

# For-Profit Higher Education

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Growth, Innovation and Regulation

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Center for College Affordability and Productivity



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## Introduction

During the 2008-2009 academic year, there were nearly 1.8 million students enrolled at more than 2,800 for-profit institutions of higher learning in the United States. Students in for-profit colleges and universities accounted for over 9% of all students enrolled in postsecondary education.<sup>1</sup> The numbers have continued to grow, and today (2010) the number is rapidly approaching two million, about 10 percent of total student enrollments.<sup>2</sup> The industry has also grown significantly in recent decades. Enrollment in for-profits has increased nearly six-fold since 1986, a time when the sector only enrolled about 2% of all students.<sup>3</sup> Once an insignificant part of the higher education landscape in the United States, for-profit institutions now command a substantial portion of the market and have established themselves as legitimate and viable participants in the postsecondary education arena.

The growth of for-profits is due, in no small part, to the variety of institutions and offerings the sector provides. Institutions range from small vocational and technical schools that offer hands-on career training to large fully-accredited colleges and universities that offer a traditional classroom experience. Many for-profits offer non-degree programs and technical certificates, however associates, bachelors, and doctoral programs, once reserved primarily for traditional universities, are now offered by institutions within the for-profit sector.

Traditional public and private nonprofit institutions of higher learning are similar to for-profit institutions in that they are all providers of instruction at the postsecondary level. The traditional universities and for-profits differ, however, in their control, operation, and mission. Traditional universities are configured as nonprofit organizations whose stated mission often invokes a service of the public good. In contrast, for-profits are structured as profit-maximizing firms whose success depends on providing a valuable service to the student/customer. For-profit institutions can only be profitable if they are able to provide a service that is valuable to the student.

While traditional colleges and universities rely heavily on government appropriations and private donations, for-profits must be self-sufficient and respond to market forces to be successful. The marketplace naturally forces for-profit institutions to offer an educational product that is valuable to students and to do so at a reasonable price. Traditional institutions, however, are not always subject to this threat of “creative destruction.” The recent growth and success of for-profits at a time when many traditional universities are struggling financially serves as a testament to the viability of the sector.

The recent growth of the for-profit education industry has aroused some criticism and concerns about the place of profit in an educational setting and practices within the industry. Critics argue that for-profit universities are simply diploma mills that push students through programs of dubious quality with the primary goal of increasing the firm’s bottom line. Supporters of the industry assert that it provides educational opportunities to traditionally underserved students in areas of study that directly increase students’ employability. While neither extreme view is likely to be completely accurate, there is no doubt that for-profit educational institutions are becoming a much more prominent part of the higher education landscape. The primary purposes of this report are to provide an objective overview of the industry and its students, to discuss operational differences between the traditional educational sector and for-profits, to assess the regulatory environment facing the industry, and to examine the economics of education as a profit-making enterprise.

### A View from the Inside

In preparing this report, we considered it important to talk to leaders in the for-profit education industry. We talked to many different senior officials with for-profit institutions, for example, Randy Best (several interrelated higher education companies), Andrew Clark and Jane McCauliffe of Bridgepoint Education, Mark Pelesh, a senior vice president of Corinthian Colleges, Andrew Rosen and several other associates at Kaplan Higher Education, Richard Bishirjian of Yorktown University, and Michael Clifford, a person intimately involved in financing or supporting several major companies. We also talked to lower level professional personnel, including faculty, at several other schools, such as ITT Educational Services and Rasmussen College. In part to avoid revealing any sensitive information or assign viewpoints to specific individuals who preferred to remain anonymous, we avoid specific quotes in the following discussion.

One thing was clear from talking to everyone above, in marked contrast to talks with similar high ranking people in the nonprofit sector: the focus is strongly on the student—what does she or he want taught? How can we get better learning outcomes in a cost effective way? Should we offer new courses or programs? In conversations with presidents of major nonprofit universities, conversation often turns to issues associated with raising money from third parties, the difficulties of dealing with intercollegiate athletic issues, the problem of exploding costs at university hospitals, the difficulties in measuring and convincing the federal government about research overhead expenditures, the rankings of the college in various magazines, and a host of other matters not directly related to pleasing the undergraduate customer.

