



# Perils in the Provision of Trust Goods

Consumer Protection and the Public Interest in Higher Education

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By Robert Shireman    May 2014



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# Introduction and summary

For Americans seeking to improve their standard of living, higher education is the surest route available. Widespread education and training beyond high school is key to a stronger economy, reduced income inequality, healthy families, and vibrant communities.

At the same time, the American postsecondary education system is increasingly dependent on debt financing. A recent Center for American Progress analysis found that with more than \$1 trillion in student-loan debt outstanding, as many as 40 percent of borrowers are not able to keep current on their payments.<sup>1</sup> Given the individual and taxpayer costs of higher education and its critical role in the nation's future, it is essential to ensure that teaching and learning in the nation's colleges are of the highest possible quality.

This report examines why education is generally provided through nonprofit and public entities, as well as what makes for-profit companies in higher education different. Because quality is difficult to monitor and measure, investor pressures frequently lead for-profit institutions to compromise student and public needs in the pursuit of growth and profit. While all colleges seek revenue, nonprofit institutions are subject to a nondistribution constraint, meaning that they are overseen by boards without an ownership interest. This reduces the likelihood that students will be misled or overcharged in the pursuit of personal gain. The primary purpose of nonprofit status is to eliminate the potentially hazardous aspects of investor-owners that provide services such as education. The rejection of the nondistribution constraint by for-profit institutions explains their generally worse outcomes.

As higher education has become more important to a secure future for individuals and for the nation, policymakers should adopt market-based reforms that promote quality outcomes at a reasonable cost. First, Congress should restore the expectation that colleges demonstrate the market viability of their programs by enrolling some students without federal financial aid. Second, the U.S.

Department of Education should adopt a strong gainful-employment regulation to ensure that career programs lead more frequently to a better future than to crippling debt. Third, quality and value in higher education would improve if consumers and expert analysts had access to more information about all colleges, including the qualifications of instructors, accreditation reports, and audits submitted to the Education Department. Finally, a more radical solution could improve quality across all higher-education sectors: Through independent, expert review of student work and teacher-student interactions, colleges and faculty members would have every incentive to engage in practices that promote deeper learning and stronger critical thinking skills.

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### Market failure in higher education

The nation's largest regional accreditor of colleges and universities, the North Central Association of Colleges and Schools, makes a point of emphasizing in its accreditation standards that higher education is different from a dry cleaning business, requiring a more complex standard of care. "What the students buy, with money, time, and effort," it states, "is not merely a good, like a credential, but experiences that have the potential to transform lives, or to harm them."<sup>2</sup>

It is a different type of business because of the trust involved in delivering a quality product. In education, as in medicine and other select industries, customers "can easily be taken advantage of—at the extreme, consumers may not be informed about whether they have bought anything at all." By the time an adult figures out the value of the education he or she purchased, it is too late to do anything about it.<sup>3</sup>

Consider, for example, a professor who is supportive but fails to take advantage of the opportunity to encourage a student's further intellectual engagement in the subject matter. As long as the student gets a decent grade in the class, he will walk away satisfied, never knowing what might have been if he had been challenged more. While the student plays a major role in his own education, what he does or does not do—and whether it is adequate—is guided by the expertise of the instructors employed by the college. Ultimately, as John G. Sperling—the founder of the University of Phoenix—declared, a bachelor's degree is "what any college or university says it is."<sup>4</sup>

Higher education exhibits what Henry Hansmann, in his seminal article on nonprofit enterprises, called contract failure. When it is difficult to evaluate the quality of the promised or provided product, a profit seeker can more easily charge too much or deliver inferior goods or services. “As a consequence,” says Hansmann, “consumer welfare may suffer considerably.”<sup>5</sup>

In these circumstances, a nonprofit entity may be the more effective provider because of the nondistribution constraint. This constraint is the primary distinction between nonprofit and for-profit organizations: A nonprofit may not distribute any profits to those who control the organization, and there are no owners who can sell stock for personal gain. Therefore, the nonprofit has less incentive to take advantage of consumers. Economists argue that putting nonowners in control serves as an internal regulatory mechanism, muting the temptation to “cut corners on quality or otherwise take advantage of user vulnerability.” As a result, nonprofits “are more immune against moral hazards than for-profit firms would be under similar circumstances.”<sup>6</sup>

Investor pressure to reduce costs and to grow an enterprise is constructive when the product or outcome is well defined. However, when the product is intangible—such as with higher education—those same pressures can destroy consumer value without the consumer even being aware. Nonprofit status addresses this problem by eliminating owners and investors from the equation, leaving the institution’s management answerable to a board that uses criteria other than personal financial benefit to set organizational priorities.

