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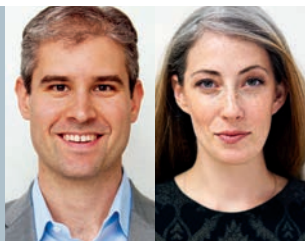
# RETHINKING THE RULES on Federal Higher-Ed Spending

## HOW CAN CONGRESS SPUR INNOVATION WHILE CLAMPING DOWN ON FRAUD?

With the cost of college soaring and the national six-year completion rate below 60 percent, the federal government's support for higher education is facing heightened scrutiny. What kind of regulation and accountability should Congress impose on what might be termed the world's largest voucher program—Washington's hefty funding of Pell grants and subsidized loans? As legislators turn their attention to revising the Higher Education Act, are current levels of regulation sufficient and appropriate, or is there perhaps too much paperwork, bureaucracy, and compliance? What can be learned from the Obama administration's efforts to hold underperforming programs to account? In this forum we hear from Michael B. Horn, co-founder of the Clayton Christensen Institute and an executive editor of *Education Next*, with Alana Dunagan, a research fellow at the Christensen Institute, and from Kevin Carey, vice president for education policy and knowledge management at New America.

### CHANGE THE RULES TO UNLEASH INNOVATION

by MICHAEL B. HORN  
and ALANA DUNAGAN



**EVERY YEAR THE FEDERAL GOVERNMENT** spends more than \$100 billion on higher education, mainly in the form of grants and subsidized loans to students. The historical purpose of this spending has been to broaden access to higher education. Without federal subsidy, students from low-income backgrounds in particular would struggle to afford higher education. They would lose out on the personal and economic benefits that accrue from higher levels of educational attainment, and society would miss out on their potential contributions.

Although federal spending on *(continued on page 52)*

### STRONG HAND OF REGULATION PROTECTS STUDENTS

by KEVIN CAREY

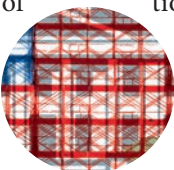


**LAWMAKERS CHARGED WITH WRITING** a new Higher Education Act (HEA) face a dilemma. Innovation in the higher-ed marketplace is badly needed to improve student learning and break the relentless cycle of increasing cost that puts college out of reach for many families. But innovation can also create new opportunities for bad actors to exploit students and taxpayers.

The conversation about managing that tension should start with the lessons of the Obama administration, which tried to create consumer protections for vulnerable college students and was proven right *(continued on page 53)*

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higher education has expanded access, it has also had an unintended effect. Federal funds are available on a pay-for-enrollment basis: as long as students are enrolled in an eligible degree or certificate program, they can receive a Pell grant or apply for a loan. This practice allows students to enroll in programs with low course-completion and graduation rates. Funding is not tied directly to a program's track record of placing students into good jobs, and inevitably, some students end up with debt that they struggle to repay. With pay-for-enrollment, the government ends up investing taxpayer dollars in programs with a low return, whether measured by loans repaid or by social benefit. On top of this, recent evidence suggests that federal spending has partially fueled the annual tuition increases that in recent decades have become endemic at colleges and universities. For instance, David Lucca of the Federal



it limits how programs may deliver their services. The result has been too much regulation and, at the same time, far too little accountability.

### Regulation and Accountability

The House of Representatives has produced a draft reauthorization of the Higher Education Act called the Promoting Real Opportunity, Success, and Prosperity through Education Reform (PROSPER) Act. PROSPER's authors tout it as promoting innovation because it eliminates some of HEA's regulations intended as consumer protections, including the gainful-employment provision that the Obama administration used to hold career training programs accountable if their students graduated with debt they couldn't afford, and the 90/10 rule, requiring for-profit schools to raise at least 10 percent of their revenue from non-federal sources. The draft bill also does

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Reserve Bank and his colleagues examined the connection between the expansion of student-loan credit and the rise in college tuition from 2000 to 2012. They found a "pass-through effect on tuition of [increases] in subsidized maximums of about 60 cents on the dollar for subsidized federal loans" and smaller effects for unsubsidized loans.

