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Time to Reform Higher Education Financing and Accreditation

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As Congress considers reauthorization of the Higher Education Act (HEA), it should pursue two overarching goals: decoupling federal financing from accreditation, a policy included in the Higher Education Reform and Opportunity (HERO) Act, and structurally reforming the federal loan programs to encourage private lending.

Specifically, decoupling federal financing from accreditation and issuing all new loans under the current terms of Graduate Stafford Loans would generate savings relative to the Congressional Budget Office (CBO) baseline of $9.4 billion under the Federal Credit Reform Act (FCRA), or a cost of $2.5 billion under fair value (FV) accounting, and bring savings closer to revenue neutrality than any other loan type. Capping federal lending at $7,500 per student per year and including an aggregate lifetime borrowing cap would save American taxpayers $33 billion over the next decade, reduce total federal student lending by 35.5 percent, and enhance the private lending market's ability to serve students.

The Higher Education Reform and Opportunity Act

In 2014, Senator Mike Lee (R–UT) and Representative Ron DeSantis (R–FL) introduced the Higher Education Reform and Opportunity Act. Unlike the policy contained in the HEA, which conditions access to federal student aid on accreditation through federally approved accrediting entities, the HERO Act would allow all states and the District of Columbia to opt out of the current federally sanctioned accreditation structure and allow any entities approved by a state to accredit colleges and courses of study and credential individual classes. As Senator Lee explained in a speech at The Heritage Foundation:

> Imagine having access to credit and student aid for a program in computer science accredited by Apple or in music accredited by the New York Philharmonic; college-level history classes on-site at Mount Vernon or Gettysburg; medical-technician training developed by the Mayo Clinic.... Students could mix and match courses, programs, tests, online credits à la carte, pursuing their degree or certification at their own pace while bringing down costs to themselves, their families, and the taxpayers.[1]

This student-centered approach to accreditation reform could foster much-needed innovation in higher education and link student learning to skills needed in the marketplace. With outstanding student loan debt now exceeding $1.3 trillion and another $1.2 trillion in new federal student loans expected to be originated in the next 10 years,[2] students and taxpayers have much to gain from accreditation reforms that increase learning options and lower costs.

This paper, in its entirety, can be found at **http://report.heritage.org/ib4668**

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Coupling Accreditation Reform with Changes to Federal Student Aid

In recent years, Washington has increased its involvement in higher education to the point that 90 percent of all student loans are originated by the federal government.[3] This is problematic for several reasons. First, federal lending offers students below-market interest rates together with generous repayment options such as income-based repayment as low as 10 percent of discretionary income with loan forgiveness after 10–25 years. In an effort to ease the burden of high college tuition, policymakers have made many students virtually immune to tuition price increases by encouraging them to take on larger amounts of debt and insulating them from repayment through generous caps and forgiveness policies.

In fact, substantial evidence suggests that the federal government's unrestrained lending practices incentivize colleges and universities to *raise* their tuition prices. A 2015 report from the Federal Reserve Bank of New York found that every additional dollar an institution receives in federally subsidized student loans leads to a tuition increase of an astounding 63 cents.[4] Similarly, economists at the Mercatus Center at George Mason University found that the rise in college tuition is closely linked to the rise in federal student aid programs, even after accounting for declines in state appropriations, which are often blamed for increases in tuition.[5]

In light of the growing body of research suggesting that existing student loan policies do little to make college affordable, policymakers should consider widespread restructuring of the federal government's lending practices. Consolidating the current loan options into a single loan program that includes annual and lifetime borrowing caps would encourage private lending, reduce student loan burdens, and put long-overdue pressure on colleges and universities to rein in costs.