Yet it should be stressed that the for-profit community is far from uniform in its views of some issues. Take accreditation. Two of the individuals interviewed were very hostile to current accreditation procedures, one going so far as to suggest that accreditation barriers were the single biggest obstacle to offering quality low cost education to American students. The second made a strong case that both accrediting rules and potentially damaging federal government regulations were the single biggest obstacle to entering business, arguing that for a small higher education start-up company with, say, \$5 million or less in assets, it often takes literally millions of dollars to receive accreditation and rights to engage in business in multiple states. Both individuals noted the irrationality of having firms engaged in business nationally often having to receive approval from multiple regional accrediting agencies or state licensure agencies.

Yet others took a different position. At least two of those interviewed said accreditation agencies sometimes did irrational and costly things, but also provided implicitly an endorsement of achievement of at least minimal quality standards, useful in achieving customer acceptance. As a segment of the industry without a long-standing academic reputation, the for-profits often find the accreditation endorsement crucial to winning consumer acceptance, independent of the fact that students cannot borrow money via the federal student loan program without accreditation. Moreover, they acknowledged accreditation did help sometimes get rid of diploma mills and other consumer scams that reduced the reputation of the entire sector, hurting business for all the legitimate operators. In general, smaller firms were more critical of accreditation than larger ones. At least one individual with a smaller enterprise argued that accreditation should be favored by the big firms because it served to reduce new startup competition.

Yet on most issues there was more agreement than disagreement. All thought that both online and live human instruction would play a role in the future. Everyone thought that the future was generally bright, and that demand for proprietary higher education in the United States is far from saturated. Some thought, however, that international expansion was desirable because of an inevitable slowdown in American

demand growth sometime in the not-too-distant future (and one favored it because of what was viewed as excessive regulation of firms in America relative to some other countries), while others believed they had their hands full expanding within the United States. Reaching new market niches appealed to some, such as introducing college courses more aggressively to high school audiences, a market segment others found relatively unappealing. One or two leaders talked about entering the traditional liberal arts oriented market of residential styled colleges in at least small ways, while others considered it unadvisable to compete head on with established (and always subsidized by third parties) traditional providers.

One huge difference between for-profit and traditional institutions relates to facilities. The for-profit institutions have fewer square feet of space per student (even excluding online programs), use their space more intensively and, most important, generally do not own it—they rent from private entrepreneurs. The for-profit sites we have visited generally were clean, well lighted with good temperature controls, and ample parking. But they did not have fancy atriums, expensive art work, etc., and little or nothing in the way of recreational facilities or other non-instructional “frills” for students.

We asked several executives, “why do you rent most of the space you use, instead of own it?” One response was the one we expected: “we are experts in the education business, not the real estate business.” Another was, “in this environment with vast vacancy in commercial office space, it is possible to get real value by renting, conserving our capital.” Still a third response emphasized flexibility—if you own buildings you have a vast fixed cost, which is reduced dramatically with short to medium length lease agreements. Rental allows schools to respond with respect to their space needs more quickly to changes in student demand with respect to both location and subject matter.

There was particular reluctance to talk on the record about current policy issues relating to higher education, one reason we decided to not explicitly quote individuals in this essay. It is fair to say that concerns are very high (changes in stock prices of for-profit firms in response to policy announcements are often fairly substantial, suggesting considerable investor nervousness on this point). In general, executives felt the Bush Administration was mostly sympathetic and willing to work with the for-profits, while the Obama Administration is more hostile. Changes in student loan policies were not pleasing, as student borrowers must now deal with a single loan provider rather than a multiplicity of private providers. While the expansion of Pell Grants was welcomed, statements by administration officials singling out for-profits for questionable behavior have frightened and angered some senior executives.

