

TESTIMONY OF RICHARD K. VEDDER
DIRECTOR, CENTER FOR COLLEGE AFFORDABILITY AND PRODUCTIVITY
BEFORE THE COMMITTEE ON THE BUDGET
UNITED STATES SENATE
JUNE 4, 2014

CAN COLLEGE BE MADE MORE AFFORDABLE? IT'S ABOUT MORE THAN STUDENT LOANS

Senator Murray, Senator Sessions, and members of the Budget Committee:

I am Richard Vedder. I direct the Center for College Affordability and Productivity, a Washington-based research organization, and am also an economics professor at Ohio University and an Adjunct Scholar at the American Enterprise Institute.

I wish to make three key points this morning. First, the current student loan debt crisis would never have happened had college costs increased at the general rate of inflation. The major cause of the student debt problem is increased university fees –period. To deal long term with this issue, you must address the root cause, namely runaway college cost inflation.

Second, there are many reasons for this university price inflation, some of which are mentioned in this written statement that I submit for the record. *But one relevant major contributor to the rise in tuition fees, in my judgment, is the federal student financial assistance program itself.* No significant successful solution to the problem of rising college costs can occur without rethinking the magnitude and nature of the federal financing role.

Third, we are at or near a tipping point, where fundamental change will come to higher education. Early indications are that these changes are starting to happen. I will elaborate a bit on this. I will argue that many policy proposals gaining prominence these days do not fundamentally address the problems leading to big changes, and, indeed, they would likely worsen rather than improve the existing situation.

First: Runaway College Tuition Inflation

Table 1 looks at the inflation-adjusted increases in tuition fees over the past 75 years. The data prior to 1978 are less solid than the post-1978 numbers, being based just on public institutions; 1978 is the year the Bureau of Labor Statistics began calculating a tuition price index. Note that changes in real tuition fees have accelerated over time. In the period before 1978, fees tended to rise roughly one percent faster annually than the overall rate of inflation; since 1978, the increases have accelerated a great deal, to the 3 to 4 percent range. There are some technical

issues related to the calculation of fee increases, but under almost any scenario the cost of going to college is rising faster in the last generation –and from a higher base –than in the previous two generations.

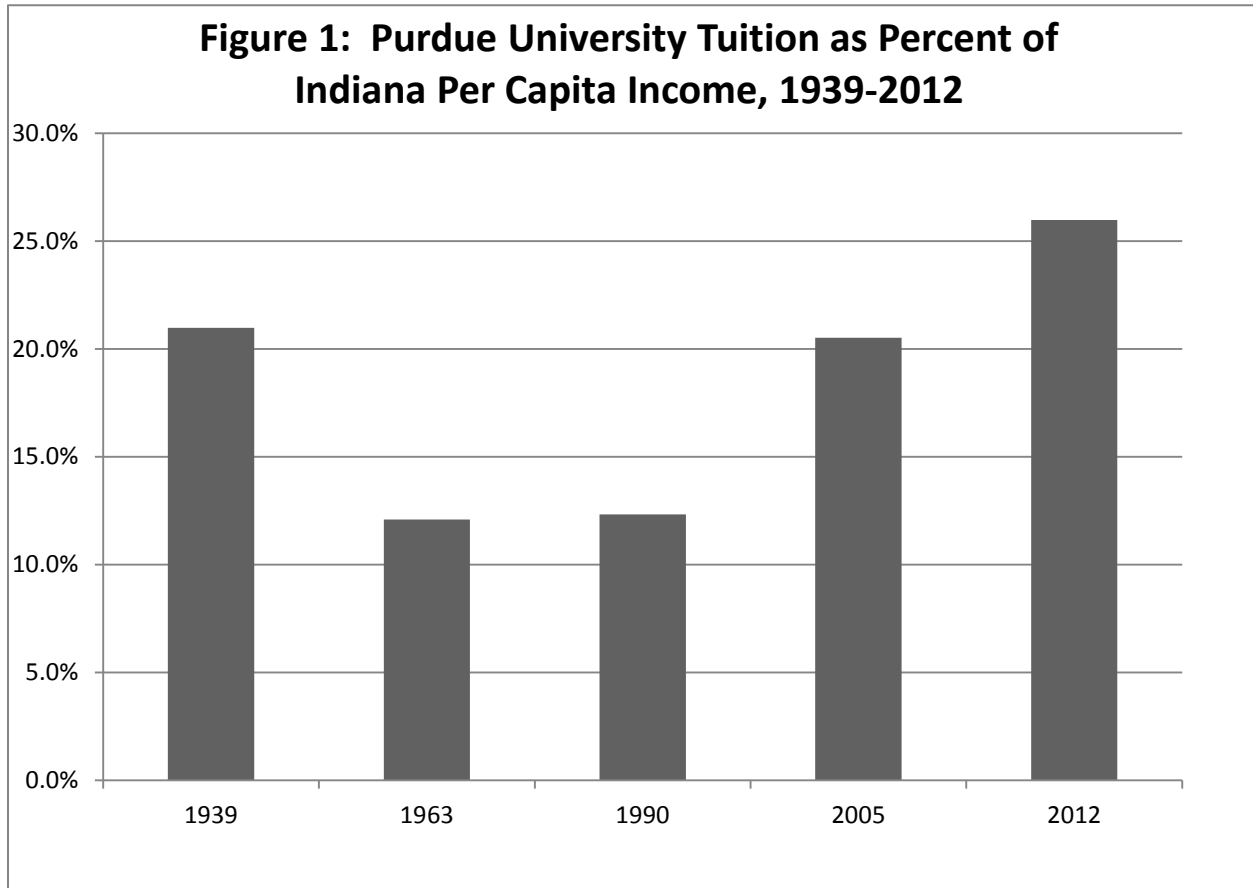
Table 1: Changes in Real (Inflation Adjusted) Tuition Fees at American Universities, 1939 to 2014		
Time Period	Annual Percent Change in Tuition Fees	Federal Student Financial Aid Presence?
1939-1964	1.26%	Zero to Moderate
1964-1978	0.43	Moderate
1978-1990	3.14	Fairly Large
1990-2002	3.71	Large
2002-2014	3.80	Very Large

