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Subsidy-Absorbing Institutions of Higher Education

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by Daniel L. Bennett

The government often decides that it would like to subsidize a particular good or service in an attempt to make it more affordable for consumers. It generally does so with good intentions. However, such subsidies are frequently captured by the providers and fail to result in lower prices for the consumer. In such instances, the providers simply increase their prices by the amount, or some portion of, the subsidy. They maintain their margins and increase their revenues, all thanks to the generosity of the public purse (or perhaps politician's failure to understand basic economics). This problem is especially prevalent for subsidized goods and services that economists consider to be relatively inelastic. The term inelastic simply refers to a good whose demand is relatively unresponsive to a change in price. Health care, food and education are often thought to fit the bill of an inelastic good – consumer's generally continue to pay for them even when prices rise.

Higher education is a relatively inelastic good that is highly subsidized by the government. Past politicians decided that it was in the public's interest for more Americans to attend college. Ignoring the 1944 and subsequent GI Bills (which provided returning veterans from WWII and later wars with assistance to pursue further education), 1965 marked the

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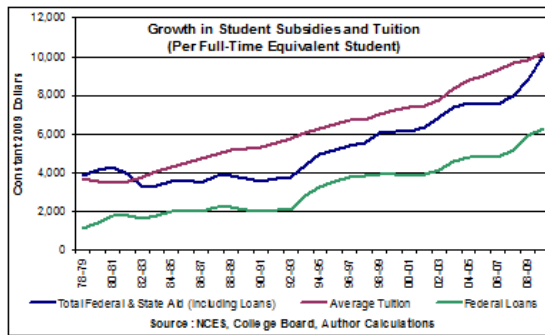
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beginning of the federal government’s adventure in subsidizing students to pursue postsecondary education. It started off in a relatively moderate sense, providing grants and loans to financially needy students who may have otherwise not gone to college. But like many government programs, it soon grew from its fledgling infancy of subsidizing only the poor to subsidizing all students, regardless of financial need.

In 1978, Congress passed the Middle Income Student Assistance Act, which effectively made federally subsidized student loans an entitlement program available to all. Since then, the federal student loan program has exploded, growing at an inflation-adjusted compound annual (real) rate of 7.7 percent between 1978-79 and 2009-10. Last year, the federal government made nearly \$100 billion in student loans. Meanwhile, federal student grants grew at a real annual rate of 2.5 percent during the same period, topping more than \$41 billion in total expenditures last year. In addition, state governments made student grants to the tune of \$8.7 billion last year, which represented a real annual growth rate of 4.1 percent since 1978-79. All student aid programs combined, which also includes tax benefits and work study programs, grew at a real annual rate of around 3.1 percent. This figure does not include subsidies made directly to institutions.

During the above mentioned period, full-time equivalent weighted average tuition increased by an annual real rate of 3.3 percent, outpacing the growth in student aid over the period. This suggests that colleges have increased the prices that they charge students and captured most of the subsidies intended to make college more affordable. The chart below displays the growth in student aid and tuition since 1978-79.



The growth in student subsidies over the past 30 plus years has certainly increased student’s ability to pay for college, but there is a growing body of research suggesting that the subsidies have done little to make college more affordable. A recent study by my colleagues at the [Center for College Affordability and Productivity](#) goes into more detail on how [College Pricing Undermines Financial Aid](#), suggesting that

“colleges often deliberately raise their prices when aid is available, in essence “capturing” the aid. The end result is that higher financial aid does not produce an improvement in college affordability but rather an increased ability on the parts of colleges to fund other programs which are not related to fulfilling their educational missions.”

The below chart plots the growth in total federal and state student aid against the change in one measure of college affordability: the ratio of real average FTE enrollment-weighted tuition to real median family income. I indexed both figures to the base year of 1978-79 in order to provide a comparable view of how the two measures have changed over time, since the former is a dollar figure and the latter a percentage.

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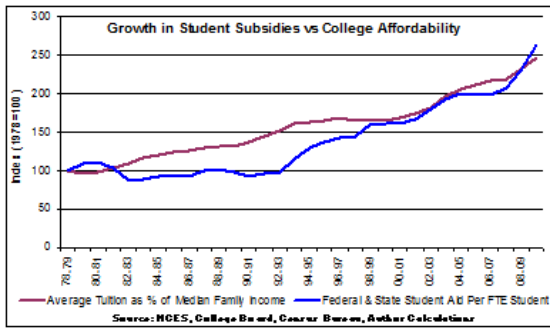
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As measured, college affordability has declined over the past three plus decades. In 1978-79, it took 6.9 percent of the median family income to pay the average tuition charge. This figure reached 10 percent by 1991-92, and has grown to 17 percent since then. The data appears to support the theory: student subsidies have done little to make college more affordable, as the increased subsidies have increased student’s ability to pay, with much of the increase being captured by the providers of the education. Many defenders of higher education attribute the rise in prices to an alleged decline in state appropriations to higher ed. As [Neal McCluskey](#) of the Cato Institute and [others](#) have demonstrated, this allegation doesn’t match the facts. State subsidies to public colleges, although volatile with the economy, have remained relatively constant in real per student dollars, and private colleges don’t receive institutional subsidies, so this hardly explains the surge in tuition. The evidence is relatively clear, public subsidies for higher education are being absorbed by the institutions and used to finance campus expansion and growing [university bureaucracies](#).

Daniel L. Bennett is a research fellow at the Center for College Affordability and Productivity and doctoral student in economics at Florida State University.

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