More than one executive pointed out that both state and federal government lack the resources to vastly expand colleges, something that seems implicit in presidential goals for high rates of higher education attainment. As one person put it, “the State of California is not going to build eight new campuses for the University of California.” They note that the proprietary schools are already picking up a significant portion of the incremental college enrollments, and disproportionately serve underrepresented populations. Some argued that putting up higher barriers to entry (unreasonable licensing requirements for online providers for example) actually makes it more difficult to meet stated goals with respect to college attainment. The so-called “90/10” rule limiting the proportion of revenues generated from federal financial aid programs was mentioned as a barrier by one respondent, but was something of secondary importance to most of those interviewed.

Regarding faculty, none of those interviewed viewed the prospect of faculty unionization as a threat. We asked whether they expected to make greater use of even lower cost faculty in oversea locales, such as Indian instructors of mathematics, but generally found that little effort was being made to aggressively do this, although some did not rule it out. Most saw no problem with obtaining relatively reliable and

inexpensive staff in coming years as enrollments grow. Some admitted that they “piggy back” off other nonprofit universities, and using moonlighting faculty from traditional universities sometimes gives them an advantage (since these instructors often work for less than the average salary they receive per course from other schools.)

Despite regulatory concerns, all the individuals we talked to were bullish about the future, planning significant investments in coming years. As indicated before, some are increasing their attention beyond the market niches currently favored by for-profits—the adult, vocationally-oriented market. A majority predicted more consolidation of firms will occur, although perhaps not for several years. The recent practice of for-profits buying nonprofit institutions may even accelerate, one or two of those interviewed thought.

### History of For-Profit Education

The roots of market-based education stretch as far back as classical Greece in the fifth century B.C., when proprietary schools and travelling teachers for hire, known as sophists, provided instruction to students willing to pay for their services. The Greek citizenry’s growing demand for educational services combined with the freedom of educators to establish private for-profit schools led to the emergence of a nimble educational system, which was particularly prominent in Athens. In response to the needs of the students and their families, educators taught the subjects students wanted to learn.<sup>4</sup>

Competition among sophists and proprietary schools was brisk and produced two beneficial outcomes for the consumers of education: affordability and quality. Since there was no state-run monopoly on the provision of education, there always existed the threat that one school could undercut the tuition of another, which kept fees at reasonable levels. Education was not just a luxury for children from wealthy families; underprivileged families were also able to send their children to school, if only for a short time.<sup>5</sup> Competition in the marketplace naturally maintained quality in the Athenian educational system. Able teachers whose lessons were valuable to students thrived, while teachers who provided instruction of questionable quality and value were swiftly forced out of the market.

The proprietary educational system in Athens was adept at responding to the changing demands of students and was able to provide tailored educational offerings to a varied array of students. Sophists, motivated by potential profit, travelled to areas where their services were in most demand and subsequently modified their offerings to their new customers’ needs. As Greek society developed and changed over time, so too did the offerings of Athenian teachers in response to the changing needs of their customers.

Educational outcomes were outstanding for that period in history; literacy rates in Athens were the highest of any area in the West at the time, which allowed commerce to flourish and was instrumental to the ascendancy of Athens as a bastion of quality education and an intellectual and cultural powerhouse.<sup>6</sup> Market forces shaped one of the most successful educational systems in the classical world in which affordability, quality, and flexibility were maintained naturally by the forces of competition and responsiveness to the demands of consumers.

The proprietary educational system in Athens was so successful because of its ability to adapt to the ever changing wants and needs of its students; profit acted as an incentive for educators to provide instruction that was in demand. Swift adaptation to the demands of the customer was an aspect of for-profit education that was vital to the success of the Athenian system, but which has also been an important component of for-profit education ever since.

Historically, for-profit institutions have been the first to step in when an instructional vacuum has



existed, created by the inability or unwillingness of the educational establishment to adapt to the changing needs of students. Private instructors in commerce during the Renaissance provide another example of this phenomenon. While traditional universities were primarily focused on classical scholarly pursuits during the era, merchants employed private instructors to deliver lessons in accounting.<sup>7</sup> A focus on teaching skills readily applicable to the working world is another theme that has been important to the provision of for-profit education historically, and which is still important to the industry today.

