# A College Access Contract

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America's financial aid system provides too much taxpayer support to banks making college loans and demands too little of students assuming them. The system fails to reward rigorous college preparatory work in high school and penalizes students who hold jobs while in college. Lenders make extraordinary profits, while young people leave college burdened with massive debt and, more often than not, without the degree or skills necessary for a good-paying job that will enable them to repay that debt absent significant economic hardship.

A new College Access Contract would harness the free market so that students get more aid and banks get less. Students from low-income families would have the opportunity to graduate debt-free (up to the maximum of $23,000 in cumulative federal student loan debt), while students from middle-class families could graduate with interest-free federal student loan debt, but *only if* they: (1) work hard in high school to prepare for college, (2) work or perform community service while in college, and (3) evidence a minimum level of academic work or competency upon completing their postsecondary studies.

The three student behavior conditions associated with a new College Access Contract would address three key problems in higher education—inadequate preparation in high school, the college work penalty, and unsatisfactory college completion rates and curricular rigor. All three contribute to the difficulty students confront in repaying their college debt. To finance the contract, the student loan system could be reformed to embrace market mechanisms and save billions. Philosophically, this approach joins progressive goals and market principles. Politically, it embraces traditional values like hard work, service, and reciprocity.

## Excess Subsidies to Student Loan Providers

Forty years ago, banks were reluctant to make student loans to young people with little credit history or collateral. The government intervened to guarantee student loans against default *and* to provide banks with a subsidy payment on top of borrower interest payments. Currently, 99 percent of a student's loan principal is guaranteed against default. In addition, banks are guaranteed a profit equal to the prevailing market interest rate for commercial borrowing, plus 2.34 percentage points. That's a far larger subsidy than most people realize.

A 2.34 percentage point boost on top of a bank's core cost of commercial borrowing—which has been reported to be 5.4 percentage points for student loan giant Sallie Mae—translates into a *43 percent* profit on capital. There are reasons Sallie Mae's stock has increased by 2,000 percent in the last decade, and those reasons are a government guarantee against risk and very large government subsidies.

Government subsidies to student loan banks are excessive in part because of political lobbying, but also by design, because the government wants to be certain that banks will make loans available to college students. The problem is that no lobbyist, no economist, and certainly no member of Congress knows what the right subsidy level is—one just high enough to ensure banks make loans, but low enough so taxpayers' costs are minimized.

