Higher Education Subsidies

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May 2009

Overview

The Department of Education spends about $30 billion a year on subsidies for higher education. The bulk of that funding goes toward student aid programs, with the balance going toward grants to educational institutions. In 2008, grants to institutions cost $2.3 billion and aid programs cost $27.6 billion, which included $17.4 billion for student grants, $9.6 billion for student loans, and $0.6 billion for administration.[1]

In the next section, we explore the origins of federal subsidies for higher education and its rapid growth since the 1960s. Following that we focus on the harmful effects of higher education subsidies. Those effects include education cost inflation, increased regulatory control of colleges and universities, and huge fraud and waste in student aid programs.

Origins and Growth of Subsidies

Federal subsidies for higher education began in 1862 with the Morrill Act, which provided grants of federal land to the states. The states were supposed to use the proceeds of land sales to create colleges focused on agricultural and mechanical studies, but “many states squandered the revenue from this endowment.”[2] In 1890, a second Morrill Act began regular appropriations for the land-grant colleges.

In 1917, Congress passed the Smith-Hughes Act, which funded the salaries of vocational education teachers. The Act imposed a range of detailed rules on funded schools, which created an early precedent for today’s huge burden of federal regulations on state and local education systems.

The first major subsidy for students in higher education was the Servicemen’s Readjustment Act of 1944—the G.I. Bill—which allowed World War II veterans to attend college at no cost. The G.I. Bill is widely admired legislation, but like all subsidy programs it led to substantial wasteful spending and abuse. Some colleges and universities used federal funds for extraneous purposes, such as swimming pools and stadiums, while others increased tuition rates charged to veterans.[3] There were also cases of outright fraud by schools aimed at garnering extra federal funds.

In 1958, the National Defense Education Act was approved in response to the Soviet Union’s launch of Sputnik, which spread fear that the communists were getting ahead of Americans in technical skills. The Act authorized funding for higher education loans and fellowships, vocational teacher training, and programs in the K-12 schools, including math, science, and foreign language activities.

The year 1965 was a landmark for federal expansion into both the K-12 schools and higher education. The Higher Education Act of 1965 is the basis for many of today’s postsecondary education subsidies, including student loan and grant programs, college library aid, teacher training programs, and other subsidies.

Since 1965, the federal government has provided increasing amounts of funding for higher education as grant and loan programs have been expanded, and new programs added. Federal aid for higher education soared from $10 billion in fiscal 2000 to $30 billion in fiscal 2008.[4]

Of the total $30 billion in 2008, $2.3 billion went toward higher educational institutions, including large shares to Gallaudet College and Howard University. The remaining $27.6 billion went toward student aid: $5.5 billion for direct student loans made by the government, $4.9 billion for federally guaranteed loans made by private lenders, $15.7 billion for grants, and the rest for federal administration.[5] Note that the figures for loans are the net amount of federal support, based on assumptions about loan repayments. The gross amount of loans is much larger—in fiscal 2008, the gross amount of loans was $110 billion.[6]

In recent years, Congress has expanded subsidies for higher education. The College Cost Reduction and Access Act of 2007 cut interest rates on federally subsidized loans in half, thus encouraging more student borrowing. The Ensuring Continued Access to Student Loans Act of 2008 increased the borrowing limits on certain student loans and gave the Department of Education new authority to fund student lending. In 2008, Congress increased Pell Grant maximums from $5,800 to $8,000 over time, authorized forgiveness of up to $10,000 in federal loans for people working in an area of “national need,” and expanded other subsidies.

In 2009, President Obama proposed to eliminate all student loans through private financial firms guaranteed by the government, and thus make all federal loans “direct loans” from the Treasury. He also proposed to increase Pell grants and to budget for them as an “entitlement” program, thus putting spending on automatic pilot and not needed annual budgeting action from Congress.

Outside of the Department of Education, the federal government offers other aid programs for higher education, such as tuition assistance for military personnel in the Department of Defense. Also, the federal government funds more than $30 billion of research at the nation’s universities through various departments. [7]

Finally, a growing part of federal support for education comes through the tax code. In 1995, there were just 7 special breaks in the income tax code for K-12 and higher education. Today, there are 16 breaks, including the lifetime learning tax credit, Hope scholarship, education savings accounts, and education facility bonds. Politicians of both parties continue to offer more breaks, so the tax code will likely get more crowded with such giveaways.