As corporate entities, nonprofits evolved from the common law concept of trusts, in which a person holds property for the benefit of another. While a trustee controls property, he does not control it for his own personal benefit but instead is required to act in good conscience in favor of an intended beneficiary.<sup>7</sup> To accommodate organizations dedicated to a public purpose—such as churches, schools, or soup kitchens—states extended the trust concept beyond property held on behalf of specific people to trusts for a public purpose. Volunteers generally govern these organizations; it is their duty to protect the organization’s underlying purpose while avoiding personal profit. When the United States began taxing corporate earnings, the law recognized these special entities and exempted them from the tax because their earnings are already fully dedicated to a social purpose. (see Table 1)<sup>8</sup>

## Determining profit status

The point of a nonprofit is not tax treatment. Tax status is the result of an accountability choice. Leaders of an entity must declare one of the following to determine status:

- All plans and budgets will be determined by people whose goal is to produce net earnings they can share with other owners. (for-profit)
- All plans and budgets will be subject to oversight by people without any claim on net earnings. (nonprofit)



TABLE 1

## Similarities and differences: What distinguishes for-profit corporations from nonprofit corporations

For-profit corporations	Nonprofit 501(c)(3) corporations
Fundamentally different: Governance and conflicts of interest	
Owned by shareholders.	No owners; controlled by trustees on behalf of an educational, charitable, or religious purpose.
Salaries and other compensation are unlimited.	Compensation must be reasonable.
Any revenue exceeding expenses may be distributed to owners.	Revenue exceeding expenses may not be distributed; it must be allocated toward the corporation's purpose.
Board and executive compensation not disclosed—with the exception of some executives of publicly traded corporations.	Compensation of board, executives, and key employees must be disclosed; major contractors also disclosed.
Board members and managers may take actions to increase the value of their shares. When educational goals conflict with profit goals, they may choose any course of action; there are no restrictions and no public disclosure.	Board members are prohibited from involvement in issues that would affect them financially. Potential conflicts between the corporation's purpose and personal financial interests of the board and executives must be publicly disclosed.
No restrictions on lobbying or on independent political expenditures or activities.	Lobbying is restricted; partisan activities by the corporation are prohibited.
Not really that different: Tax treatment	
Investors may deduct losses on income taxes and pay reduced taxes on capital gains.	Donors may deduct donations on income taxes.
Corporation pays income taxes* and payroll taxes; employees pay income taxes.	Corporation pays payroll taxes; employees pay income taxes.
Net revenue that is reinvested in the corporation as an expense is not taxed.	All net revenue must be reinvested in the corporation.
May benefit from various state, local, and federal tax incentives or exemptions.	

\* The less a for-profit college spends on education, the more corporate income taxes it will owe.

Source: Author's summary based on Internal Revenue Service Guidance documents.

Arthur C. Brooks, president of the American Enterprise Institute, or AEI, and author of *The Road to Freedom: How to Win the Fight for Free Enterprise*, points out that the intangible nature of products such as the arts leads to market failure and to “structural differences between an orchestra and, say, a steel mill.”<sup>9</sup> Higher education has traditionally been provided through nonprofit and public entities for precisely the reason that nonprofit status exists: to address market failure in the socially optimal production of intangible goods. Imposing a nondistribution constraint “increase[s] the probability” that customers and donors get what they are paying for.<sup>10</sup> Nonprofits need money. But as Brooks points out, while a for-profit has one clear goal—value for shareholders—nonprofits must balance “a double bottom line” of making ends meet financially and pursuing their social impact.<sup>11</sup> Importantly, the people ultimately responsible for that difficult balancing act are prohibited from having a personal financial conflict of interest.

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## The nondistribution constraint has been effective

Every indication is that nonprofit status has resulted in a reduced incidence of predatory behavior in higher education. Peer-reviewed research by economists found that after controlling for student demographic factors, those in nonprofit and public certificate programs, when compared with similar students at for-profit institutions:<sup>12</sup>

- Had lower debt burdens
- Had higher earnings and lower unemployment six years later
- Had lower student-loan default rates
- Were more satisfied with their programs

Comparing open-enrollment four-year institutions across sectors, another study found that graduation rates at for-profit colleges were less than one-third the rates at colleges subject to the nondistribution constraint.<sup>13</sup> Even the for-profit industry's own study found that after accounting for differences in student demographics, students attending for-profit colleges are at least twice as likely to default on student loans as students at other types of colleges.<sup>14</sup>

There will always be arguments about causation due to the enormous number of relevant variables and potential outcomes. Indeed, these measurement challenges are the reason for the nonprofit provision. However, the data that are available strongly support the underlying hypothesis that education is improved when the provider opts for the nondistribution constraint. In fact, the evidence is so strong that AEI's Frederick M. Hess, an ardent advocate of for-profits, bluntly called it "absolutely a no-brainer that the proprietary [for-profit] higher ed sector is rife with sleazy operators."<sup>15</sup>

Does the nondistribution constraint have the same effect in other industries? Nonprofit hospitals and health plans are found to do a better job than their for-profit counterparts even with robust regulation, including government licensing of individual doctors and price caps imposed by insurance companies and government programs. Patients who have poor or fair health are more satisfied with nonprofit plans, while the for-profits provide less preventive care, spend less on patient care, reject more claims, and have more customers drop or change their plans.<sup>16</sup> In nursing-home care, a meta-analysis in the *British Medical Journal* found



that nonprofit nursing homes tended to deliver higher-quality care.<sup>17</sup> In child care, according to an AEI study, “the quality of for-profit programs is generally lower than that of government-provided and private nonprofit programs.” Similar to the challenge in higher education, the report explains the reason for the market failure is the difficulty of measuring and monitoring quality:

*Before enrolling their child, a parent can inspect if a facility is safe and clean. A particularly thorough parent might track down information on the program’s child-to-teacher ratio or the number of books in the classroom. Yet the important day-to-day interactions between children, teachers, and content remain largely hidden from view. ... Moreover, the young children who are the direct consumers of these early care and education services are often unable to determine the quality of these services.<sup>18</sup>*