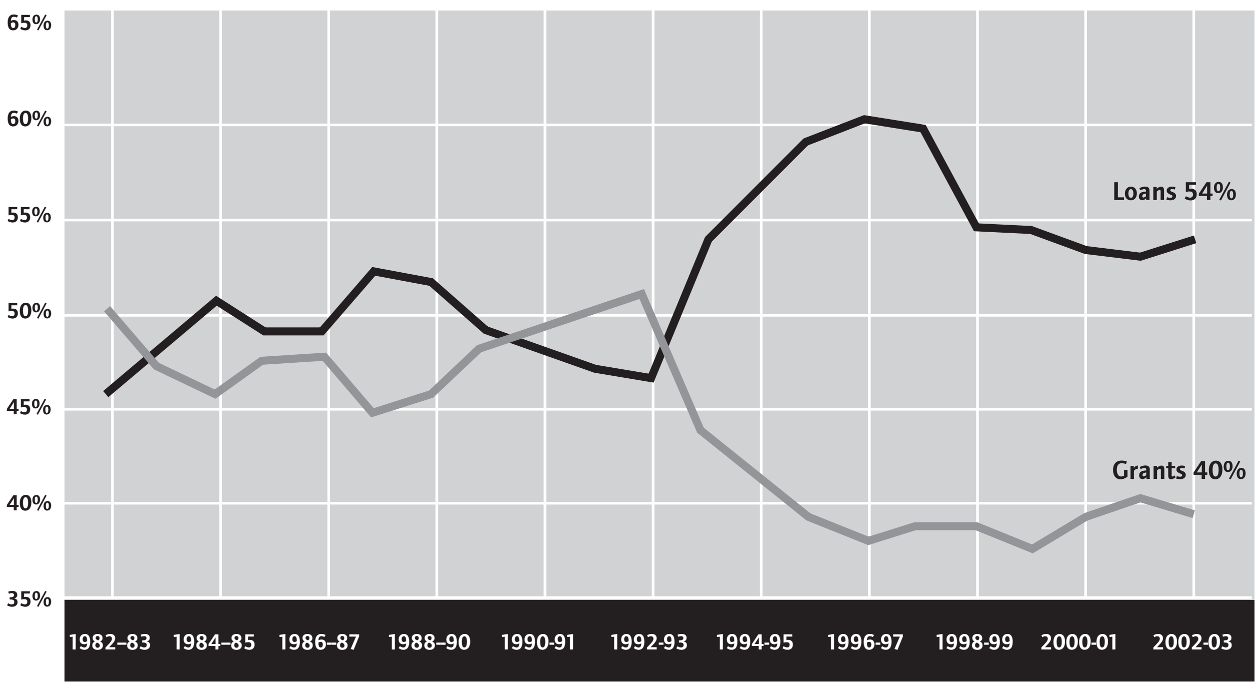
In fact, there is consensus that setting lender terms by congressional fiat has been wasteful. President Bush's 2006 budget pointed to "evidence of significant cost inefficiencies in the [guaranteed student loan] program." According to the Congressional Budget Office, student loan bank subsidy rates could be reduced by "as much as 13 percent" without affecting loan availability. And according to the Government Accountability Office, "billions of dollars" could be saved each year by making student loan programs more efficient.

### Perverse Incentives and Exploding Debt

On top of excess subsidies to student loan providers, America's financial aid system is rife with perverse incentives. Lenders have little reason to put resources into collecting payment from delinquent borrowers because student loans carry a 99 percent government guarantee. The federal government and states have little reason to increase grant aid to keep up with rapidly rising college costs because student loans are available to back up aid reductions and tuition hikes.

A particularly perverse incentive in our financial aid system is the *penalty* that exists for students who try to work their way through college, even though

GRANTS VS. LOANS, PERCENT SHARE OF TOTAL AID, 1982–83 TO 2002–03




Source: The College Board, *Trends in Student Aid,* 2003.

attending and completing college is more challenging for lower-income students than their upper-income peers. There is a reduction in federal financial aid of 50 cents for every dollar a student earns above approximately $3,000 over the course of a calendar year. A typical lower-middle-class student who works to pay for college gets zero federal grant aid.

Because of the work penalty, students have to assume larger student loans. In fact, students are borrowing more than ever. According to the Project on Student Debt, two-thirds of students graduating from four-year colleges accumulate an average of almost $20,000 in college loan debt, more than double the average college loan debt of ten years ago. At private, nonprofit colleges, three-quarters of all students graduate with student loan debt. One-fourth graduate with almost $30,000 in student loan debt, while 10 percent accumulate debt in excess of $40,000. Since federal student loan borrowing is capped for undergraduates at $23,000 over five years, borrowing above that level is in the form of high-interest, non-government-guaranteed private loans. The interest rate on those private loans reaches as high as 16 percent a year on top of up-front fees of up to 10 percent of principal borrowed.

### High School Matters More Than Money

In addition to perverse incentives that discourage college students from working outside of school, high school students are not asked to work very hard academically before going to college. In general, federal financial aid for postsecondary education is available to any student accepted by any university, college, community college, or trade school without regard to how prepared the student is for postsecondary work. Under this policy, higher education is broadly accessible. A large share of high school graduates may not go immediately to college or attend a traditional four-year college. But three-quarters of Americans between the ages of 18 and 24 participate in some form of postsecondary education, be it attending a private or public university, community college, or a proprietary program, such as a cosmetology school.