Sources: Bureau of Labor Statistics; Purdue University, National Center for Education Statistics, author’s calculations; data before 1978 are based on data for public institutions.

Suppose tuition fees since 1978 had risen by one percent a year in inflation adjusted terms—roughly the average growth in the period 1939 to 1978. Today, fees would average about 59 percent lower than they actually are. The state university with a \$10,000 in-state tuition charge would be charging a bit over \$4,000 a year. Student debt loads would be a very small fraction of what they actually are—probably less than one-third on average compared with current debt levels. Indeed, I suspect the proportion of students graduating from college debt free would be dramatically greater than it actually is. As a consequence, the national uproar over rising college tuition fees would be nonexistent or dramatically less. At the most elite private schools, posted tuition fees, now over \$50,000 a year, would have been around \$20,000 if tuition fees had risen like they did in the 1939-78 period, and at more typical private schools, the tuition fee would be perhaps \$15,000 instead of \$35,000.

In Figure 1, I look at the ratio of in-state tuition charges at one of the primary public institutions in Indiana, Purdue University, to Indiana’s per capita income, for various dates over time. Note that in 1939, at the end of the Great Depression, it took about 22 percent of income per person to pay the Purdue tuition. With economic growth and only modest tuition inflation, the burden of attending Purdue fell markedly, to about 12 percent of income by the early 1960s. Since then, the acceleration of tuition fee increases meant an end to further declines in the burden; it was also about 12 percent in 1990, but has risen by startling amounts in recent years,

to 20 percent by 2005 and to about 26 percent by 2012. Attending Purdue has become a greater burden than it was over seven decades earlier in the Great Depression. Purdue is not an atypical institution.