Subsidies and Education Inflation

There are numerous problems with federal subsidies for higher education. For one thing, such subsidies benefit people who will earn higher than average incomes during their careers. Thus, the effect of subsidy programs, in part, is to impose taxes on blue collar workers, who have not attended college, to pay for the tuition of future white-collar professionals. Why should the government subsidize future high earners at the expense of average working people?

Supporters of student aid subsidies argue that higher education is a “public good” that would be underprovided in a free market. However, that is probably not the case. People have a strong incentive to invest in their own education because it will lead to higher earnings. Those with a college degree will earn, on average, 75 percent more during their lifetime than those with just high-school degrees.[8] That is a big incentive for people to save or borrow in private markets to pay for their own college costs. There is no “market failure” here.

Interestingly, the main effect of federal student aid programs may not be to transfer wealth from taxpayers to students as mentioned, but from taxpayers to academic institutions. That’s because the rise in student subsidies over the decades appears to have fueled inflation in education costs. Tuition and other college costs have soared as subsidies have risen.

It is matter of supply and demand. More and more Americans have sought a college education, which has pushed prices higher. Ordinarily, such upward pressure would be restrained by consumers’ willingness and ability to pay, but as government subsidies have helped absorb tuition increases, the public’s budget constraint has been lifted.[9] Peter Wood, a professor at Boston University noted that federal subsidies “are seen by colleges and universities as money that is there for the taking . . . tuition is set high enough to capture those funds and whatever else we think can be extracted from parents.”[10]

One can look at average cost data to see the inflationary effect of rising student aid. From 1987 to 2007, there was a strong upward trend in average per-student costs of private and public universities (tuition, fees, and room and board). However, if you subtract from those costs federal grants, loans, and tax benefits, there has been only a modest increase over two decades.

Consider four-year private colleges and universities. The average real cost (in 2006 dollars) per student rose from $18,122 in 1986 to $30,497 in 2006, a 68 percent increase. But students didn’t bear that large increase because of grants, loans, and tax benefits. After these benefits, the cost grew from $10,943 to $14,158, a much more modest 29 percent increase. A similar pattern holds for price increases and public institutions.

Nonetheless, even after taking inflated prices into account, federal aid has probably helped increase student enrollment. Total U.S. college and university enrollment increased about 48 percent between 1986 and 2006. But have those enrollment increases been an entirely good thing?

Many of those additional students may not have been ready, or suited, for college. As evidenced by the rising shares of college students who require remedial work. Further evidence of the problem is that institutions have lowered their standards to adapt to the rise in second-rate students. The American Academy of Arts and Sciences reported that from the mid-1960s to the mid-1990s, college grade point averages grew steadily but Scholastic Aptitude Test scores declined.[11] The share of entering college students who complete degrees has also fallen over the decades.[12] In addition, while college attendance is up, overall adult literacy has barely budged over the last 15 years.[13]

With all this in mind, phasing out federal aid would probably not result in reduced accessibility for truly college-ready students. Indeed, college cost inflation induced by federal aid probably hurts low-income families—the people that federal aid was supposed to target—more than others. Further, many private philanthropists support promising, low-income college kids, and they would have greater interest in doing so if the federal government was not in the aid business.

The value of a college education is very real, so young people and their families have a strong incentive to invest in higher education themselves, and private lenders have an incentive to lend to them. By cutting federal subsidies, tuition and related costs would fall as students shopped around for the best deals, which in turn would force schools to reduce their bloated cost structures.

There is plenty of evidence of bloat in academia. Consider congressional earmarks, which often fund dubious projects at colleges and universities. The number and value of educational earmarks has soared in recent years.[14] In 2008, earmarks included $140,502 “to maintain healthful interscholastic youth-sports programs” at the University of Maine; $98,000 to build a “Student Wellness and Recreation Center” at Heidelberg College in Ohio; and $1,915,934 for the Charles Rangel Center for Public Service at the City University of New York.