Projected Scores for HERO with Various Direct Student Loan Program Reforms

The budgetary impact of decoupling federal financing from accreditation would likely be small, primarily facilitating short-term, lower-cost educational opportunities. If the HERO Act, for example, were to lead to a doubling of participation in academic programs of less than two years (the smallest unit of analysis to model that is close to students using Title IV funds for individual classes and courses of study), it would increase participation in undergraduate Title IV programs by only 2 percent,[6] Pell Grant outlays would increase by $6.1 billion, from $304.6 billion to $310.7 billion, and Direct Student Loan Program outlays would decline by $0.8 billion, from -$62.5 billion to -$63.3 billion, for a net increase of $5.3 billion in outlays relative to the CBO baseline from fiscal year (FY) 2018 through FY 2027.[7]

1. Senator Mike Lee, "What's Next for Conservatives," Speech at The Heritage Foundation, October 29, 2013, https://www.lee.senate.gov/public/index.cfm/speeches?ID=a752e38d-3589-4320-811f-2187636b377c (accessed March 22, 2017).
2. The CBO expects $1,179.1 billion in new federal student loans to be originated during fiscal years 2018–2027. Congressional Budget Office, "CBO's January 2017 Baseline Projections for the Student Loan Program," January 2017, Table 2, https://www.cbo.gov/sites/default/files/recurringdata/51310-2017-01-studentloan.pdf (accessed March 22, 2017).
3. College Board, *Trends in Student Aid 2016*, Trends in Higher Education Series, December 2016, p. 15, figure 5, https://trends.collegeboard.org/sites/default/files/2016-trends-student-aid_0.pdf (accessed March 15, 2017).
4. David O. Lucca, Taylor Nadauld, and Karen Shen, "Credit Supply and the Rise in College Tuition: Evidence from the Expansion in Federal Student Aid Programs" Federal Reserve Bank of New York *Staff Report* No. 733, July 2015, revised February 2017, p. 19, https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr733.pdf (accessed March 22, 2017).
5. Mark J. Warshawsky and Ross Marchand, "Dysfunctions in the Federal Financing of Higher Education," Mercatus Center at George Mason University, January 2017, p. 42, https://www.mercatus.org/system/files/mercatus-warshawsky-financing-higher-education-v1.pdf (accessed March 22, 2017).
6. Students attending for-profit institutions with programs of less than two years currently receive roughly 2 percent of undergraduate Title IV benefits, according to authors' calculations based on U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 2015*, NCES 2016-014, December 2016, p. 717, Table 331.50, https://nces.ed.gov/pubs2016/2016014.pdf (accessed March 16, 2017).
7. Authors' estimates based on Congressional Budget Office, "CBO's January 2017 Baseline Projections for the Student Loan Program."

TABLE 1

CBO's January 2017 Baseline Projections for the Direct Student Loan Program, Fiscal Years 2018–2027

	LOAN TYPE					
Characteristics	**Subsidized Stafford**	**Unsubsidized Stafford**	**Graduate Stafford**	**GradPLUS**	**PLUS**	**Total**
Borrower	Undergraduate	Undergraduate	Graduate	Graduate	Parent(s) of Undergraduate	
Origination Fee	1.00%	1.00%	1.00%	4.00%	4.00%	1.73%
Interest Rate: 10–Year Treasury + …	2.05%	2.05%	3.60%	4.60%	4.60%	3.12%
Interest Accrues While Enrolled	No	Yes	Yes	Yes	Yes	77.3.% Yes, 22.7% No
Loan Volume						
Billions	$268.2	$279.6	$344.8	$136.5	$150.1	$1,179.1
Share (%)	22.7%	23.7%	29.2%	11.6%	12.7%	100.0%
Number of Loans						
Millions	76.7	76.2	22.6	6.6	10.4	192.5
Share (%)	39.8%	39.6%	11.7%	3.4%	5.4%	100.0%
Average Loan Amount	$3,497	$3,667	$15,272	$20,627	$14,449	$6,125
Subsidy Rate (%)						
FCRA	6.7%	–4.0%	–12.0%	–13.2%	–31.5%	–8.3%
FV	24.7%	16.1%	7.4%	7.2%	–15.1%	10.6%
Subsidy (Billions)						
FCRA	$18.0	–$11.1	–$41.4	–$12.7	–$47.3	–$94.4
FV	$66.2	$45.1	$25.4	$6.9	–$22.7	$120.8

SOURCE: Authors' calculations based on https://www.cbo.gov/sites/default/files/recurringdata/51310-2017-01-studentloan.pdf (accessed March 8, 2017).