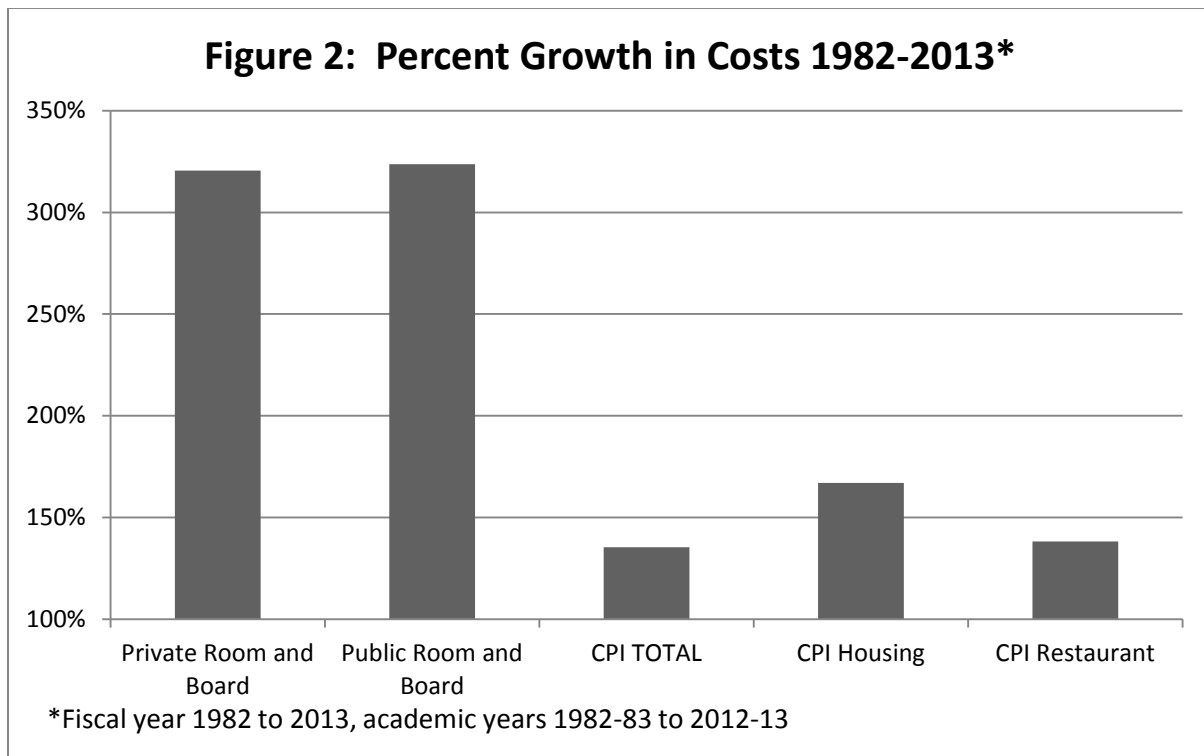


Source: Purdue University, Bureau of Economic Analysis, Author's Calculations

Some writers note a distinction between a rise in tuition *prices* to students and a rise in the total *cost* of higher education to society. In the past decade, for example, tuition prices paid by students have risen far more than the increase in total higher education costs per student. Others note that because of tuition fee discounts, the true increase in college prices even to students is often less than portrayed by official statistics. While both of these claims have some validity, the reality is, however measured, the cost or price of higher education is far higher today than it was a generation or two ago.

Interestingly, even college room and board fees have risen faster than inflation in food or housing prices, as Figure 2 shows. This suggests one or more of three things: the quality of college housing and food is improving relative to that for the general population, colleges are inefficient in providing housing and food services, or they are using their monopoly position over students to extort profits from them to fund university programs, meaning they are

effectively understating the true extent tuition fees (cost of the instructional services) have increased over time.



Sources: Trends in Higher Education, The College Board; and the Federal Reserve Bank of St. Louis

Second, Why Have Tuition Fees Risen So Much?

A number of scholars, including myself, have written longish books on the reasons tuition fees have risen so much, so today's discussion must merely abridge more complicated and nuanced analysis of that issue. Let me discuss three commonly mentioned explanations of rising tuition fees. One view is that of Professor William Baumol and others who have noted that higher education is a service industry, and that teaching is inherently a labor-intensive activity where costs cannot easily be reduced by substituting capital equipment for labor, unlike in manufacturing, agriculture or construction. Teachers are like actors; it takes as many actors to perform King Lear as when Shakespeare wrote it 400 years ago; similarly, college professors teach much like Socrates did 2,400 years ago.

While there is some truth to this argument, its importance is often overstated. In a typical university today, faculty salaries are rarely more than 40 percent of total spending –far more dollars are spent on non-instructional items than on faculty salaries. Moreover, even a good bit of faculty salaries go to support non-teaching activities, such as low teaching loads that allow for

research. Those teaching loads on average have declined over time. Moreover, new technologies allow professors to transcend the barriers imposed by distance and limited hearing capacity, and allow us to replicate at very low cost time and time again lectures using electronic means. On Monday I lectured from Athens, Ohio to a Georgetown University class in Qatar and I think I was nearly as effective as if I had lectured in person, but as a small fraction of the cost. In short, teaching is susceptible to substituting capital for labor.

A second argument is that the tuition price explosion reflects a sharp decline in state government appropriations for universities. Again, there is an element of truth to the assertion, but it is a grossly exaggerated claim. In real inflation-adjusted terms, state appropriations for universities are generally higher than they were a generation ago. Because of enrollment increases, in many states those appropriations are relatively flat on a per student inflation-adjusted basis. However, the real culprit forcing tuition up is not falling state appropriations as much as it is increasing total university expenditures per student. To be sure, from 2008 to 2011, there were significant reductions in real state spending per student as a result of the recession and sluggish recovery. But tuition fees have generally risen faster than the inflation rate even in periods when state appropriations were rising. And it is noteworthy that tuition fees have risen nearly as much over time at private schools that do not receive state aid.