Unfortunately, federal financial aid often pays for students to learn in college what they should have learned in high school. Approximately 40 percent of college students need to take at least one remedial course while in college. These students, who are disproportionately low-income and minority, are also twice as likely to drop out of college, according to the National Center on Education Statistics. If they do complete college, it will take them longer to do so because of the need for extra remedial coursework. Consequently, their total college costs and borrowing are inflated.

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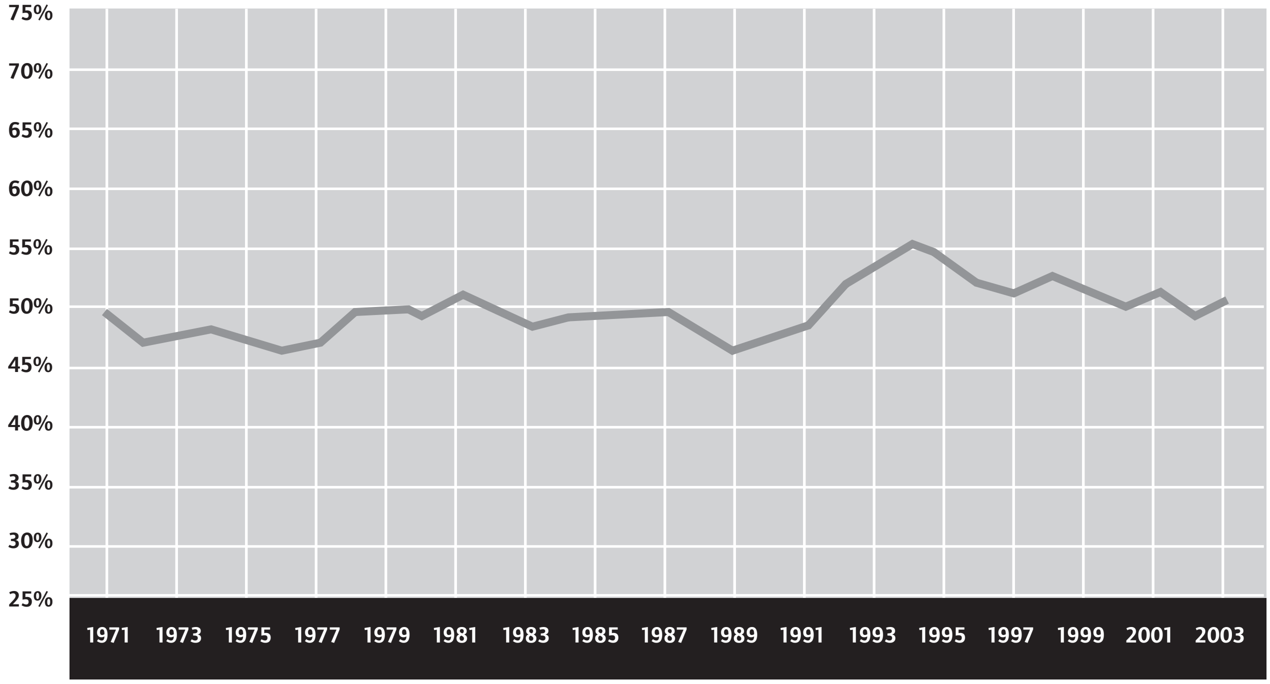
### Colleges Are Failing Students

The excess taxpayer payments to student loan banks, the work penalty, the grant/loan imbalance, and the disregard for academic preparation in high school all might be tolerable if college students were learning the skills they will need in the workplace. But too many students are not working hard academically in college either, and too many colleges are failing students. Consequently, students leave postsecondary institutions ill-prepared for work and thus less able to pay off their student loan debt.

First, an unacceptable number of college students are leaving school without a degree. Approximately one out of three students attending a four-year institution of higher education fails to obtain a bachelor's degree within six years of initial enrollment. For minorities and students from low-income backgrounds, the college dropout rate is over 50 percent. Dropout rates for two-year community college students are even higher.