Absent fiscal incentives, lawmakers and regulators have historically relied on complex, clunky, and mostly input-laden definitions and rules to try to lure good behavior out of higher-education providers. The current Higher Education Act (HEA), for example, spells out 10 standards for college accreditors to monitor, only one of which pertains to outcomes. This strategy has failed on two counts. First, although aggressive regulation in the Obama years may have forced a handful of for-profit schools out of business, the federal government's historical policy-and-regulatory approach has not raised the quality of the higher-education sector as a whole. Instead, the incentives have, by and large, encouraged schools to imitate each other rather than striving to improve continually and according to their own goals. Second, an input-driven approach in which the resources and processes of higher-education providers are tightly controlled is, by definition, stifling to innovation, because

away with cumbersome and ineffective input-based definitions such as the "regular and substantive interaction" clause. This provision was established to prevent fraud by ensuring that students in distance-education programs eligible for federal financial aid have sufficient interaction with faculty, but it has had the unintended consequence of bedeviling online and competency-based education providers by limiting innovative and streamlined staffing models that take advantage of new technologies.

The proposals in PROSPER have drawn understandable pushback. Innovation often advances the state of the art, but innovation at the expense of student protection could also be a great deal for charlatans, whose abusive practices could hurt students and taxpayers. The tradeoff between innovation and student protection is a false one, however. Regulated properly, innovation in higher education can create tremendous benefits for students. And innovators focused on creating value for students and society have an incentive to operate within a regulatory context that discourages the proliferation of charlatans. In other words, the right focus is not on whether there should be more or less regulation but on the kind of regulation.

Based on the last several decades (*continued on page 54*)

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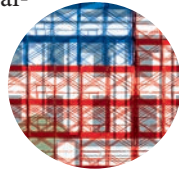
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about everything that matters most.

The Obama efforts began during the earliest days of the administration and continued until the final hours before Donald Trump's inauguration.

Under Obama, the U.S. Department of Education (ED) created new regulations interpreting the long-established "gainful employment" clause of the federal Higher Education Act, which requires job-preparation programs to succeed in preparing people for jobs in order to receive federal financial aid.

Recognizing that it was far beyond the capacity or proper role of the federal government to directly assess tens of thousands of individual programs, the department chose to rely instead on evidence from the labor market to gauge quality. Rather than measuring inputs and processes, the regulations focused exclusively on student outcomes. If too many graduates of a given program couldn't make enough money to pay back their loans—not



failing programs were clustered in a small group of publicly traded corporations, including Corinthian Colleges, the Career Education Corporation, the Education Management Corporation, and ITT Tech. Other well-known for-profits, like the University of Phoenix, were relatively unscathed.

Over the next half decade, while the gainful-employment regulations were held up in court, the for-profit sector was beset by a series of scandals, failures, and bankruptcies. Many of them were concentrated among the same group of institutions—including Corinthian Colleges, the Career Education Corporation, the Education Management Corporation, and ITT Tech. The University of Phoenix and others remained open for business.

In other words, the programs that the Obama higher-education accountability system identified as very bad were, in fact, just that. The process revealed a high degree of correlation between educational incompetence, financial mismanagement, and fraud.

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will be shut off before they reap their profits.

just in one year, but for several in a row—the rules assumed that the job preparation had fallen short, the tuition was too high, or both. Federal aid would be cut off. This was, among other things, a straightforward matter of sound lending policy, since the federal government makes or guarantees the large majority of all student loans.

Most of the programs that had bad debt-to-earnings ratios were run by for-profit colleges. The industry immediately cried foul at the new rules. Millions of dollars were spent on lobbyists in Washington. Lawsuits were filed and fought. The rules were torn up and laboriously revised. Bills were introduced in Congress to prohibit ED from ever so regulating again. Throughout years of conflict, industry representatives insisted that the gainful-employment regulations were "arbitrary," "biased," "a bad-faith attempt to cut off access to education," "ideological," "irrational," "unlawful," and so forth.