This brings me to what is called the Bennett Hypothesis, named after former Education Secretary William Bennett, who asserted in a 1987 *New York Times* op-ed that colleges take advantage of federal student loan and grant programs, and have raised their fees to capture most of the aid money for themselves. In other words, the students are not the beneficiaries of the aid, but rather the colleges. There has been a lot written on this, and studies have reached different conclusions, but my reading of the evidence is that Bennett is mostly right. Let me show you some generally supportive evidence. Look at Table 1. In the era when the federal presence in financing higher education was mostly modest, such as the 1940s, 1950s, and 1960s, tuition price inflation was about one-third as great as it has been in the era of significant and rapidly growing federal student financial assistance programs. The federal financial assistance programs, in my judgment, have increased the demand for higher education more than the supply, leading to higher prices. Indeed, a very good case can be made that federal student loans have fueled an academic arms race financed in large part by rising tuition fees, an arms race that has led to a proliferation in higher education bureaucracies, expensive recreational facilities, lower teaching loads that have funded largely unread esoteric research, bigger subsidies of intercollegiate athletics, and other spending unrelated to promoting the core university mission of disseminating and expanding our stock of knowledge and cultural capital. Without massive federal aid programs, I doubt we would have so many million dollar university presidents.

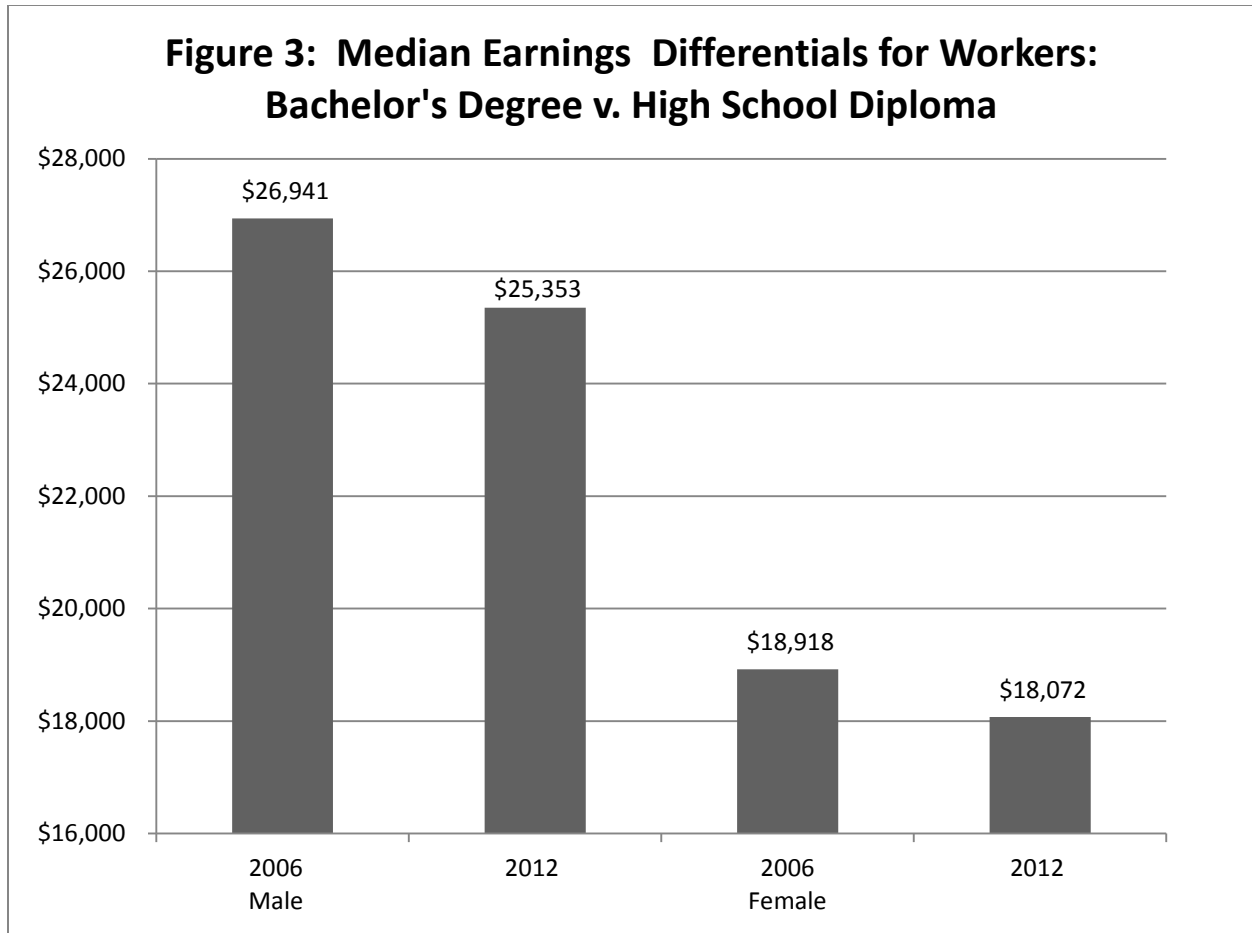
I also believe the overexpansion of federal financial assistance programs have contributed to a number of other problems, such as the current massive underemployment of