Second, and more troubling, a majority of students who complete college do not appear to have gained the skills that might be expected of a college graduate. Over two-thirds of students graduate from college unable to comprehend ordinary narra-

PERCENTAGE OF STUDENTS WHO COMPLETE COLLEGE DEGREES, 1971–2003




Source: U.S. Department of Commerce, Census Bureau, Current Population Surveys, October, various years.

Note: The rate was computed by dividing the number of students with “some college” by the percentage who had “college degrees.” Until 1990 the definition of the category “some college” was one year or more of postsecondary schooling; after 1990 the category included individuals with any amount of postsecondary schooling.

tive texts, such as a newspaper article, according to the National Assessment of Adult Literacy. Twenty percent of college graduates have only basic quantitative skills, meaning, for example, that they are unable to perform even a simple task, such as calculating the cost of ordering office supplies, according to the American Institutes for Research. Fewer than one in five college graduates enter the labor force with the writing and communication skills that employers say they need, according to the Conference Board, a respected business research firm.

**Make Work Pay: A College Access Contract**
What America needs is a College Access Contract that gives less to banks and asks more from students. A meaningful College Access Contract would guarantee that low-income students can graduate from college free of federal student loan debt—and that middle-class students can graduate with zero interest federal student loans—if they: (1) work hard in high school to prepare for college, as evidenced by completing a rigorous college preparatory track or scoring college-ready on a recognized placement exam; (2) work or perform community service while in college for an average of ten hours a week each semester; and (3) evidence a minimum level of academic work or competency upon completing college. By rooting out inefficiencies in the federal student loan system, we could offset the cost of this new contract with young Americans.

The College Access Contract would:

- **Require students to complete a rigorous college prep curriculum in high school.** The single greatest change we could make to improve college graduation rates would be to ensure that all students take a rigorous college preparatory curriculum in high school. High school curricular rigor is the number one indicator of college completion—more important than race, family income, or parent education, according to two major Department of Education studies. Getting high school students to complete a college preparatory curricular track in high school would significantly improve college completion rates, not to mention high school achievement.

  The quickest way to get high schools to upgrade curricula is to get parents to demand it. High schools and school district administrators respond to active parents, and active parents of high school students tend to be driven by college requirements and concerns about college cost. A College Access Contract that would reduce the federal student loan burden, conditioned on completing a college preparatory curriculum in high school, could inspire parents on a mass scale to demand more rigorous curricula in their local high schools. Not only would participating students be more likely to leave college with a reduced student loan debt burden, they would also be more likely to actually earn a degree because they would be better prepared for the demands of college work.

- **Reward work instead of penalizing it.** A College Access Contract should condition new federal student loan debt relief on a manageable but mandatory work or community service requirement. In exchange for debt reduction, students should be required to work at a paid job or perform community service for an average of ten hours a week while in college. Regular earnings would reduce the total amount that students needed to borrow. Beyond that, however, a work or service requirement mitigates the moral and political hazard associated with guaranteeing debt-free college or zero-interest borrowing. Loan forgiveness in the absence of reciprocal responsibility on the part of students encourages more borrowing.

  Moreover, politically, Middle America is more apt to embrace the idea of extending additional taxpayer financial aid to students if it sees its values reflected in student behavior. It is not enough that a better educated workforce is in everyone's interest. Young people should demonstrate that they are willing to work to get extra help for college.

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  Equally if not more important, a work and service requirement is likely to help students do better academically in college. Students who work up to 15 hours a week while in college report that they manage their time better and study more effectively, according to the U.S. Public Interest Research Group. Fifteen hours a week is the tipping point: more than that, students' studies suffer. But ten hours of paid work a week leads to improved grades. Nothing makes a young person appreciate college like hard work.

  Ideally, students would work or perform community service on or near campus in an area linked to their major field of study in jobs that combine earning and learning—placements that colleges and states should be encouraged to facilitate. But, administratively, it would be simpler to let students fulfill their College Access Contract obligation by working or serving anywhere. They should have to prove to participating states that they have fulfilled their contractual obligation by providing wage receipts, end of the year tax returns, or IRS nonprofit certified service organization filings. Service organizations already confirm participation for AmeriCorps awards.

