Testimony before the Senate Committee on Health, Education, Labor, and Pensions
Risk-Sharing Policies and Higher Education
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Chairman Alexander, Ranking Member Murray, and distinguished members of the Committee, thank you for inviting me to this important hearing. As a researcher who strives to do policy relevant work in the area of higher education, this is truly an honor.

My name is Doug Webber, and I am currently an assistant professor in the Department of Economics at Temple University and a Research Fellow at the Institute for the Study of Labor. My main areas of research are the economics of higher education and labor economics. I have Bachelor's degrees in Economics and Mathematics from the University of Florida, and Masters and Ph.D. degrees from Cornell University. During my last two years of graduate study, I also worked as an Economist at the U.S. Census Bureau's Center for Economic Studies.

National student loan debt currently tops $1.3 trillion, the vast majority of which is backed by the federal government. At a macroeconomic level, student loan debt has been compared to the housing bubble of last decade. At a microeconomic level, many individuals are burdened by debt, which has been shown to negatively impact many measures of well-being[1] in addition to the clear strain on financial security. It is thus in the best interest of students and the economy as a whole for the committee to adopt the reforms discussed in the various hearings on the reauthorization of the Higher Education Act.

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[1] Reduced financial security has been found to impact a wide range of important decisions such as marriage, fertility, occupation, and many others.

My testimony today focuses on the economic motivation and social appeal of a risk-sharing program, how it might be structured, and possible implications for institutions and students based on my own research.

While there are many factors which contribute to an individual defaulting on his or her student loan debt, some proportion of the fault must lie with the institutions that accept the loan-bearing students. It is important to state that there need not to be fraudulent intent or even poor teaching for institutions to be responsible for some share of the blame. For example, students may be pushed into certificate or major programs which are intellectually stimulating, but have poor job prospects upon graduation, without being given adequate information by their school.

Under the current system, if a student defaults, the institution bears no responsibility in terms of repaying the loan. Thus, the institutions reap the benefits of these loans, i.e., they are able to extract revenues, but they pay none of the costs when the loan is not repaid. Instead, the burden falls on the American tax payer. Furthermore, the current incentive system, which restricts access to federal student aid if cohort default rates fall above certain thresholds based on cohort default rates, effectively only applies to a handful[2] of schools with the highest default rates. Under this system, the vast majority of schools have no direct financial stake in their students' outcomes once students are no longer enrolled.

In a well-functioning market, a "skin in the game" incentive system would be less critical because market forces would drive out any institutional bad actors and force the remaining schools to operate efficiently and in their students' best interest. However, the market for higher education is far from perfect, characterized by a substantial lack of consumer information, a large growth in administrative bureaucracy,[3] and sometimes wasteful spending.[4]

How to Structure a Risk-Sharing System

For reasons relating to fairness, efficiency, and economic incentives, I am in favor of all universities which participate in federal student aid programs being subject to risk-sharing requirements. While the majority of policy discussions tend to focus on for-profit colleges, all institutions lack sufficient incentives to address the issue of student loan defaults, and thus we should consider all institutions in our policy response.

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[2] See https://kelchenoneducation.wordpress.com/2014/09/24/analyzing-the-new-cohort-default-rate-data/
[3] See http://necir.org/2014/02/06/new-analysis-shows-problematic-boom-in-higher-ed-administrators/
[4] See http://www.nytimes.com/2014/09/21/fashion/college-recreation-now-includes-pool-parties-and-river-rides.html?_r=0

I believe this is the correct policy response in terms of efficiency for two reasons: requiring all institutions to participate (1) reduces government monitoring costs/time, and (2) reduces the ability of institutions to escape risk-sharing costs by "gaming" the system.[5]

As for economic incentives, the gains to society of preventing one default are the same whether that default is prevented at a school with a 25% default rate and 80% borrowing or an institution with a 3% default rate and 5% borrowing. By requiring all schools to be subject to risk-sharing, everyone will be incentivized to reduce their students' default probabilities.

I support using the dollar-based cohort default rate[6] both as the metric and also as the key determinant of liability. For example, each school might be required to pay a risk-sharing penalty equal to 20% of the value of the student loans which have gone into default in the past year. The primary reason I support this approach is that it sidesteps many of the problems we currently see plaguing the accountability system using cohort default rates as the metric. Considerable time and money has been spent trying to create a system which makes schools accountable, but does not unfairly penalize schools which happen to fall on the bad side of blunt metrics. For instance, some schools with very small class sizes have exceeded the current default rate standards simply by random chance.[7] Moreover, a program with 30 total students (10 defaulting) has an entirely different implication for taxpayers' financial responsibility from a program with 30,000 students (8,000) defaulting). Between these two schools, clearly the government should be more concerned about the latter, even though the cohort default rate is lower (33.3% versus 26.6%).