recent college graduates and the decrease in academic quality in our schools. A recent Pew Research Center study suggests the savings and net worth of those with student loan debts is strikingly lower than those without such obligations. Even worse, the proportion of recent college graduates from lower income backgrounds is lower today than it was in 1970 –before we even had Pell Grants and loan programs were in their infancy. Federal Reserve Bank of New York data suggest that, in a very real sense, the delinquency rate today on federal student loans is around 30 percent, nearly double the figure commonly cited. This all suggests that a very good case can be made that universities in America today on balance contribute to income inequality and a growing distance between individuals of different economic circumstance. If you believe that reducing income inequality should be a major American goal, on balance you should favor programs that would reduce, not increase, federal involvement in higher education.

Summing up, our federal financial aid programs have, in my judgment been colossal failures –raising costs, reducing access and quality, and leading to overinvestment of federal resources in higher education. They need radical revision.

Third, The Tipping Point: What Should We Do to Avert Disaster?

The cost of college cannot rise faster than people's income forever. That is simply unsustainable. The evidence is the benefits of going to college are falling, while the costs are rising. As to the benefits falling, look at Figure 3, which, using data from the Census Bureau, depicts for both male and female workers over 25 years of age the median earnings differential (in 2012 dollars) between high school graduates and holders of bachelor's degrees, for two years, 2006 and 2012. The absolute annual dollar earnings advantage associated with holding a bachelor's degree declined by \$1,598 annually for males, and \$846 for females over that six year period, the latest for which we have data. My guess is if the data were confined to graduates from, say, 25 to 29 years of age, the drop in the college earnings advantage would have been even greater because of other evidence that shows that young college graduates have particularly suffered financially in recent years. For example, the unemployment rate among very recent college graduates (those aged 21 to 24) in 2013 was 8.2 percent, higher than the 7.4 percent unemployment rate for the entire labor force. Other labor force data show a sharp increase in modern times in college graduates taking relatively low paying positions such as baristas, retail sales personnel, taxi drivers, and janitors.



Source: U.S. Bureau of the Census, Author's Calculation

If the financial benefits of college are starting to decline, but the costs are continuing to rise, the rate of return on the investment in college is certainly falling, which, in time, should lead to lower enrollment rates. That has already begun. According to the National Student Clearinghouse, total postsecondary enrollments for the spring semester 2014 were down from those a year earlier, extending to three years a trend of spring semester enrollment declines. That is a very unusual occurrence in contemporary America. Related to that is the evidence that, despite massive government subsidies, there are increasing signs that a growing number of weak colleges are in danger of closing or being forced to merge with stronger institutions. Moody's Investors Service has issued increasingly negative assessments of the financial stability of higher education institutions.

The most visible and talked about signs of financial stress arising out of this, however, are a consequence of the roughly \$1.2 trillion in student debt obligations. The ratio of debt to income has risen to precariously high levels for some borrowers, and there is even some

evidence that burdensome debt obligations are impacting on such things as household formation and home purchases.

Administration and Congressional Initiatives

This brings us to various solutions to the college cost explosion. Let me first talk about some ideas being promoted by the Obama Administration and some Democratic lawmakers, and then some alternative ideas that I think perhaps have merit.

I should start by commenting on the President's ratings plan. Details of the plan are still unknown. As I said in a recent opinion piece, the proposal appears to have both positive and negative aspects. On the plus side, colleges need to face consequences when their performance is shoddy. Too often the federal government has directly or indirectly written checks to colleges or their students without any assessment of performance or results. People are demanding greater accountability for colleges, and the ratings proposal is one way of addressing those concerns.