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The Direct Student Loan Program generates a profit of $62.5 billion, or 8.3 percent of loan volume, in the CBO baseline, which is based on the Federal Credit Reform Act of 1990 (FCRA) and uses U.S. Treasury rates to discount future cash flows. (See Table 1.) Under the FV estimation method, which discounts future cash flows at a higher rate to better account for risk in the timing of those flows, the program loses $160.2 billion, or 10.6 percent of loan volume. However, the Department of Education currently issues five different types of direct student loans with varying requirements and terms.

Under FCRA, only Subsidized Stafford Loans are considered unprofitable, while under FV, only PLUS Loans to parents are considered profitable. Issuing all future direct loans under a single set of terms would simplify the program and eliminate some perverse incentives in current law.[8] As noted, issuing all new loans under the current terms of Graduate Stafford Loans would generate savings relative to the

8. For example, 20 U.S. Code § 1078–8(d)(4)(A) rewards irresponsible behavior by allowing a dependent undergraduate student whose parents are unable to qualify for a PLUS Loan to borrow more money on more favorable terms as an Unsubsidized Stafford Loan.

TABLE 2

Projected Scores for HERO with Various Direct Student Loan Program Reforms, Fiscal Years 2018–2027

FIGURES ARE IN BILLIONS OF DOLLARS

	CBO BASELINE				CHANGE FROM CBO BASELINE			
LOAN TYPE	Pell Grant Volume	Loan Volume	FCRA Outlays	FV Outlays	Pell Grant Volume	Loan Volume	FCRA Outlays	FV Outlays
CBO Baseline: Various Direct Loan Types	$304.6	$1,179.1	$242.1	$464.8	$0.0	$0.0	$0.0	$0.0
HERO: Various Direct Loan Types	$310.7	$1,193.1	$247.4	$472.6	$6.1	$14.0	$5.3	$7.9
HERO + issue all new loans under the terms of a single one of the five existing direct loan programs								
Subsidized Stafford	$310.7	$1,184.3	$423.0	$634.9	$6.1	$5.2	$181.0	$170.1
Unsubsidized Stafford	$310.7	$1,184.3	$286.4	$520.5	$6.1	$5.2	$44.3	$55.7
Graduate Stafford	$310.7	$1,184.3	$232.7	$467.3	$6.1	$5.2	–$9.4	$2.5
GradPLUS	$310.7	$1,205.9	$168.2	$407.4	$6.1	$26.8	–$73.9	–$57.4
PLUS	$310.7	$1,205.9	–$23.4	$170.0	$6.1	$26.8	–$265.5	–$294.8
HERO + issue all new loans under the terms of a single one of the five existing direct loan programs, capped at $7,500 per student per year								
Subsidized Stafford	$310.7	$756.1	$397.8	$548.1	$6.1	–$423.0	$155.7	$83.3
Unsubsidized Stafford	$310.7	$756.1	$302.8	$468.7	$6.1	–$423.0	$60.8	$3.9
Graduate Stafford	$310.7	$756.1	$265.5	$431.7	$6.1	–$423.0	$23.5	–$33.0
GradPLUS	$310.7	$756.1	$216.9	$383.3	$6.1	–$423.0	–$25.2	–$81.4
PLUS	$310.7	$756.1	$86.2	$221.4	$6.1	–$423.0	–$155.8	–$243.4

NOTE: Projected outlays include only the budgetary impact of those specific measures listed above attributable to Pell Grants awarded and new Direct Student Loans originated in Fiscal Years 2018–2027. Notably, these figures do not account for the possible elimination of Direct Consolidation Loans or phaseout of various loan forgiveness programs, either of which would reduce outlays.
SOURCE: Authors' calculations based on https://www.cbo.gov/sites/default/files/recurringdata/51310-2017-01-studentloan.pdf (accessed March 8, 2017).

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CBO baseline of $9.4 billion under FCRA, or a cost of $2.5 billion under FV accounting, closer to revenue neutrality than any other loan type. (See Table 2.)