# Inside for-profit colleges

John D. Murphy was justifiably proud of the innovative model for working adults that he and his co-founder, John G. Sperling, created at the University of Phoenix. But Murphy says that the company's evolution as a business offers "a cautionary tale of what can happen when the financial values of the corporate world are applied to the provision of postsecondary education." Ultimately, the good reputation and educational mission of the university was sacrificed on what Murphy labels the "altar of commerce," in which the growth in the value of stock in the Apollo Education Group, the parent company of the University of Phoenix, became the only thing that seemed to matter.<sup>19</sup>

Murphy's experience provides a useful backdrop for anyone who spends time listening to the earnings calls that publicly traded companies have with investors and analysts. Pick any call, and the themes are the same. For example, on DeVry University's February 2013 call, CEO Daniel M. Hamburger described how the company's three-part performance plan—reduced costs, short-term growth, and long-term growth—add up to "value creation" for investors.<sup>20</sup> Perhaps most tellingly, Hamburger used the phrase "improve class size" to mean an increase in the number of students per instructor in each class. Increasing class sizes may have been a justifiable cost-reduction measure, but no leader of a nonprofit college would ever describe an increase in class size as an improvement.

Managers of for-profit colleges must cater to the single-minded focus of investors. According to an article by Seeking Alpha's Troy Bayer, just two factors matter in the for-profit education sector: enrollment numbers and profit margin. They must draw more students in while they "keep operating expenses down to maximize profit."<sup>21</sup> Cutting costs is exactly what Hamburger promises. He said that "all these actions and others are designed to create a leaner cost structure. Last quarter, we increased our goal for efficiencies and value creation for the year to at least \$60 million."<sup>22</sup>

Will these “efficiencies” actually be achieved without hurting quality, or will they rob students of intellectual interactions in ways that are real but extremely difficult to monitor or measure? There is no way for us to know because higher education is a trust good. We have no choice but to trust what the CEO tells us about the quality of the product.

How low can instructional spending go in the pursuit of investor value? A U.S. Senate investigation found that at the publicly traded for-profit education companies, annual instructional spending ranged from \$892 to \$3,969 per student in 2009—as little as one-tenth of the instructional spending at private nonprofit colleges with similar tuition revenues. The drive to satisfy investors’ demand for constant enrollment growth meant that at some for-profits, the spending on recruiting and marketing was double or triple the spending on instruction.<sup>23</sup>

Some executives of for-profit colleges acknowledge the problematic behavior that their organizational incentives can encourage given the trust-good nature of higher education. In his book *Change.edu: Rebooting for the New Talent Economy*, which describes the promise of the for-profit college industry, Andrew S. Rosen, chairman of Kaplan, Inc., admits a constant hazard exists that executives will “shortchange the educational offering in order to minimize costs and maximize short-term profits.” Publicly traded companies in particular suffer from pressure to “exploit the short-term opportunity for profits that’s inherent in this model in a way that hurts students, taxpayers and the entire industry.” Managers at for-profit colleges have both the means and the incentive to “rev up the recruitment engine, reduce investment in educational outcomes,” and deliver “a dramatic return on investment,” according to Rosen.<sup>24</sup>

Divergent behavior between the for-profit and nonprofit sectors is evident not only with regard to the level of focus on recruitment but also with regard to the strategies that are considered ethical. College counselors have long taken the position that when college recruiters are paid by commission—a bounty payment for each successful recruit—their interactions with students are fundamentally, negatively altered. Bounties turn advisors into the classic used-car salesperson, using every trick in the book to get the sale.<sup>25</sup> In 1992, Congress agreed that bounty-paid admissions were problematic and outlawed the practice for any type of college. Yet for-profit colleges have violated the ban time and again.<sup>26</sup> When the U.S. Department of Justice joined a whistleblower suit in 2011 against the Education Management Corporation—owner of the Art Institutes and other colleges—*The New York Times* summarized the charges:

- *The company had a ‘boiler-room style sales culture’ in which recruiters were instructed to use high-pressure sales techniques and inflated claims about career placement to increase student enrollment, regardless of applicants’ qualifications.*
- *Recruiters were encouraged to enroll even applicants who were unable to write coherently, who appeared to be under the influence of drugs or who sought to enroll in an online program but had no computer.*
- *Recruiters were also led to exploit applicants’ psychological vulnerabilities—for example, a parent’s hopes of moving a child out of a dangerous neighborhood.<sup>27</sup>*

Rather than demonstrating a commitment to abide by the bounty ban, the Association of Private Sector Colleges and Universities, the trade association made up of for-profit colleges, has recently filed a lawsuit and pursued legislation to weaken the law.<sup>28</sup>

Why the different behavior by sector? The whistleblower laws apply to all types of institutions, and if bounties were happening at public institutions, the deep pockets would certainly draw the interest of trial lawyers. One explanation can be predicted by economic theory: Governance by self-interested investors motivates the for-profit sector to care less about the damage that can result from paying bounties to recruiters. It is a behavioral outcome of the moral hazard that stems from the for-profit model.