At the same time, I am very concerned that we are diluting and maybe annihilating one of the great strengths of American higher education—its diversity. We have thousands of universities and colleges of all different sizes, curricular offerings, religious orientations, political leanings and the like. Americans have thrived on this—no single Ministry of Education makes decisions that stifle institutional originality and competition. The ratings system appears a step away from that tradition of no centralized direction. One-size-fits-all sets of criteria determining degrees of excellence or expectations regarding performance are almost certainly inappropriate. I am not against ranking schools—to the contrary, my organization compiles the *Forbes* Best College rankings. I am concerned, however, that politically determined criteria for evaluating schools might hinder rather than expand academic excellence and competition, and do little to improve affordability.

Similarly, the Administration's attempt to impose standards on career colleges is also flawed. The administration is correct on insisting that schools with substandard performance records should face consequences. But the effort to largely limit these performance standards to for-profit institutions is completely inappropriate. If true "gainful employment" standards are to be applied, they should apply as well to all public and private four year institutions with scandalously low graduation rates and high levels of loan default. Our nation has urban universities with less than 10 percent graduation rates that arguably should be closed because of poor performance. Yet the "gainful employment rules" will not apply to them. If federal regulation is to be applied, it should be applied on a level playing field.

Finally, there have been attempts, both by the President and members of this body, to alleviate the burden of those borrowing for student loans. Last year's bipartisan legislation, while

imperfect, at least tied student loan interest rates to market conditions, although those conditions are admittedly highly distorted by what I view as irresponsibly expansive Federal Reserve monetary policy. The bill introduced by Senator Elizabeth Warren to lower interest rates on student loans to millions is, in my judgment, fundamentally flawed, for at least six reasons. First, and most important, it is only directed to past borrowers, and does *nothing* to address the future affordability of college and does absolutely nothing to contain college costs.

Second, the Warren proposal punishes those who have responsibly paid back their loans according to the terms of the loan agreement. Conscientious re-payers of loans under the Warren proposal will pay higher interest rates than others, not all of whom have a high level of conscientiousness regarding loan repayment. It is prejudicial against responsible conduct rather than supportive of it. Third, the Warren proposal increases the likelihood of irresponsible lending to students not equipped for college who face a high probability of dropping out. Remember, 40 percent or so of full-time students in four year programs drop out within six years without diplomas. If the Warren bill were to pass, students will likely be told by counselors “if it gets too tough for you to pay off your loan, Congress will likely either forgive the loan or reduce your burden by lowering interest rates.” What economists call a moral hazard problem will be worsened.

Fourth, the Warren proposal in effect penalizes those majoring in highly productive fields, such as in the STEM disciplines, as they are far less likely to have large loan repayment issues since they are in occupations that society, through the market process, especially values. One can argue the Warren proposal wishes to subsidize and encourage relatively less productive work rather than work that to a larger extent enhances our material well being. Fifth, the Warren proposal encourages higher college enrollments, at a time when labor market data suggest we are generally overinvested in terms of the educational attainment of new graduates. By one measure, nearly half of American college graduates are holding jobs requiring less than a college education to perform. Sixth, the Warren bill would materially worsen the budget deficit, a deficit that is shamefully large for a nation five years into an economic recovery. We are a nation living beyond its means, and the Warren bill exacerbates that problem. It enhances the probability that debt rating agencies might again downgrade our national debt, or fail to restore our once prized triple A rating.

Long Term Solutions Rather Than Ineffective Short Term Panaceas

There are rarely painless solutions to difficult issues. That applies here- some people are going to be unhappy with needed changes. But to fundamentally deal with the tuition cost explosion, we need to promote policies that will lead colleges to reduce the growth in tuition fees. The artificial fueling of demand for higher education through excessively exuberant federal student financial assistance policies is a major contributor to funding the wasteful academic arms

race. We can humanely cut back on these programs over time without significantly hurting truly low income students –those from households living in poverty or well below the median income level. Indeed, we can increase the *proportion* of funds going to lower income students, which progressive Democrats should like, while reducing overall expenditures, which Republicans should like, in the process reducing the tuition-enhancing features of the federal financial assistance programs. For example, federal tuition tax credits and the PLUS loan program benefit relatively affluent folks. Why don't we eliminate or drastically reduce these programs? As Janet Lorin of Bloomberg recently revealed, a majority of the \$62 billion in PLUS loans are not being actively repaid. Moreover, the Administration is apparently contemplating relaxing already lax credit standards. I agree with the University of Michigan's Susan Dynarski, who said "I don't understand the logic behind deferral on a PLUS loan."

