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Perils in the Provision of Trust Goods

Consumer Protection and the Public Interest in Higher Education

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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.[1] 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.

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."[2]

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.[3]

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."[4]

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."[5]

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."[6]

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.[7] 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)[8]

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."[9] 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.[10] 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.[11] Importantly, the people ultimately responsible for that difficult balancing act are prohibited from having a personal financial conflict of interest.

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:[12]

- 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.[13] 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.[14]

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."[15]

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.[16] In nursing-home care, a meta-analysis in the *British Medical Journal* found that nonprofit nursing homes tended to deliver higher-quality care.[17] 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.*[18]

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