- **Require degree completion or demonstrated academic competence.** Finally, a College Access Contract should also require minimum student competency in an academic area, with participating colleges required to publicly report results. Public reporting would inspire institutions of higher education to pay more attention to the quality of teaching and learning. An existing higher education accrediting agency, the U.S. Department of Education, or some other body would have to define “minimum competency.” This might simply mean graduating with a degree in an academic major from a rigorously accredited institution or, in other cases, passing a critical analysis and communications skills competency test, such as the existing Collegiate Learning Assessment. Regardless of the indicator selected, institutions that fail to prepare students to a minimum competency level would have to improve or face a loss in consumer demand.

**Only the free market, by means of an auction, can ensure the government subsidy to student loan providers is as low as possible.**

### How to Pay for the Contract

Infusing market mechanisms into the student loan delivery system can save taxpayers billions each year. The highest published estimate of savings to be garnered from heightened student loan delivery efficiency is $60 billion over ten years. An effective approach would be to construct a “rights-based auction” for the delivery of Federal Family Education Loans. Only through an auction can the government ensure that taxpayer subsidies to student loan providers are as low as possible.

Under a rights-based auction, the government would put out to bid the right to originate government-guaranteed student loans at a group of schools or the right to be the “presumed,” but not sole, government-guaranteed lender at a group of schools. Lenders would compete for business by offering the government the highest bid of payments for the right to originate guaranteed loans, or by putting forth the lowest bid of subsidies that they would be willing to accept from the government in return for originating loans. Members of Congress would no longer write into law student loan bank subsidy amounts. Instead, the market would determine the most efficient subsidy level.

A rights-based auction for student loans would not change the terms or conditions of federal college loans for borrowers, which are established by statute, or their availability. Winning bidders would be required to make the same government-guaranteed loans available to all eligible students at schools to which they won the authority to provide federally backed loans. That authority and the group of schools covered would be determined by the government in advance and last throughout each student cohort’s attendance at those schools. Such a system would allow lenders to spread fixed costs over time and students to make payments to just one lender for each school they attend. In the event of poor service to students or schools, colleges and students would retain the option of shifting to the government’s own Direct Loan program, which provides the same loans under the same terms and conditions as the bank-subsidized alternative.

The government has significant experience with auctions. It currently runs 37 different auction programs for everything from spectrum license sales to timber cutting and offshore oil drilling rights to Treasury security sales. According to the Congressional Budget Office, a rights-based auction for student loans would be simple to put into place because it would require little change in the current delivery system for student loans, no change in students’ terms and conditions, and minimal additional investment by lenders.

Taxpayer savings generated by embracing student loan auctions could finance both student loan debt (or interest) forgiveness and the operative conditions of the College Access Contract. Instead of needlessly going into bank coffers, saved taxpayer funds would go to states to pay down the debt of students and upgrade local high schools, particularly high schools serving concentrations of low-income students that disproportionately need better curricula and teachers. To ensure that states do not merely reduce their own education funding as a result of additional federal dollars, they would be required to maintain a fiscal effort for education. Because inflation-adjusted reductions in state aid to higher education are the single greatest contributor to tuition increases nationally, a "maintenance of effort" condition would have the added effect of keeping public college cost increases down.

**Something for Something**

America's entire approach to education from preschool to graduate school needs to be revamped if we are successfully to prepare youth for the global competitive challenges that lay ahead. A new College Access Contract that would reduce the student loan debt burden is a good place to start. It addresses a pressing issue for the middle class. And there is more agreement among policy experts on what needs to be done with respect to college affordability and student loans than on improving elementary and secondary education. The high school/higher education nexus is a policy vacuum; businesses need an educated workforce, so they have a vested interest in students' collegiate success.

But the main reason to embrace the College Access Contract is to teach young people that in this life, you don't get something—even a college education—for nothing. You have to work for it.❖