Here are some other signs that both students and institutions could tighten their belts:

- College students devote 3.2 hours to education on an average weekday, versus 3.9 hours to “leisure and sports;”[15]
- The six-year graduation rate for bachelor’s students is only about 56 percent, indicating that many students are not very serious about

education;[16]

- Almost half of full-time college students binge drink or abuse drugs, and the incidence of such behaviors is rising.[17]
- Between 1983 and 2007, energy consumption costs at America's colleges rose twice as fast as energy costs in the private business sector, indicating that colleges are not very cost-conscious.[18]

Rising Federal Regulatory Control

Even with its problems, the American postsecondary education system is considered to be the best in the world. Driven by freedom of choice by consumers and competition between independent institutions, it has an unmatched vibrancy.

However, increasing top-down control and subsidization from Washington is creating a threat to the strength of the American system. As we have seen in K-12 education, the growth in federal subsidies is usually accompanied by calls for more oversight, micromanagement, and rising levels of red tape imposed by Washington.

A classic case of top-down federal control coming as a package deal with federal money was Title IX of the education amendments law of 1972. It banned discrimination on the basis of sex for any education-related program receiving federal assistance. Title IX has created many dislocations in activities such as college athletics, and it has generated large bureaucracies of lawyers to administer, enforce, and litigate the complex rules. The law is enforced by the Office of Civil Rights in the Department of Education, which had 629 employees in 2008. Title IX is a regulatory octopus with arms in education programs, athletics, cheerleading, the Boy Scouts, fraternities, and many other activities. Whole books have been written about its broad-ranging and problematic effects.[19]

Today, a growing regulatory threat to higher education are the calls for "national standards," similar to the top-down rules imposed on K-12 education. In 2005, then secretary of education Margaret Spellings created a commission to formulate a "comprehensive national strategy" for higher education. The Bush administration signaled that it wanted to tighten federal control over higher education as it had done over K-12 education under the No Child Left Behind Act. The commission's final report stopped short of advocating outright federal imposition of standards and tests, but it did call for the creation of "a national strategy for lifelong learning" and a federal database with information on every college student in the country.[20]

Secretary Spellings also tried to impose outcome-measurement requirements on colleges through the regulation of accreditors, which are organizations whose stamp of approval is needed for the receipt of federal aid. In her plan, accreditors would be required to have schools report explicit outcome measures, which would probably mean standardized tests for incoming and outgoing students.

For the time being, Congress has rejected these proposed advances of federal intervention into higher education. However, Americans need to be aware that federal subsidies and regulations create a growing threat to academic independence, and would jeopardize the nation's outstanding system of autonomous and competing institutions of higher learning.

Waste, Fraud, and Abuse

Just about every federal program that hands out subsidies to individuals or businesses suffers from large waste, fraud, and abuse problems. Those problems are an ongoing issue in Medicare, Medicaid, housing subsidies, food stamps, farm aid, and other budget areas. When programs hand out billions of dollars of grants or loans, they attract cheaters and fraud artists. What makes it worse is that federal policymakers have shown themselves to be incapable of standing up for taxpayers and ending the waste.

Federal student loan and grant programs have been subject to waste and fraud for decades, and have taken many forms. One problem with needs-based student aid, for example, is that it creates incentives for families to misreport their income to garner excess federal cash. With the Pell grant program, this fraud problem costs taxpayers hundreds of millions of dollars per year.[21] Another ongoing problem is the high default rate on student loan programs. In 2001, the Government Accountability Office found that there were about $22 billion of student loans in default.[22]

Students aren't the only culprits in education aid abuse. Under most student loan and grant programs, the aid is sent directly to thousands of educational institutions, which are supposed to distribute it to the eligible students. However, that distribution system has attracted swarms of shady school operators, who have lined their own pockets with funds meant for students. A related type of waste that has grabbed news headlines recently regards the large returns earned by the financial institutions that are subsidized to service student loans.

The magnitude of waste and fraud in federal student aid programs became clear in the early 1990s. One scandal at the time regarded the trade school American Career Training Corporation in Florida. The school recruited new "students" at food stamp offices and housing projects, and helped them take out loans.[23] The school owners received tens of millions of dollars in federally guaranteed student loans, and simply pocketed much of it.