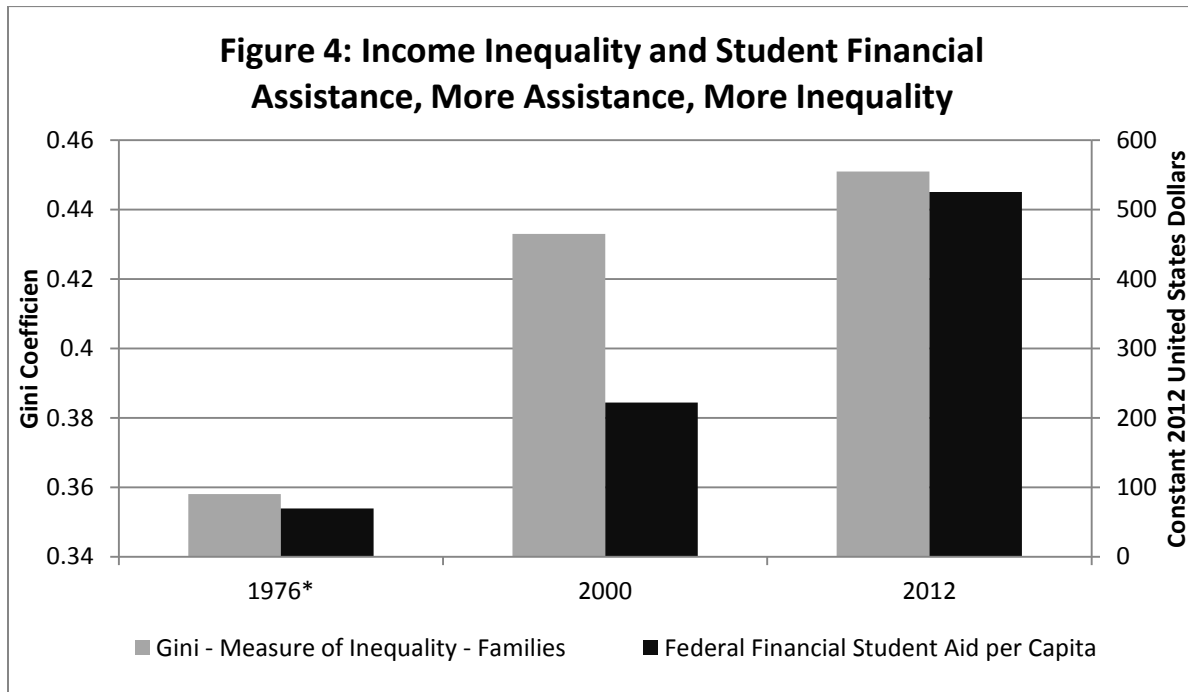
Indeed, why don't we simplify our Byzantine federal financial assistance system, going to only two federal financial aid programs? Go to a Pell Grant that is a voucher available to truly low income students and given directly to them, not to university financial aid offices, thus empowering the student more. Additionally go to a single loan program available only to those with relatively low incomes, and offered for only, say, four years of schooling.

Also, provide a legal environment which would encourage Income Share Agreements, an equity approach to student financing that would allow private entrepreneurs to buy a portion of the earnings of students in return for assistance in paying for college. Currently, students do the equivalent of selling bonds in themselves –this would allow them to sell the equivalent of stock, and reduce the obligations of the federal government. Several members of Congress, including Senator Marco Rubio and Congressman Tom Petri have indicated interest in such an approach, which is a variant on the Pay Forward scheme proposed in some states.

Rationalize the student financial assistance programs in other ways. Put in some form of performance standards. Drop aid for students whose grades suggest that the probability they will ever graduate is low. Maybe give small bonuses to students who graduate in three years. But above all, require colleges to have some skin in the game –to share in the costs of loan delinquencies when their admission actions lead to unusually poor records in terms of student loan repayment. Incentivize colleges to be careful who they admit and to push their students to graduate. There are other mechanisms, such as the use as national testing, which could be used to facilitate enforcing high performance standards and force schools and students with poor academic records to face adverse financial consequences. This approach deserves some consideration in any thoughtful revision of federal financing policies.