By basing the metric and penalties on the dollars defaulted, the rules can be made more straightforward (and thus easier to identify and enforce) without the need to create the numerous exceptions[8] and complicated rules under the current model.

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[5] See https://www.insidehighered.com/news/2015/05/13/sec-charges-itt-fraud-over-student-loan-programs for one such example.

[6] While my research focuses on the use of cohort default rates, other metrics such as the repayment rate may also be attractive to policymakers. For example, the risk-sharing penalty could be 20% of the value of student loans which are currently delinquent. If the committee prefers this metric, I would stress that the penalty must be smaller than the one they would prefer using cohort default rates to avoid placing too much financial strain on institutions. Furthermore, complications could arise when deciding how to handle accounts which are delinquent (and thus cause a penalty to be paid), but then return to good standing at a later date.

[7] Small programs are more likely to occasionally surpass any threshold which is based on a percentage based only on bad luck, even if the program

[8] See https://www.insidehighered.com/news/2014/09/24/education-dept-tweaks-default-rate-calculation-help-colleges-avoid-penalties

I am strongly in favor of a monetary penalty (based on the dollars defaulted) rather than restrictions on access to financial aid programs or enrollment. Restricting federal aid is a very blunt policy instrument which is more likely to lead to unintended consequences (e.g. lack of access for at-risk groups) than a monetary penalty tied to the number of dollars defaulted upon. Furthermore, all-or-nothing penalties are rarely the best policy option since they only incentivize institutions near the threshold, and produce highly unequal punishments for similar schools who happen to fall on different sides of the cutoff.

Research on Risk-Sharing

Opponents of risk-sharing proposals are correct to note that a potential unintended consequence of the system I described is an increase in tuition rates. This fear served as the motivation for recent research I conducted examining the impact of a risk-sharing program on institutional decision-making.

In my research,[9] I analyze the impact of a hypothetical risk-sharing program which imposes a penalty of 20% or 50% of the dollars defaulted upon by previous students using administrative data from the Integrated Postsecondary Data System (IPEDS). This was accomplished in several steps: (1) I estimated cost functions[10] for institutions which receive Title IV funding. Most importantly, I estimated the cost to each institution of educating the last student, known as the "marginal cost" in economics. (2) I assumed that each institution would respond in a financially optimal way to the imposition of risk-sharing penalties (in other words, institutions would raise tuition so as to maximize profits). This step requires knowledge of an institution's cost structure (estimated in the first step) and the demand curve (specifically a quantity known in economics as the "demand elasticity") faced by each institution. Rather than estimate these demand curves using my data, which are not well-suited for this type of analysis, I run my statistical analysis separately using low, medium, and high estimates of the demand elasticity found in the literature.[11] (3) I calculated what the optimal tuition response (i.e., how much institutions would increase their tuition) would be when either a 20% or 50% risk sharing penalty were imposed on schools.

It is important to note that throughout my paper I try to make assumptions which would lead to the worst-case scenario in terms of tuition increases. I make these assumptions because I

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[9] See Webber (2015b)
[10] This was accomplished using a panel data extension of the method pioneered in Cohn et al. (1989)
[11] See Long (2004)

believe that policymakers should be risk averse when making decisions which have such broad impacts. For instance, I assume that students who default have not repaid any of their loan balance. Furthermore, I begin by assuming that institutions will do absolutely nothing to lower their default rates, and thus there is no incentive effect of risk-sharing. In this way, the results represent an upper bound in terms of negative tuition consequences.

I find that for the vast majority of institutions, tuition increases would be fairly modest. The predicted median increase in tuition would be roughly 1% under a 20% risk-sharing penalty, and 2% under a 50% risk-sharing penalty. Only schools which satisfy all three of the following conditions appear to be at risk for appreciably higher tuition increases: high default rates, high tuition, and high rates of student borrowing. The median tuition increase for these institutions would be closer to 2.5% and 4.5% respectively under a 20% and 50% penalty. The virtue of these results is that only the schools which are causing the most harm would be appreciably impacted by a risk-sharing program. Furthermore, these figures would certainly be lower if there is any incentive effect associated with the penalties.

It should also be noted that there are numerous policies and mechanisms through which individual schools could address student debt. These include, but are not limited to, policies which impact graduation, time to degree,[12] internships, choice of major, or teaching quality. Institutions would be free to determine which of these avenues is most efficacious and cost efficient given their specific resources and needs.