Many similar rip off schemes came to light. In 1991, a year long Senate investigation found that the federal student loan program is "plagued with fraud and abuse at every level," robbing taxpayers of billions of dollars.[24] The investigation accused the Department of Education of "gross mismanagement, ineptitude and neglect" and found that it had a "dismal record" of dealing with loan abuses.[25] The report found that losses from the student loan program totaled an enormous $13 billion between 1983 and 1990.

Another fraud scheme at the time involved 21 Jewish schools in New York State, which received millions of dollars in federal Pell grant money. The schools spent hardly any of the money on education. For example, one of the schools pocketed $3.2 million in Pell grants in a year and spent just $21,000 on education.[26] Another scandal involved employees of Advanced Business College in Puerto Rico, who used Pell grant monies to buy high-end sports cars and real estate, wasting more than $3 million of taxpayer funds. Once again, auditors fingered the Department of Education for its poor management and oversight of loan programs.

In 1994, the department admitted that it was losing a staggering $3 billion or more annually to waste, fraud, and loan defaults, accounting for more than 10 percent of its entire budget. Education Secretary Richard Riley called the department's oversight "worse than lax."[27] For years the department had been wiring billions of dollars of loans and Pell grant funds to obscure trade schools based on unproven claims about how many enrolled students were qualified. Students and schools had to fill out paperwork to get the aid, but the Department of Education never verified it.

Some program changes have reduced the extraordinarily high fraud rates of the 1990s, but large amounts of funding are still wasted. One 2002 investigation revealed how easy it is to scam student loan programs: the GAO created a fake university in London with three fake students, and then applied for, and was awarded, $55,000 in federal student loans.[28] And a 2005 investigation revealed that owners of a company called the CSC Institute stole $4.3 million of the $13 million it received in Pell grants.[29]

Student aid scandals have continued in recent years. In 2007, Secretary Spellings testified to Congress, "federal student aid is crying out for reform. The system is redundant, it's Byzantine, and it's broken. In fact, it's often more difficult for students to get aid than it is for bad actors to game the system."[30] One issue is the very large return earned by some financial institutions using a loan program loophole. Under the Federal Family Education Loan Program, dozens of loan originators figured out how to earn a 9.5 percent guaranteed return from the government, even though market interest rates were much lower. The 9.5 percent rate was supposed to have been eliminated in the 1990s, but lenders figured out how to revive it, which caused subsidies on guaranteed loans to explode and lenders to earn billions of dollars at taxpayer expense.

The Democrats have used this latest scandal to try to reduce or eliminate private student loans in favor of direct loans from the government. The Republicans have reflexively supported private lenders over government-sourced loans. Our view is that the Department of Education has been a terrible financial manager of all its aid programs, including Pell grants, direct loan programs, and loan guarantees to private lenders. All of those programs should be scrapped, and students ought to rely on grants and loans from private financial institutions and philanthropic sources.

In theory, it is possible to improve federal management of higher education subsidies, but programs that hand out billions of dollars to a vast array of recipients will always be vulnerable to major rip-offs. As the Inspector General of the Department of Education noted, "the department's student loan programs are large, complex, and inherently risky … the loan programs rely upon over 6,000 postsecondary institutions [and] more than 3,000 lenders."[31] There is no reason for taxpayers to support such a large, complex, and risky scheme, especially when private alternatives are available.

Conclusions

Federal aid to students and higher educational institutions is harmful on many fronts. It drives up tuition costs, encourages bloat and inefficiency, and is an unfair burden on taxpayers. It also poses a threat to the core strengths of American higher education, including institutional autonomy, competition, and innovation. All efforts to impose top-down federal regulations on colleges and universities should be rejected, and federal subsidies to students and institutions should be phased out and eliminated.

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[1] *Budget of the U.S. Government, Fiscal Year 2009, Appendix*, p. 356.

[2] *Milestone Documents* (Washington: National Archives and Records Administration, 1995), p. 57. Quote from an excerpt at www.ourdocuments.gov/doc.php?doc=33.

[3] *U.S. News and World Report,* "More Billions for GI Schooling," August 31, 1951.