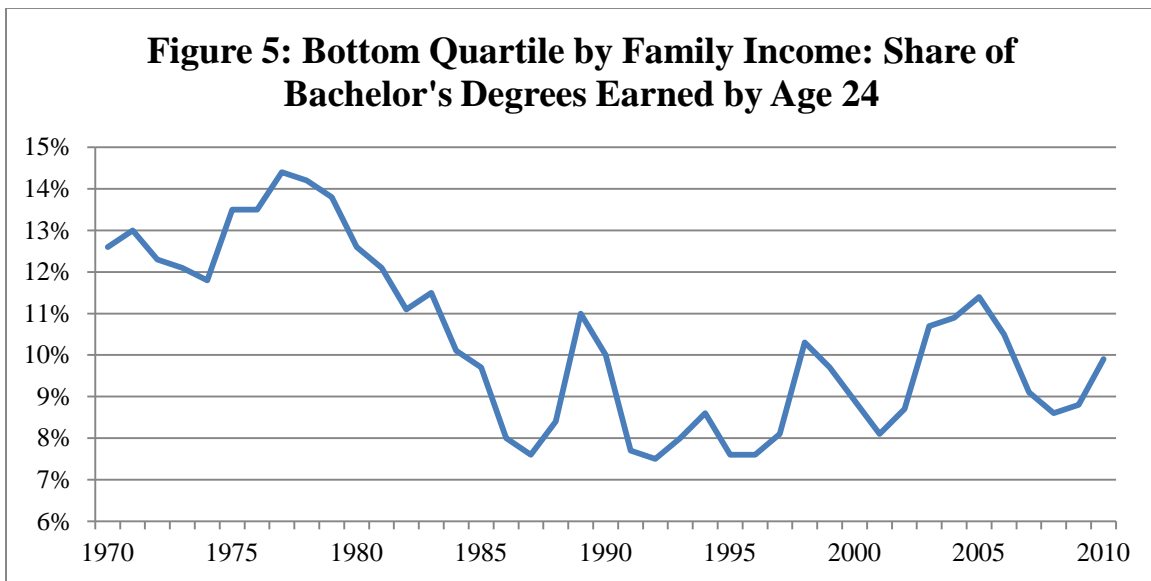
Those of you on the left that are worried about excessive accumulations of wealth and privileges, you are making a big mistake in pushing federal financial aid policies that have been historically associated with reductions, not improvements, in income equality. As Figure 4

shows, the rise in federal student financial assistance programs has moved in tandem with rises in measured income inequality. If you want to demonstrate your progressive egalitarian bona fides, do something different. For example, propose removing tax exemptions for schools with very high endowment accumulations, say more than \$300,000 a student. You might want to propose outlawing legacy admission preferences to reduce the perpetuation of academic aristocracies. Use the federal tax exemption powers you have more aggressively and judiciously. Outlaw stadium skybox tax subsidies, indeed tax subsidies for anything not strictly academic, including housing and food facilities. Limit all federal student loans and grants to, say, \$8,000 a year and cripple the ability of expensive schools which are largely enclaves for affluent students to raise tuition fees thinking they will be easily financed by greater loans. You want to help the poor? I repeat: *a smaller percentage of recent college today are from the bottom quartile of the income distribution than in 1970 –before the Pell Grant existed, and when college loan programs were in their infancy* (see Figure 5).



*1976 Data for federal student aid per capita reflect author’s estimate

Source: U.S. Bureau of the Census, College Board *Trends in Higher Education*: Financial data are constant 2012 dollars, author’s calculations.



Source: Postsecondary Education Opportunity; U.S. Bureau of the Census

There are other things you could do that might be useful. Give students and parents better post-graduate information on students by requiring the IRS to provide aggregate data on earnings of students graduating, say, five years earlier from every college or university participating in federal loan and grant programs. Regardless of what university administrators tell you, the key item of interest to most students is their likely post-graduate earnings prospects. I could expand on these and other ideas. The point is that the solution is not to do more of what we have done in the past, like making loan programs more attractive. The solution lies in changing the environment that incentives colleges and universities to raise their fees to students.

This brief survey of higher education ignores many areas of potential cost saving, and understates some serious problems. I have said little or nothing about MOOCs (massively open on-line courses), about the serious underutilization of student, faculty and physical resources, about the worrisome decline in academic standards, the reduction in intellectual diversity arising from attempts by some in the academy to enforce academic uniformity, about curbing the massive increase in university administrative personnel, about the negative effects on innovation and competition of our accreditation system, and so forth. Those are topics for another day and venue.

Conclusions

Let me leave you on a moderately optimistic note. If you were to do absolutely nothing, I think market forces, muted as they have been by the distortive effect of government subsidies,

would nonetheless work in the near future to lower sharply future tuition increases. Enrollments are stagnant and many schools are desperate for students. New forms of innovative competition will eat into the market of traditional high cost schools. Fighting for survival, schools will be forced to be more innovative, more affordable, and better performing. Creative destruction or disruptive innovation has worked brilliantly in developing a vibrant competitive market economy that has made us the most prosperous of all large nations. It can work in higher education as well –if we give it a chance.