Profit per se is not the problem with for-profit colleges. The problem is the decisions and behavior that can result from the drive for investor value. The result is countless Americans who enroll in college each year, only to be left with a feeling of failure, betrayal, and mounting student loans. Data released by the U.S. Department of Education reveal that there are programs at for-profit institutions where the number of former students who defaulted on their loans in a single year exceeded the number of students who finished the program over two years.<sup>29</sup> In other words, there are more defaulters than graduates. The table below lists those programs for which the number of defaulters exceeds the number of graduates by 100 or more. (see Table 2)

**TABLE 2**  
**College programs with more defaulters than graduates**

Institution	Degree type and category		Number of graduates in fiscal years 2007 and 2008	Number of defaults among former students entering repayment in FY 2009	Difference
Art Institute of Pittsburgh	Associate's	Graphic design	159	307	148
	Bachelor's	Criminal justice	77	226	149
Ashford University	Bachelor's	Business administration and management	70	190	120
	Bachelor's	Health care administration and management	45	158	113
Colorado Technical University	Associate's	Medical insurance billing	409	742	333
	Associate's	Criminal justice	289	596	307
	Associate's	Information technology	138	395	257
	Associate's	Business administration and management	760	925	165
DeVry University	Bachelor's	Computer software engineering	201	891	690
Everest College Phoenix	Associate's	Securities services administration and management	43	160	117
Everest University	Associate's	Business, management, and marketing	79	204	125
Grand Canyon University	Bachelor's	Elementary education	38	175	137
	Bachelor's	Business administration and management	67	194	127
	Bachelor's	Psychology	33	133	100
ITT Technical Institute	Associate's	Criminal justice	518	867	349
	Associate's	Design and visual communications	32	379	347
	Bachelor's	Criminal justice	453	696	243
Kaplan University	Associate's	Interdisciplinary studies	294	724	430
	Bachelor's	Criminal justice	713	978	265
	Associate's	Business and commerce	672	860	188
	Associate's	Medical transcription	73	242	169
	Bachelor's	Information technology	341	496	155
	Associate's	Information technology	293	447	154
	Associate's	Criminal justice	614	748	134

Institution	Degree type and category		Number of graduates in fiscal years 2007 and 2008	Number of defaults among former students entering repayment in FY 2009	Difference
University of Phoenix	Associate's	Office management and supervision	6,200	9,835	3,635
	Associate's	Corrections and criminal justice	1,512	4,641	3,129
	Associate's	Psychology	273	2,326	2,053
	Associate's	Medical office assistant	1,858	3,789	1,931
	Associate's	Teacher's aide	304	1,543	1,239
	Associate's	Medical records technician	51	1,207	1,156
	Associate's	Human services	135	1,177	1,042
	Associate's	Network systems administrator	410	1,181	771
	Associate's	Information technology	992	1,715	723
	Associate's	Accounting and bookkeeping	1,350	1,936	586
	Associate's	Behavioral sciences	159	628	469
	Associate's	Web-page design	269	732	463
	Associate's	Professional and technical writing	70	316	246
	Bachelor's	Behavioral sciences	353	583	230
	Bachelor's	Elementary education	71	293	222

Source: Author's calculations from Department of Education data. See U.S. Department of Education, "2012 GE Informational Rates," available at <http://www2.ed.gov/policy/highered/reg/hearule-making/2012/gainfulemployment.html> (last accessed May 2014). A similar top-level analysis that did not address data by institution was nonetheless informative to the author's own work. For more information, see Admin, "Where More Default Than Graduate: Career Education Program Parasites," The Institute for College Access & Success, May 15, 2014, available at <http://views.ticas.org/?p=1301>.



# Nonprofits have problems too

When Ashford University, a for-profit college with more than 77,000 students enrolled, was denied accreditation in 2012, the accrediting agency faulted Ashford for focusing too much attention and resources on growing its enrollment rather than on the integrity and quality of its academic programs. The accreditor cited the online interactions between faculty and students, which it said were “often limited to a few words of encouragement and lacking in substantive exchange between student and teacher.”<sup>30</sup>

Derek Bok, former president of Harvard University, warns that online education aimed at unwary audiences “carries a grave risk of exploiting students.”<sup>31</sup> But Bok was focusing his attention not on for-profit colleges but instead on traditional colleges that seek to pad their institutions’ bottom lines by enrolling large numbers of students in courses that are cheap to deliver. The problem, Bok says, is that to bring in more students, the colleges opt for simple rather than intellectually demanding coursework with significant student-teacher interaction. As a result, student learning is limited. Even in the brick-and-mortar campus environment, according to Bok, there is inadequate attention to student learning: “[L]ectures are frequently boring, most of the teaching is too passive, and feedback to students is often too skimpy and too late to be effective.”<sup>32</sup>

William G. Tierney, a professor of higher education and co-director of the Pullias Center for Higher Education at the University of Southern California, laments that even when classes are small, there is little incentive for intellectual engagement between students and faculty. Students are willing to work harder, but professors who demand more of students risk losing enrollment, as the rational response for students is to abandon the class for one with a higher “easiness” rating on professor-rating websites. The traditional business drive to satisfy the customer in the education space can portend a race to the bottom in terms of the educational goal. Students who are challenged ultimately are quite pleased, but it can be a struggle to get there.<sup>33</sup>

Why has the nondistribution constraint not yet solved the problem of contract failure in higher education? Hansmann explains that the provision of any trust good is likely to be suboptimal. Because of the difficult-to-judge nature of the product, he says, “any approach to organizing production is likely to be a question of ‘second best.’”<sup>34</sup> If the problem with for-profits is that they have too much single-minded clarity of purpose, then the problem with nonprofits is that they have too little. Nonprofit boards know what they are prohibited from doing—taking the money for themselves—but what they should be focusing their efforts and the college’s resources on is often a matter of constant, and sometimes agonizing, debate. As a result, there is a vast amount of literature on improving higher-education governance. There are also at least two initiatives aimed at energizing or redirecting the focus of university trustees, as well as efforts to address governance dysfunction in California community colleges.<sup>35</sup>

Suboptimal is a frustrating place to be, which is why there are constant efforts in both education and health care to find ways to promote innovation and choice that reduces costs without undermining quality.