The beginnings of proprietary education in America date back to the mid seventeenth century when Dutch settlers established private, evening schools. As the colonies developed and commerce expanded, there grew a strong demand for instruction in disciplines important to employment, including surveying, navigation, and accounting.<sup>8</sup> Since these subjects were not traditionally taught in the colleges of the era, proprietary for-profit institutions stepped in to fill the void.

Early colonial colleges such as Harvard, William and Mary, and Yale were established as offshoots of organized religion. As such, their curriculums were rigid and focused primarily on theology, ancient languages, and philosophy. During the late colonial period through the mid nineteenth century, however, there grew a demand for instruction in the areas of business, farming, and engineering that was not adequately satisfied by the classical colleges. By 1800, farmers' organizations were imploring colleges to provide education on the rapidly developing science of agriculture, but the colleges were unwilling to change their curricula. The first traditional agricultural college was not established until 1855. During this half-century gap, a host of successful for-profit agricultural schools sprang up to satisfy the demand.<sup>9</sup>

Modern for-profit universities can trace their lineage primarily to the proprietary business schools that emerged as a dominant force in education in the United States during the nineteenth century. In 1850 only twenty such institutions existed, while by 1890 there were around 250 in operation with total enrollment of 81,000 students.<sup>10</sup> At the height of the Industrial Revolution, these schools satisfied a strong demand for practical skills training that was not provided by traditional universities of the era.<sup>11</sup> An 1873 U.S. Bureau of Education report stated, "The rapid growth of the schools and the large number of pupils seeking the special training afforded by them sufficiently attest that they meet a want which is supplied by no other schools in an equal degree."<sup>12</sup> The most influential of the early for-profit business schools were the Bryant and Stratton colleges, established in 1852. The Bryant and Stratton schools developed some of the efficiency-enhancing tactics used by modern multi-campus for-profit universities today such as textbook and curriculum standardization.<sup>13</sup> Several of the pioneer for-profit business schools are still in operation today including Strayer University and the now nonprofit Rider University.<sup>14</sup>

The growth in the for-profit higher education industry sped up in the mid twentieth century following World War II, when federal financial assistance for students increased. Under the GI Bill, for-profit institutions became qualified to accept students taking advantage of the legislation's benefits. Further accelerating the growth of the sector was the reauthorization of the Higher Education Act in 1972 which permitted tuition subsidies, like the Pell Grant, to be used by students at for-profit institutions.<sup>15</sup>

With the introduction of federal student funding to the for-profit sector came a wave of scandals and fraud. A host of disreputable "schools" were established with the sole purpose of cashing in on the influx of federal money. Government investigations quickly followed and the industry was eventually purged of most illegitimate operations. By the 1990's the industry was strongly regulated at the federal level to prevent abuse.<sup>16</sup> The emergence and subsequent removal of fly-by-night scams in the industry left, for the most part, only legitimate for-profit institutions in the industry. This cleansing set the stage for the increasingly prominent position for-profits occupy in the education space today.