But real-world events proved them wrong.

When the rules were first proposed, ED released estimates of how programs would eventually be rated. The regulations applied to for-profit colleges as well as thousands of job-focused programs at community colleges and other public and nonprofit institutions.

Not all colleges fared equally in this preview from ED. Many

To be clear, the lesson here is not that the free market took care of the problem. The very bad programs only persisted as long as they did because they were able to gull naive consumers and stay afloat on a sea of taxpayer dollars. The industry's anti-accountability obstruction resulted in hundreds of thousands of vulnerable students wasting years of their lives while accumulating unmanageable debt that the Trump administration now refuses to write off. Billions of additional public dollars were squandered.

In fairness, it is a challenge for colleges to gather accurate information about how much their alumni earn. Only the federal government can systematically amass that information, by matching data from its student financial-aid system with IRS income records. Once the final list of failing programs was released, most colleges didn't try to reform them in order to prevent eventual sanctions. They just shut the programs down.

In other words, the regulations worked just as intended. The Department of Education, as the steward of taxpayer dollars and protector of consumer interests, applied a simple, transparent, common-sense test of quality, using unique federal data. Individual colleges determined for themselves how to respond, free from advice or interference by federal bureaucrats. If the *(continued on page 55)*

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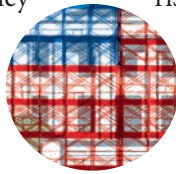
of federal higher-education and K–12 policy, we know that input-based regulation is both stifling to innovation and ineffective at bolstering student outcomes.

Eliminating rules for the sake of driving innovation without developing a new outcomes-based regulatory approach, however, risks further lowering the individual and societal returns on higher education. The reason is that federal aid has created a third-party-payer market in which college costs are obscured for students paying through financial aid. Conservatives who oppose any regulation of higher-education providers by Uncle Sam and who believe in an unconstrained free market are ignoring the lessons from the rise of poor-quality for-profit providers over the previous decade and the fact that no free market operates with money lenders that do not assess the creditworthiness of the people and projects to which they are lending. So long as federal dollars follow students to institutions in a third-party-payer market, it stands to reason that the federal government should have a role in evaluating which institutions are eligible for

authorized several providers to operate CBE programs.

These programs are currently a square peg in a round hole, however, as they seek to operate within a framework designed for time-based arrangements. Gaining approval to operate a CBE program is a lengthy endeavor; getting access to federal financial aid takes even longer. This has limited the growth of the CBE universe. Although hundreds of institutions are developing CBE programs, or considering doing so, only a handful are actively operating CBE models eligible for federal aid.

The PROSPER Act strips away many of the rules and definitions that constrain CBE programs. The Washington-based think tank New America has described this approach as “too much too fast,” writing that “while CBE has significant potential to help students complete their degrees on their own (faster or slower) schedules, opening the floodgates too quickly presents a huge risk, to students and to the field.” The risk is that a lack of rules governing CBE programs—in combination with nearly unlimited federal financial-aid dollars and low transparency around learning or long-term outcomes—attracts a rush of low-quality providers. That isn’t innovation. It’s rent seeking.



Instead of using a pay-for-enrollment model and a long list of rules and definitions, regulators could focus on making students’ postgraduation outcomes transparent for all programs and on realigning federal aid to a pay-for-outcomes model.

how much aid. (This arrangement is different in subtle but important ways from one in which individuals would receive government-funded, lifelong education savings accounts up front with far more dollars than Pell provides and in which they themselves could also invest.)

Funding mechanisms should ultimately reward programs that achieve a strong return on investment and defund programs that don’t work, an approach that could spur innovation in ways that benefit both students and society.