## Solutions under our noses

Before diving into a discussion of the solutions, it is important to clarify the problem, as so far this report has described two distinct issues. First, there is the problem that, too often, for-profit colleges engage in practices that are destructive to their students or that fail to advance students despite large investments of taxpayer dollars. The nondistribution constraint adopted by nonprofit institutions dramatically reduces the instances of this type of predatory behavior. However, this leads to the second issue: Nonprofit and public institutions are not nearly as effective at educating students as they could be. These problems are inter-related in that there is policymaker interest in finding a way to harness the profit motive in ways that address the second problem without exacerbating the first.

Because the for-profit lobbyists portray the public policy dilemma differently, it is important to first address their argument. They say the problem is that they have been “unfairly singled out” because of “prejudice” or “bias” against the sector.<sup>36</sup> They say they simply seek a “level playing field” of regulations, a single set of rules for all colleges regardless of sector.<sup>37</sup> While this request sounds reasonable, it is nonsensical because for-profit colleges have, by definition, rejected the regulation that levels the field and is most effective at reducing the incidence of predatory practices: the nondistribution constraint.

**TABLE 3**  
**Public and nonprofit colleges are more regulated than for-profit colleges**

Regulation	Sector application		
	Nonprofit	Public	For-profit
Nondistribution constraint (assets must be controlled by people with no personal financial interest).	Yes	Yes	No
Accreditation reports publicly available.	No	Yes	No
Resource allocation occurs in public meetings.	No	Yes	No
Compensation of executives and administrators disclosed.	Yes	Yes	No
Incentive-based compensation of recruiters prohibited.	Yes	Yes	Yes
Programs must lead to gainful employment in a recognized occupation.	Applies to all nondegree programs in all sectors. For-profit provision—degree or nondegree—is allowed if the program meets this requirement.		
Demonstrate 10 percent market-based customers, or the 90-10 rule.	No	No	Yes
Institutions with high loan default rates eliminated from eligibility.	Yes	Yes	Yes

Source: Summary by author.

As Table 3 shows, for-profit institutions are subject to less regulation and accountability than are nonprofit institutions. The for-profit lobbyists’ plea for equality is in reality a ploy to get special treatment: They want to be treated equally except when it comes to the whopper of a regulation that they want to ignore.

For-profit colleges have shown a disproportionate tendency to engage in problematic behavior because they have opted for less regulation. If for-profit colleges are more often suspected of such behavior, suspicion is not based on discrimination or “second-class citizenship” but is rather the result of their own choices.<sup>38</sup> They are like a shopper who refuses to check his backpack at the store’s door: Extra scrutiny is warranted. Offered below are three practical, easily implemented proposals that could serve to better direct the profit motive toward socially optimal ends. The fourth and final recommendation is bolder, designed to address the problem of teaching and learning in higher education more broadly while rendering the sector distinctions less important.

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## 1. Front-end market test

In its first two decades, the University of Phoenix built a strong reputation, and by all accounts it was well deserved. The for-profit company “catered to middle managers whose employers paid for them to finish their degrees. Students had to be at least 23 years old and have two years of work experience as well as prior college credits.”<sup>39</sup> The employers who were paying the bills for some students would not put up with a program that failed to offer what their employees needed or charged too high a price. As Derek Bok notes, the “customers” for executive education programs “are corporations that know their own needs and are quite capable of protecting their interests.”<sup>40</sup> In addition, the prospective students themselves had some experience in college and so knew what they should expect. The knowledgeable customers who were paying out of their own pockets or supported by an employer served as a form of accountability, keeping the University of Phoenix honest. It was the company’s 2001 decision to drop those requirements and to pursue more students using federal aid that led to enormous profits but a decline in quality and reputation.<sup>41</sup>

We all benefit from the customers who are more demanding than we are—the person who insists on returning a poor-quality product or complains about bad service. In the case of complicated products such as stocks and bonds, everyone who owns stocks or mutual funds benefits from the scrutiny that well-heeled investors give to Securities and Exchange Commission, or SEC, reports and to companies’ plans. In efforts to promote quality child care, experts emphasize the importance of mixed-income programs both for the market forces that promote quality and for the child and parent interactions.<sup>42</sup> Similar efforts are made in low-income housing programs, where experts recommend that developments have fewer than 40 percent of subsidized units. As *Renée Lewis Glover*, the former CEO of the Atlanta Housing Authority explains, “The long-term success of mixed-income communities must be driven by the same market factors that drive the success of every other real estate development. Daily competition[s] to attract market rate renters ... require that the properties are managed and operated at a superlative level.”<sup>43</sup>