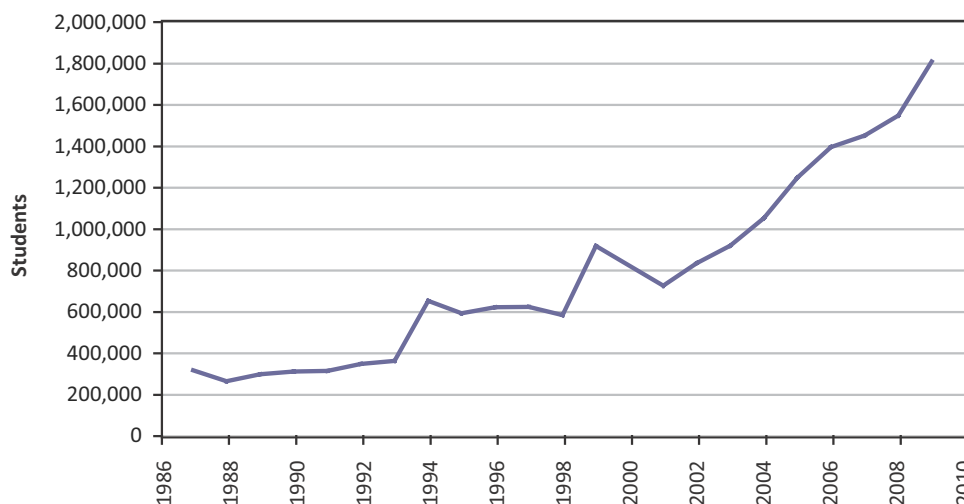
## Recent Trends in Student Characteristics and Enrollment

The for-profit higher education sector in the United States has grown swiftly over the past two decades. As shown in Figure 1, in 1986 these institutions enrolled just over 300,000 students, while by 2008 enrollment had climbed to nearly 1.8 million.<sup>17</sup> The growth of the sector has significantly outpaced the growth of traditional nonprofit institutions and the higher education industry as a whole. From 1986 to 2008, the for-profit sector grew at an average annualized rate of 8.4%, while public universities and private nonprofit institutions grew at 1.6% and 1.4% per year, respectively, for the same 22 year period.<sup>18</sup>

While the absolute change in for-profit enrollment has been impressive, even more revealing of industry’s increasing prominence is the share of the total higher education market that it has been able to capture. For-profit market share, as defined by its share of total students enrolled in institutions of higher learning in the United States, stood at 9.2% in 2008, up from just 2.4% in 1986, as shown in Figure 2.<sup>19</sup>

For-profit institutions satisfy a real and growing demand for their educational services, as evidenced by the significant share of the total market they have been able to capture. A closer look at the characteristics of students enrolled at for-profits indicates that the growth of the sector has been achieved, in part, by providing educational opportunities for students historically underserved by traditional institutions of higher learning. As shown in Figure 3, for-profit institutions generally serve an older student population. In 2007, more than half of all students enrolled in for-profit institutions were older than 25, while only one quarter to one third of students enrolled in traditional private nonprofit and public universities were 25 or older.<sup>20</sup>

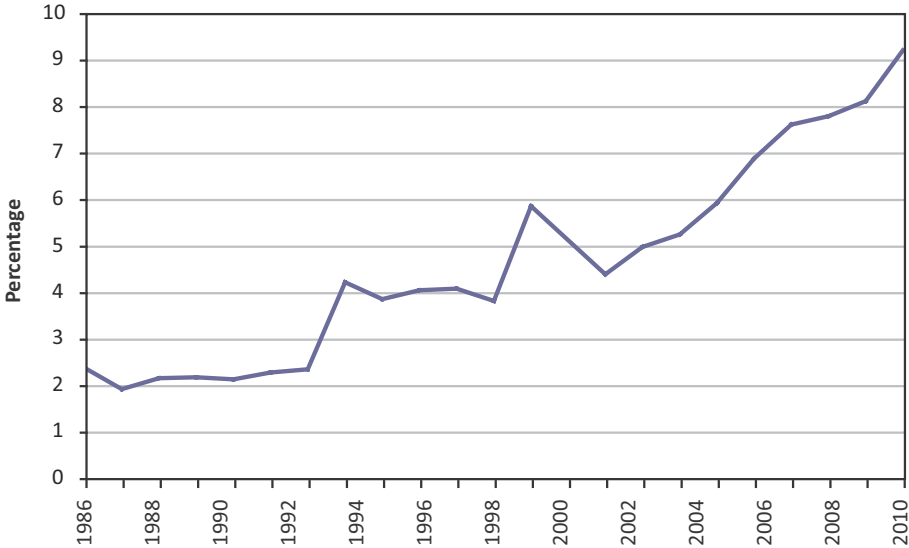
FIGURE 1  
TOTAL ENROLLMENT IN FOR-PROFIT INSTITUTIONS, 1986–2008



Source: U.S. Department of Education, NCES, IPEDS.