### Competency-Based Education

One model that illustrates both the challenges of the current funding approach and the promise of a new one is competency-based education (CBE), which assesses student progress based on demonstrated mastery of content and skills rather than on time spent (or credit hours earned) in school. CBE has the potential to lower costs, enhance learning, and align higher education to workforce needs. In recent years, CBE has been on the rise as lawmakers have promoted it and regulators have

Although these fears are well placed, strategies to regulate CBE providers by tightly defining what qualifies as a competency-based model are misguided. For example, New America has recommended creating a statutory definition for CBE that maintains the requirement for regular and substantive interaction between faculty and students, but modifies it for the CBE context. This kind of policy, while well intended, would sharply curb innovation at the expense of students. Witness the unintended regulatory hurdles that have ensnared Western Governors University, a high-quality online CBE provider with an innovative staffing model, in legal wrangling with the Department of Education’s inspector general over whether students were experiencing regular and substantive interaction with faculty.

Lawmakers should choose a different path. Instead of using a pay-for-enrollment model and a long list of rules and definitions, regulators could focus on making students’ postgraduation outcomes transparent for all programs and on realigning federal aid to a pay-for-outcomes model. This approach could take a variety of (*continued on page 56*)

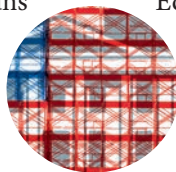
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gainful-employment standards are kept in place, investors will become wary of pumping money into shoddy, marketing-driven programs, fearing that the funding spigot will be shut off before they reap their profits.

What lessons can we learn from the experience of the last nine years? And how should that wisdom be applied to the reauthorization of the Higher Education Act?

To start, the old, pre-Obama higher-education accountability system, which relied on accreditation as a guarantee of quality, will not suffice. Every one of the failing, bankrupt for-profits that have scarred the collegiate landscape over the last decade remained accredited until the day they shut their doors. Peer review through the accreditation process may be a good way to support continuous improvement. It is a terrible way to prevent fraud. The higher-education market runs largely on federal subsidies in the form of grants and loans to students—many of them naive consumers. Absent the strong hand of government regulation, we have a recipe for large-scale exploitation.



Like any other industry trying to protect a sweet combination of massive public subsidies and minuscule public obligations, colleges and universities like to argue that they're burdened by too much paperwork, bureaucracy, and compliance. There is no credible evidence to support this claim. Meanwhile, the industry's defenders in Congress are trying to hobble ED's ability to gather baseline information about which colleges and programs are helping students learn, graduate, and pay back loans. Displaying the disregard for empiricism, public interest, and common sense that we have come to expect from the Trump administration, education secretary Betsy DeVos is actively working to tear down the Obama-era accountability system.

The Republican majority in the House of Representatives has introduced a new version of the Higher Education Act (Promoting Real Opportunity, Success, and Prosperity through Education Reform, or PROSPER) that would eliminate the gainful-employment provision and not replace it with any comparably strong regulations. It would also ax the "90/10" rule, which currently requires colleges to raise a minimum of 10 percent of their revenues

It's possible to create a broad, outcomes-driven accountability system that is agnostic toward the education model an institution uses—and thus, is hospitable to innovation—while protecting vulnerable consumers from predation.

And while the problem of bad programs is concentrated among for-profit colleges, it is not exclusive to them. It turns out that even Harvard University was running a small program in the performing arts with an alarming debt-to-earnings ratio. Senate Committee on Health, Education, Labor, and Pensions (HELP) chairman Lamar Alexander's staff recently released a report calling this "a telling example of how [the gainful-employment] rule has had unintended results." Not so. What the Harvard example tells us is that well-designed accountability systems don't exclude exalted institutions. Once Harvard was notified of the troubling program results, it suspended enrollment so it could revamp its approach to student aid. This is how accountability systems are *supposed to work*.

The limitations of the statutory authority granted by the gainful-employment language meant that ED couldn't regulate public and nonprofit programs that aren't explicitly job-focused. But that's not an argument against accountability. It's an argument for expanding accountability to include programs at all colleges and universities.

from sources other than federal financial aid and thereby uses market outcomes as a proxy for quality.

