit from entering a labor market where their newly acquired skills will fetch them a prosperous career. This can only be achieved by moving away from the high-tax, high-regulation environment that the Obama Administration created over the past eight years. It is time for a change in course in order to help current and future high school students, college students, and graduates.

CONCLUSION

Rather than preparing students for the 21st century, the Obama Administration's policies have led to unsustainable levels of student debt, rising tuition prices, fewer opportunities and rewards for achieving success, and greater risk for taxpayers.

Recommendations

The Committee Majority recommends that policy makers examine alternative approaches to expand opportunities and promote responsible choices, such as:

- Asking colleges and universities to share the risk associated with student loans;
- Including a greater role for private lenders in the student loan system;

- Shifting the risk of student loans to borrowers and lenders rather than taxpayers;
- Promoting reforms that increase rather than deter the reward for acquiring skills—college or otherwise—encouraging Americans to better themselves; and
- Expanding school choice and charter school opportunities for students, especially for those forced to attend failing schools.

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