Additionally, there are many potential reforms which have been discussed in other hearings on the Higher Education Act that would reduce or eliminate upward pressure on tuition when coupled with a risk-sharing program. For example, a majority of Associate's Degree programs require at least 65 or 66 credits to obtain a degree, two full classes above the norm of 60. Many of these programs require more than 70 credits.[13] This growth in required classes has been seen even in general education programs, where it is difficult to argue that the extra courses serve a crucial role in students' future careers. Depending on the state and specific program, this could be due accreditation regulations or institution-level bureaucracy. Longer programs increase the likelihood of student default both because of larger student loans taken out and a

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[12] For instance, Temple University President Neil Theobald introduced an innovative program entitled "Fly in Four", which provides grants to students in exchange for meeting regular progress to degree benchmarks and a promise not to work more than 10 hours per week during enrollment. http://chronicle.com/blogs/headcount/temple-u-program-will-help-students-work-fewer-hours-graduate-on-time/37593

[13] See Johnson et al. (2012)

lower probability of graduation. Reforms which allow and encourage institutions to be more efficient in producing graduates would simultaneously ease upward pressure on tuition due to risk-sharing policies and reduce future student loan defaults.

Another set of reforms which would prevent tuition increases relates to the consumer information focus of the Higher Education Act reauthorization. There are enormous differences in earnings across different majors.[14] For example, the median graduate with and degree in economics earns roughly $1 million more over their lifetime[15] than the median college graduate with a management degree. There are many students whose education does not pay off until very late in life or ever.[16] Yet students and parents, in particular more vulnerable students and parents, often do not have the facts necessary to make arguably the most important financial decisions in life: 1) which school to attend and 2) what major to select. Providing labor market and student loan outcomes, in an easy to understand format, at the institution and program level would enable students to make informed decisions and could drastically lower the number of future loan defaults (and thus alleviate upward pressure on tuition from a risk-sharing program).

The way in which a risk-sharing proposal is operationalized is critical to its success. For example, it has been proposed that risk-sharing could be implemented through a system akin to Unemployment Insurance (UI) rather than the penalty structure described above. While it is true that a perfectly designed insurance system could have the same incentive effects as a penalty based on the number of dollars defaulted upon, I caution against an insurance system for two reasons. First, administrative cost and complexity should be minimized to make risk-sharing as straightforward and efficient as possible; a UI-like system might be counterproductive in this respect. Second, an insurance system, almost by definition, leads to cross-subsidization. In this case, schools with a small number of dollars defaulted would effectively subsidize those schools with a high number of defaults. There are positives and negatives to this sort of subsidization. On one hand, it would dampen the incentive effect of risk-sharing at the schools that are performing very well in terms of their default rates. On the positive side, it could ensure that risk-sharing penalties are not so severe as to cripple an institution's finances following a particularly bad year (of course this could also be accomplished by putting a cap on the penalty).

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[14] See Webber (2014)

[15] http://www.cla.temple.edu/economics/files/2014/04/Expected-lifetime-earnings-All1-copy.pdf

[16] See Webber (2015a)

Regardless, cross-subsidization is something that the committee should keep in mind when deciding how to implement risk-sharing proposal.

It should also be noted that another potentially negative unintended consequence of risk-sharing is that institutions could effectively credit rate their students applications, and refuse to admit those students who most likely to default. A common refutation of this concern is that "if the students are likely to default, then they obviously didn't benefit from the education, and shouldn't have gone in the first place". While it is certainly true that some individuals are best served not spending considerable time and money getting advanced degrees, the possibility that schools could discriminate in the admissions process is still something society has an interest in protecting against. Fortunately, the risk-sharing program I am advocating for is unlikely to substantially incentivize this behavior as long as the penalty is not set too high (I would recommend no higher than 50%). The reason is that there are typically not binding enrollment constraints at the type of universities which are most impacted by risk-sharing (high default rate, high borrowing, and high tuition). In the absence of a binding enrollment constraint, a school will not turn down an applicant for financial reasons as long as it is still profitable on average to admit that applicant (even if he or she does indeed default). In other words, the tuition must be greater than the sum of the cost of educating the student and the expected risk-sharing penalty. This is the case at more than 95% of institutions based on the findings from my paper.

There are similar calls for risk-sharing in the Pell Grant system. Since Pell Grants cannot be defaulted upon, this might involve comparing the labor market outcomes of Pell recipients against some benchmark. While I am strongly in favor of implementing risk-sharing in the student loan market, I am much more apprehensive about its application to the Pell system. The students receiving Pell Grants are among the most vulnerable to discrimination, and their success in higher education is arguably more beneficial to society as a whole than any other group. For these reasons I would only support a risk-sharing program applied to Pell Grants if it also contained substantial protections for this vulnerable student population.

To summarize my testimony, a risk-sharing policy which imposes a financial penalty on institutions based on the number of dollars defaulted upon will provide powerful financial incentives for all institutions to improve the labor market outcomes of their students, while specifically targeting the institutions which are most responsible for our national growing student debt burden. The most effective and efficient risk-sharing policy would be coupled with reforms

aimed at accreditation and consumer information to reduce the risk of unintended adverse consequences for students.

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