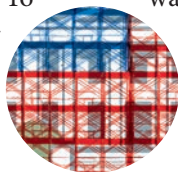
Eliminating these provisions weakens the foundation of consumer protection on which innovation-promoting policies must rest. At New America, we have long championed ideas like competency-based education and other approaches that move past traditional, "seat time" measures of learning. I devoted an entire book, *The End of College*, to exploring how radical new higher-education models can upend the status quo. But the promise of future technology-driven innovation can't blind us to the present-day risk of unscrupulous actors exploiting new rules to fleece the system.

The history of the gainful-employment regulation shows that it's possible to create a broad, outcomes-driven accountability system that is agnostic toward the education model an institution uses—and thus, is hospitable to innovation—while protecting vulnerable consumers from predation. Congress should aggressively work to create room for many new kinds of college education while ensuring that every college, new or old, traditional or yet-to-be-invented, is held accountable for results. ■

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forms, and Congress could use the Experimental Sites Initiative, which waives certain regulations for colleges and universities running experimental programs, to test a variety of schemes and investigate their various impacts and unintended consequences. Currently, there is a dearth of research on the impact of different financial-aid mechanisms on student outcomes.

For example, Congress could authorize risk sharing, whereby colleges would have to repay some financial-aid dollars if students default on their loans. This trial could comprise a set of experiments that test the effects of varying percentages of risk on the college's part. Congress could also experiment with income-share agreements—arrangements in which students pay back a set percentage of their future income for a limited period of time—in which, through a similar risk-sharing mechanism, some college revenues would be contingent on a student's future earnings. To illustrate how this might work: If a program was eligible for \$50,000 in federal financial aid to educate one student, it would receive only 75 percent of that sum up front. When the student graduated, she would



As innovative providers gain market share and serve more students, and as we learn which outcomes-based funding mechanisms work best, the policies can be extended to more of the postsecondary market.

begin paying back the federal government a certain percentage of her salary—perhaps 10 percent over a set number of years. Once the student had paid the government \$50,000, the institution would receive the remaining 25 percent of the federal money. Congress could also make funds more available to providers that produce relatively strong outcomes, which would create more liquidity for programs that deliver a higher return for students and would naturally guide students toward them. This last step would move beyond the current gainful-employment rule—which was an important first move toward outcome-based accountability—because access to funding wouldn't be based on whether a program cleared an arbitrary debt-to-income ratio of its graduates but on the performance of a program relative to that of other schools and on actual market conditions.

All of these funding models would provide incentives for colleges to ensure that their programs are adequately preparing students to succeed in today's labor market. Transparency

around outcomes broken out by demographic segment and information about why students attended those institutions would make it possible for students to make college decisions based on the results.

Using outcomes to create guardrails against waste, fraud, and abuse would be more effective than complex federal definitions of what qualifies as competency-based or online education. The authors of the next HEA reauthorization cannot reasonably be expected to create definitions that will remain relevant through the next decade of technological change and business-model evolution. Focusing on outcomes instead will allow higher-education providers to innovate.

### Where to Start

This type of regulatory approach could be applied broadly across higher education to beneficial effect. But one can anticipate that traditional institutions will fight and try to water down these new regulatory attempts. For political reasons, innovative programs must therefore serve as the guinea pigs for such policies—doing so would be in their own self-interest and would also advance higher education overall. In exchange for the free-

dom to operate as they see fit (that is, with waivers from input-based regulations) and still receive federal financial aid, innovative programs would be funded based on their outcomes—which is how functioning consumer and business markets ultimately operate. Providers that innovate and deliver outcomes tend to grow, while those that innovate but don't deliver will fade. Over time, as innovative providers gain market share and serve more students, and as we learn which outcomes-based funding mechanisms work best with the fewest unintended consequences, the policies can be extended to more of the postsecondary market.

With the pending reauthorization of the HEA, policymakers have an opportunity to craft a framework that unleashes innovators and stimulates them to focus on creating value for students and society. The key, though, isn't to debate whether there is too little or too much regulation but to concentrate on paying innovators for outcomes instead of constraining them by regulating inputs. ■