What are we to think, then, of the for-profit college industry’s insistence that there is no problem at all with colleges in which nearly every student is disadvantaged and subsidized? Kaplan Chairman Andrew S. Rosen’s assertion that for-profit colleges “are built to serve riskier students” is a fig leaf for the fact that the colleges lack the qualities necessary to be considered a good value by discerning consumers, such as employers.<sup>44</sup> Indeed, if serving the poor were intentional, it would

appear in the colleges' mission statements. But a review of the mission statements of more than a dozen major, for-profit colleges finds no claim that they are designed exclusively or primarily for a disadvantaged clientele.<sup>45</sup>

The industry has embraced the problem as a political selling point. Citing his member colleges' large enrollments of low-income African American and Latino students, the Association of Private Sector Colleges and Universities, or APSCU, President and CEO Steve Gunderson declared that President Barack Obama's political base "is the very description of the students served by our private-sector colleges."<sup>46</sup> This is not a new tactic. A hundred years ago, the seminal report that led to the modernization of medicine lamented the "poor boy" steered by advertising into a "hopelessly inadequate" medical school.<sup>47</sup> Responding to the school owners' claims that their programs are worthy because they serve the poor, the report labels the argument insincere: "[T]he excuse which has hitherto been put forward in the name of the poor boy is in reality an argument on behalf of the poor medical school."<sup>48</sup>

The issue emerged again in the early history of the GI Bill. For-profit providers were targeting veterans with programs that were of low quality but that captured the full GI Bill benefit. When concerns were raised about the quality of these programs that were serving veterans only, the colleges asserted that they were specially designed with the veteran population in mind. The bipartisan leadership in Congress did not buy it. To force some market accountability on both price and quality, Congress required that no more than 17 of every 20 students in a program could be on the GI Bill.<sup>49</sup> The Senate Committee on Veterans' Affairs explained that "if an institution of higher learning cannot attract sufficient nonveteran and nonsubsidized students to its programs, it presents a great potential for abuse."<sup>50</sup> The U.S. Supreme Court ruled that the policy made sense as a "free market mechanism" designed to "minimize the risk that veterans' benefits would be wasted on educational programs of little value" by "weed[ing] out those institutions [that] could survive only by the heavy influx of Federal payments."<sup>51</sup>

In 1992, Congress adopted a similar requirement for Department of Education aid.<sup>52</sup> Its purpose is to require that at least 1 of every 10 students be independently supported. However, because the law refers to 10 percent of revenue rather than 10 percent of students, a school can have more than 90 percent aided students—complying with the letter but not the spirit of the law—by charging more than the total federal aid that is available. In other words, every student gets maximum federal aid but must pay 10 percent above that.<sup>53</sup>



Furthermore, the Department of Education's rule fails to treat aid administered by other agencies as federal aid, again allowing an institution to evade the law's purpose of demonstrating the program's market viability and value. As a result, for-profit colleges aggressively pursue soldiers and veterans to enroll in their programs so that GI Bill and Defense Department tuition assistance can be counted against the 10 percent quota in the Department of Education formula.<sup>54</sup> Organizations such as Iraq and Afghanistan Veterans of America are supporting reforms to the Department of Education's 90-10 rule because of the predatory recruiting practices that for-profit colleges have used to get veterans to enroll.<sup>55</sup>

For-profit colleges that provide good value should have no difficulty enrolling customers from a variety of backgrounds. Businesses and higher-income consumers do not demonstrate any irrational objection to for-profit entities providing goods and services. Indeed, economists note that the more knowledgeable a consumer is about a trust good such as education, the less reason he has to prefer a nonprofit based on nonprofit status alone.<sup>56</sup> A case in point is for-profit hospitals, many of which cater to higher-income consumers.

Accordingly, when knowledgeable consumers avoid a large for-profit college, it is a sign that those consumers do not see value, as the quality, given the price, is inadequate. A study that compared federally supported vocational programs at for-profit colleges to similar programs at for-profits that were not receiving federal aid found that the former charged, on average, 75 percent more.<sup>57</sup> The likely explanation is the aggressive pursuit of government aid, with no market-value reference point.

The Association of Private Sector Colleges and Universities is opposed to efforts to repair the 90-10 rule and is even seeking to weaken it. When researcher Suzanne Mettler pointed out the problem of a caste system of separate and unequal colleges, the University of Phoenix labeled her an elitist who would deny opportunity to needy students such as "hard-working veterans."<sup>58</sup> But this is a case of the pot calling the kettle black. There is nothing more elitist than the idea of sending veterans and low-income students to training programs that employers and other knowledgeable consumers find inadequate.

The first proposal: Repair the 90-10 rule and enforce it as a partial alternative to the nondistribution constraint that for-profit colleges have chosen to forgo. In order to more robustly apply this front-end market test to postsecondary institution enrollment, the so-called 90-10 rule should be restored to its previous 85-15

ratio and remove the provision that makes it a multiyear test. As envisioned when it was first applied, this regulation should count the aid status of students enrolled rather than the source of funds applied to all students. This change will remove the incentive for institutions to increase tuition above available aid levels to ensure that all students are required to provide some support. It will also ensure that programs attract students who are subsidized by an outside source or who are able to pay on their own. Finally, all sources of federal education support for students—including, for example, GI Bill benefits—should be counted when assessing a student’s aid status. If for-profit colleges object to these reforms, the burden should be on them to offer an alternative that protects students and taxpayers at least as effectively as does the nondistribution constraint.