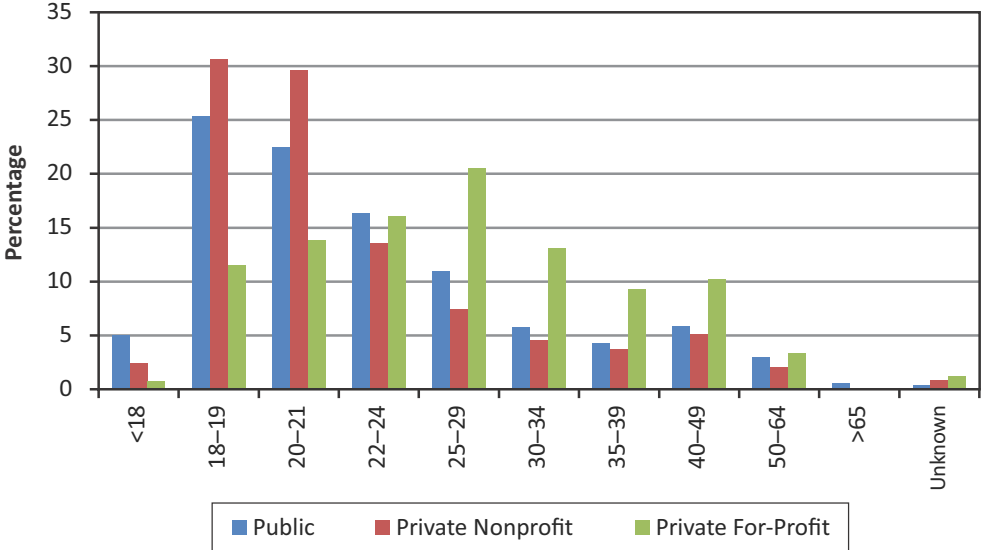


FIGURE 2  
FOR-PROFIT MARKET SHARE, 1986–2008



Source: U.S. Department of Education, NCES, IPEDS; Authors Calculations.

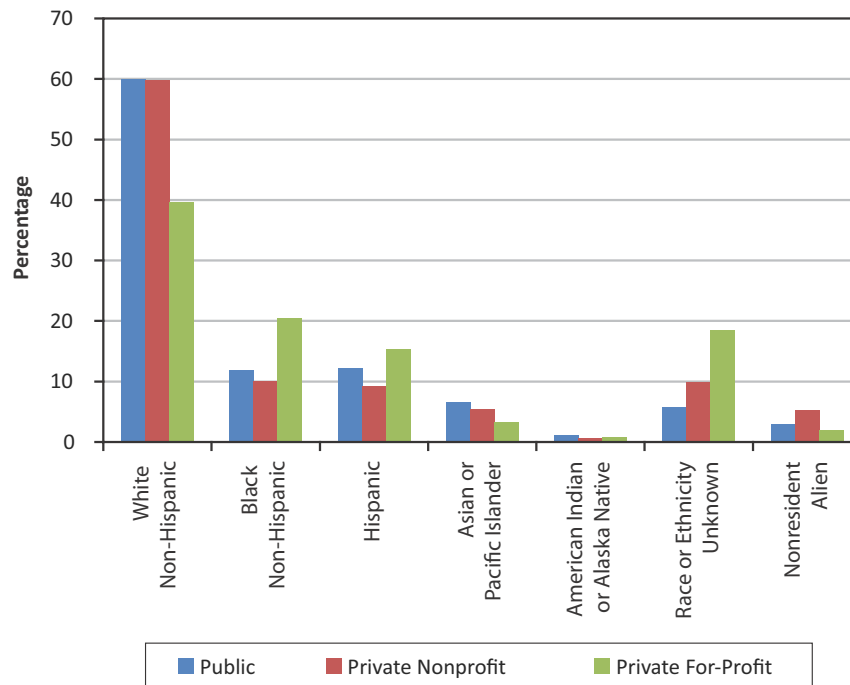
FIGURE 3  
AGE DISTRIBUTION BY SECTOR, 2007–2008



Source: U.S. Department of Education, IPEDS.