[4] For the fiscal 2000 data, see *Budget of the U.S. Government, Fiscal Year 2002, Analytical Perspectives*, Chapter 26.

[5] *Budget of the U.S. Government, Fiscal Year 2009, Appendix*, p. 356.

[6] *Budget of the U.S. Government, Fiscal Year 2009, Appendix*, p. 357.

[7] U.S. Department of Education, *Digest of Education Statistics*, 2008, Table 373.

[8] Jennifer Cheeseman Day and Eric Newburger, "The Big Payoff: Educational Attainment and Synthetic Estimates of Work-Life Earnings," Special Studies, U.S. Bureau of the Census, July 2002.

[9] For background, see Richard Vedder, *Going Broke by Degree: Why College Costs Too Much* (Washington: American Enterprise Institute, 2004).

[10] Quoted in Jeff Jacoby, "Making College Affordable," *Boston Globe*, February 10, 2005.

[11] Henry Rosovsky and Matthew Hartley, "Evaluation and the Academy: Are We Doing the Right Thing?" American Academy of Arts and Sciences, 2002.

[12] John Bound, Michael Lovenheim, and Sarah Turner, "Understanding the Decrease in College Completion Rates and the Increased Time to the Baccalaureate Degree," Report 07-626, Population Studies Center at the University of Michigan, November 2007.

[13] U.S. Department of Education, Institute of Education Sciences, National Assessment of Adult Literacy, nces.ed.gov/naal/kf_demographics.asp.

[14] Jeffrey Brainard and J.J. Hermes, "Colleges' Earmarks Grow, Amid Criticism," *Chronicle of Higher Education*, March 28, 2008.

[15] Bureau of Labor Statistics, “American Time Use Survey,” chart topic: students, www.bls.gov/tus/charts/students.htm, November 13, 2008.

[16] National Center for Higher Education Management Systems, “Six-Year Graduation Rates for Bachelors Students,” 2007, www.higheredinfo.org.

[17] National Center on Addiction and Substance Abuse, “New CASA Report Finds Half of College Students Binge Drink, Abuse Prescription and Illegal Drugs,” Press Release, March 15, 2007.

[18] Alex Davidson, “Economics 101,” *Forbes*, December 22, 2007.

[19] For example, see Jessica Gavora, *Tilting the Playing Field: Schools, Sports, Sex, and Title IX* (San Francisco: Encounter Books, 2002).

[20] The Secretary of Education’s Commission on the Future of Higher Education, “A Test of Leadership: Charting the Future of U.S. Higher Education,” U.S. Department of Education, September 2006.

[21] John Higgins, Inspector General, Department of Education, Testimony before the House Committee on Government Reform, Mary 26, 2005.

[22] Government Accountability Office, “Federal Budget: Opportunities for Oversight and Improved Use of Taxpayer Funds,” GAO-03-922T, June 18, 2003, p. 17.

[23] Karl Vick, “Florida Trade School Probed for Loan Abuse,” *St. Petersburg Times*, February 27, 1990.

[24] Quoted in Jason DeParle, “Panel Finds Wide Abuse in Student Loan Program,” *New York Times*, May 21, 1991.

[25] Quoted in Jason DeParle, “Panel Finds Wide Abuse in Student Loan Program,” *New York Times*, May 21, 1991.

[26] Michael Winerip, “Billions for School Are Lost in Fraud, Waste and Abuse,” *New York Times*, February 2, 1994. See also Mary Jordan, “A College Aid Rip-Off; Education Dept. Invites Fraud, Nunn Says,” *Washington Post*, October 28, 1993.

[27] Michael Winerip, “Billions for School Are Lost in Fraud, Waste and Abuse,” *New York Times*, February 2, 1994.

[28] Government Accountability Office, “Department of Education: Guaranteed Student Loan Program Vulnerabilities,” Letter to Senator Susan Collins (R-MA), November 21, 2002,www.gao.gov/new.items/d03268r.pdf

[29] John Shiffman, “Pair Accused of Taking $4.3 Million from Grants,” *Philadelphia Inquirer*, July 1, 2005.

[30] Margaret Spellings, Secretary of Education, Testimony before the House Committee on Education and Labor, May 10, 2007.

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