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## 2. Back-end market test

Nonprofit provision of higher education is justified by the difficulty of measuring and monitoring quality, which invites providers to educate too little and charge too much. For this reason, the original Higher Education Act did not allow for-profit providers to participate in the act’s programs. But what if the goal is not a liberal arts education but instead something more definable? The more a product can be tested for effectiveness, the safer it becomes to apply profit-focused enterprises to the task. As Eduardo Porter, an economics writer for *The New York Times*, points out, the profit motive works best “if the task is clear-cut and it’s possible to define concrete goals and reward those who meet them.”<sup>59</sup>

When Congress opened the door to allow for-profit colleges to receive federal financial aid, it did not do so across the board. Instead, it allowed federal aid for a narrow category of programs leading directly to specific jobs, preparing students for “gainful employment in a recognized occupation.”<sup>60</sup> Experts had assured Congress that aid for occupational programs would lead to graduates earning “sufficient wages so as to make the concept of student loans to be [repaid] following graduation a reasonable approach to take.”<sup>61</sup>

At the time, for-profit entities were offering training that was clearly occupational and met Porter’s test of a clear-cut task: preparing electricians, auto mechanics, and cosmetologists. These shorter-term programs are still the types of training where for-profits perform best, to a large extent because the skills taught are more objectively assessable than are the goals of longer-term degree programs.

However, in opening the door to for-profit providers, the Department of Education asked colleges to self-certify that a particular program was occupational in nature, with little or no monitoring or rejection of program type. While a program labeled “liberal arts” or “philosophy” might not pass muster, the colleges’ assertions in most cases were not questioned by the agency as long as the college could point to an occupation that was somehow related. As a result, over time, the colleges broadened and extended their offerings while continuing to check the box that would gain them access to Education Department financial aid for the program. In other words, the colleges were able to sneak in almost anything because the Education Department was not watching closely.

In the wake of rapid growth in federal aid at some institutions, combined with evidence of predatory practices, the Education Department in 2011 established clearer standards for “gainful-employment” programs.<sup>62</sup> Under these rules, programs with the worst records of high debt and low earnings would need to improve or face loss of access to federal aid. The goal was consistent with the idea Porter describes: to define concrete goals and reward them. And there was every indication that the approach was working. Despite being quite weak—only one-third of former students were expected to be repaying their loans—the regulations began to steer the industry in a positive direction. Colleges shut down some of their worst programs, reduced tuition charges, and, in some cases, made more effort to ensure that entering students were adequately prepared. Some institutions began to offer students free trial periods before they could claim their federal aid. Former Kaplan CEO Jonathan Grayer praised the Education Department’s efforts to clarify expectations of for-profit colleges: “[T]he industry needed to stand for the value proposition and we had no metrics.”<sup>63</sup>

ITT Tech reported to its shareholders in February 2012 that the regulations spurred “offering programs at lower costs or in fields with higher earnings potential.” The rule “will continue to put downward pressure on tuition prices” and prompted the company to “substantially increase our efforts to promote student loan repayment.”<sup>64</sup> Wall Street analysts indicate similar movement across the sector.<sup>65</sup> Barclays analysts reported that many companies that run for-profit colleges had made changes in their programs because of the new regulatory environment:

*This has included teaching out programs, introducing new program offerings, changing tuition, reducing the duration of programs, and even more dramatic steps including the closure of poorly performing campuses. ... As companies weigh their options, we expect further changes ahead in the form of adjustments to tuition and program durations, enrollment caps, and program/campus closures.<sup>66</sup>*

Unfortunately, the Association of Private Sector Colleges and Universities successfully sued to block the 2011 rule and continues to lobby to prevent a new version from being implemented.<sup>67</sup> Industry analysts have made it clear that the companies would revert back to their old ways if the Education Department does not follow through with a new version of the rules.<sup>68</sup> In short, oversight from the federal government is an important tool that spurs reform by the companies to the benefit of students.

The changes that colleges made in response to the regulations demonstrate that the for-profit education industry is capable of improving if the Department of Education continues to guide the way by establishing and enforcing concrete goals. With clearer targets, for-profit colleges have the opportunity to demonstrate their potential in education. The gainful-employment rules respond directly and appropriately to for-profit advocates' assertions that they should be judged by outputs instead of inputs.

The second proposal: Adopt and implement a strong gainful-employment rule, to keep for-profit colleges focused on constructive goals given their refusal to adopt the nondistribution constraint. The Education Department's current proposed rule should be strengthened to include an evaluation of programs based on the student-loan repayment rate. Default rates are inadequate because they are a snapshot measure and can be manipulated by colleges.<sup>69</sup> Again, if for-profit colleges cannot agree to this modest measure, the burden is on them to offer an alternative that protects students and taxpayers at least as effectively as does the nondistribution constraint.

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### 3. Disclosure

No one should be under any illusion that providing more information to consumers would accomplish much on its own. The volume and complexity of the relevant information for prospective college students is more likely to produce information overload than to provide useful guidance, particularly when disadvantaged populations are involved.<sup>70</sup>

Information disclosure can be useful, however, when it is available to third parties who can help analyze it on behalf of consumers. Consider the detailed prospectuses that come from stocks and mutual funds. Very few individual investors read them, but they and other filings required by the Securities and Exchange Commission have resulted in a relatively clean system for the sale of company stock to the public. Investment scams are rare because company information is scoured by the media, by institutional investors and their analysts, and by watchdog groups, essentially serving as monitors on behalf of all potential investors.