Loans to graduate students—who should face little difficulty in obtaining private financing even for costly courses of study if those courses are worthwhile—represent only 15.2 percent of the number of loans but 38.7 percent of loan value. A cap of $7,500 per student per year would reduce graduate school lending to 22.4 percent of loan value and total lending by 35.5 percent relative to the CBO baseline while costing $23.5 billion under FCRA or saving $33.0 billion under FV accounting over 10 years.

These cost estimates do not account for the tremendous potential savings associated with the elimination of loan forgiveness under income-driven repayment plans.[9] In November 2016, the Government Accountability Office (GAO) reported that loans originated in FY 2017 alone, expected to be repaid under income-driven repayment plans, will receive a subsidy of $14.6 billion under FCRA.[10] In December 2016, the CBO scored a cap on Public Service Loan Forgiveness of $57,000 per person and an extension of the repayment period from 20 to 25 years for borrowers who take out loans for graduate school as saving $19.3 billion under FCRA or $13.9 billion under FV accounting over 10 years.[11] Neither the CBO nor the GAO has estimated the savings associated with eliminating loan forgiveness altogether, and more detailed data should be released to enable researchers to apply standard analytic techniques to do so.[12]

Conclusion

Heavy federal government intervention in the higher education financing system increases bureaucratic red tape and puts harmful incentives into the marketplace, doing little to improve affordability. The policies embodied in the HERO Act would spur state-level innovation in higher education by allowing federal financing with state-level accreditation at a modest cost of an estimated $7.9 billion over 10 years under fair value accounting. Eliminating loan forgiveness policies and consolidating federal lending into a single loan program could alleviate much of the student loan burden that is placed on taxpayers and would ensure that the CBO also scores the bill as a net budgetary savings even under FCRA.

Any changes in the Higher Education Act of 1965 should incorporate these much-needed reforms of the higher education sector.

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9. As many as three non-income-based repayment plans, four income-based options with potential loan forgiveness, and two additional loan forgiveness programs are stated in the master promissory note for each type of loan; it would be difficult to change these for existing loans. However, on all future loans, they should be replaced with a simpler choice of either the standard 10-year fixed-payment repayment plan or a single income-based repayment plan option without the possibility of loan forgiveness. As the Federal Direct Student Loan Program is simplified, Direct Consolidation Loans, under which borrowers may refinance their existing student loan balances, should be eliminated. They are primarily a tool not for simplification but to lock in below-market fixed rates for an extended repayment period or to gain access to more generous repayment plans with loan forgiveness that were unavailable under the original loan terms.
10. U.S. Government Accountability Office, *Federal Student Loans: Education Needs to Improve Its Income-Driven Repayment Plan Budget Estimates,* GAO-17-22, November 2016, p. 15, figure 6, http://www.gao.gov/assets/690/681064.pdf (accessed March 8, 2017). Eliminating income-driven repayment could not completely remove this subsidy cost, as some portion of these borrowers would never repay their loans anyway, but the subsidy costs would only have to be reduced by roughly one-sixth in order to offset the costs shown under FCRA from the policies discussed earlier in this *Issue Brief*.
11. Congressional Budget Office, *Options for Reducing the Deficit: 2017 to 2026*, No. 52142, December 2016, p. 9, https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/52142-budgetoptions2.pdf (accessed March 8, 2017). The $19.3 billion in savings over 10 years under FCRA from a proposal that still allows up to $57,000 of loan forgiveness per borrower indicates that the complete elimination of loan forgiveness would easily offset the estimated $23.5 billion in costs shown under FCRA from the policies discussed earlier in this *Issue Brief*.
12. As a general rule, repayment plans that extend the period over which the loan must be repaid will be considered profitable under FCRA and costly under FV accounting, while loan forgiveness is unprofitable under either accounting method. However, specific potential changes in repayment plan options and loan forgiveness programs are difficult to score, given the lack of individual-level data. The development of a public-use microdata file for research purposes is under consideration by the Department of Education and should be encouraged.