In higher education, information disclosures that should be made available by all institutions include:

- **The names and qualifications of instructors.** Currently, colleges are not required to inform prospective students who their teachers would be or provide information about teachers' backgrounds. This provision to do so should also include instructors' employment status with the institution, specifically if they are part-time or full-time employees and if they are retained year after year. Many colleges already include this information on their websites, but some do not.
- **The college's most recent accreditation self-study, visiting team report, and action letter.** Accreditation is supposed to give us confidence that a college meets at least some minimum level of quality, but the actual substance of accreditation reviews are often hidden from public view.
- **The compliance audit, financial statement, and application for federal funds required by the Education Department.** Like SEC filings, the Education Department should post these automatically online for public inspection when a college submits them.

Making all of these documents available on a timely and regular basis would not transform higher education, but it would offer some early warnings that could prevent consumers and taxpayers from being taken advantage of.

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#### 4. Technology-enabled radical transparency

This report presents some ways that for-profit colleges could be steered away from predatory practices and toward providing more value. These are all actions that policymakers could take now to make a difference for the better. However, over the long term, we will still have Hansmann's problem of the second best—a higher-education system that is suboptimal because of the nature of the product. This report concludes with an idea that is worthy of discussion, even if it seems a phenomenal undertaking at first blush.

The quality of instruction is the single most important element of a comprehensive college education. Yet it is not available for independent analysis—once-a-decade visits by accreditors notwithstanding. Improving learning outcomes requires getting inside student-faculty interaction, the meat of higher education. What if evidence of the learning process could be made available for scrutiny by experts? By surfacing the raw material of the education process—the student papers, presentations, and tests, along with class discussions and written feedback and grades from faculty—the teaching process opens itself up to constructive review and to change.

The concept of comparing the quality of student work across institutions is not new to universities. They have staff members who engage in the task regularly in order to analyze the applicability of transfer students' prior courses to the courses at the receiving institution. Under agreed-upon principles for transfer, the sending institutions are under an obligation to provide the documentation necessary "to judge the quality and quantity of the student's work."<sup>71</sup> When standards are unclear or unknown, universities review the student work itself, spending as much as \$200 per transcript to collect additional information on an ad hoc basis in order to make more nuanced determinations about each transfer student's prior coursework.<sup>72</sup> A more systematic and shared approach to comparing student work in courses could produce efficiencies that would help pay for the process itself. Furthermore, technological advances make possible the mass collection of material that can be anonymized and farmed out in digital form to discipline experts for review.



A system of quality review should not involve top-down decisions regarding course comparability. Instead, each college must retain its right to make its own determinations regarding the adequacy of its standards and the transfer of credits. The benefit of a systematic approach is that in making those determinations, the college would have access to work samples and other experts' assessments that would make the comparability decisions less taxing and put them on firmer footing.

While student work samples may be adequate to determine the comparability of course outcomes, they probably do not provide adequate information to provide feedback regarding instruction. Videotaping class sessions, as recommended by the University of California's Robert Samuels, could add the instructional element to quality review efforts.<sup>73</sup> One possible model for analyzing instruction is the in-depth analysis of videotapes conducted by the Third International Mathematics and Science Study in 1999, in which experts reviewed and analyzed representative samples of eighth-grade lessons from seven different countries.<sup>74</sup>

Launching an effort to systematically compare the artifacts of the learning process is not a simple task. But it is also not so different from some of the processes that colleges already undertake on a regular basis. Implemented as part of an effort to improve teaching and learning, radical transparency could have a constructive and material effect on the educational value students receive for the price they pay at a variety of higher-education institutions. If college leaders and policymakers could figure out how to implement this vision, it would be the most important reform possible to advance higher learning.

# Conclusion

By deciding to operate as a for-profit enterprise, a college is subjecting itself to pressures to cut costs and to grow in ways that can be—and too often are—contrary to the interests of students and society. According to the economic theory behind nonprofit status, a greater tendency toward predatory behavior is the logical and predictable result of a college’s decision to adopt an investor-owner model, rejecting the consumer protection that comes from placing control in the hands of people without an ownership stake.

With the right market-based protections, for-profit institutions have the potential to play constructive, perhaps even revolutionary, roles in addressing the nation’s educational needs. But policymakers should not support these institutions if for-profit leaders fail to recognize that any claimed benefits of the for-profit model are matched by real hazards that must be addressed. In the current policy debate, lobbyists for for-profit colleges either dismiss or are ignorant of the important regulatory role played by nonprofit status. As policymakers consider the role of for-profit institutions, they should treat this apparent lack of self-awareness as a warning sign.

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## About the author

**Robert Shireman** served as deputy undersecretary of education from 2009 to 2010, and he now directs California Competes, a nonprofit project aimed at addressing the state's higher-education challenges. In the Obama administration, Shireman led successful efforts to reform student lending, increase Pell Grants, simplify the financial aid process, and strengthen consumer protections, efforts that earned him *Money Magazine's* "money hero" status and a Voice of Conscience award from Public Advocates, a civil rights law firm. In 2004, Shireman launched The Institute for College Access & Success, where his early leadership on the issue of rising student debt prompted Congress to adopt income-based repayment for student loans. Shireman serves on the board of uAspire and on advisory committees for ideas42 and the National Center for Education Statistics. He occasionally consults with foundations, associations, and companies on efforts to improve college access and success.

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