FIGURE 4  
 PERCENTAGE OF SECTOR ENROLLMENT BY RACE OR ETHNICITY, 2007–2008



Source: U.S. Department of Education, IPEDS.

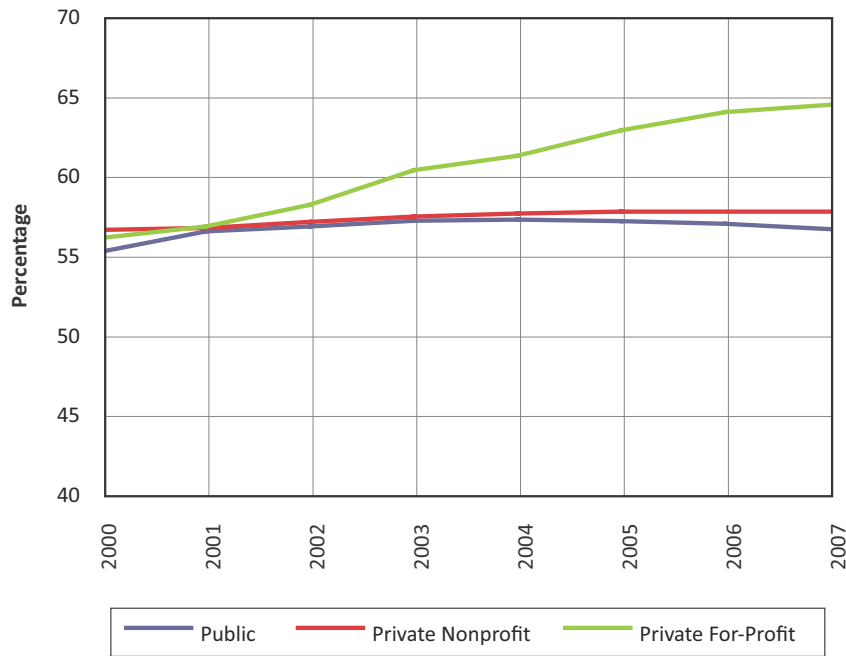
Serving racial minorities has also been instrumental in the growth of the for-profit sector. As shown in Figure 4, students enrolled in for-profit universities represent a much more diverse group than do students in traditional public and private nonprofit universities. In 2007, students who are black, Hispanic, Asian, or American Indian accounted for nearly 40% of total enrollment in for-profit schools, while the same groups accounted for only 31% and 25% of enrollment in public and private nonprofit universities, respectively.<sup>21</sup>

Female students have outnumbered male students in higher education in the United States in recent decades, but the trend is much more pronounced within the for-profit sector. As shown in Figure 5, female students make up 64% of enrollment in for-profit institutions, while in public and private nonprofit institutions females account for 57% and 58%, respectively, of total enrollment.<sup>22</sup> Not only do women outnumber men in for-profit universities, but their enrollment has grown at a much faster rate. From 1986 to 2007, female enrollment in for-profits grew at an average annualized rate of 9.6%, while male enrollment grew at an average annualized rate of 5.9%.<sup>23</sup> The growth in female enrollment at for-profit institutions has also outpaced the growth in female enrollment at traditional schools, as seen in Figure 5.

As is the case with all sectors of higher education, undergraduate students outnumber graduate students by a significant margin at for-profit institutions. As can be seen in Figure 6, graduate students account for 13% of enrollment at for-profit institutions, which is very similar to the proportion of graduate students at public institutions (10%), and the proportion of all students enrolled in an institution of higher learning (14%).<sup>24</sup>



FIGURE 5  
 FEMALE SHARE OF TOTAL ENROLLMENT BY SECTOR, 2000–2007



Source: U.S. Department of Education, IPEDS.

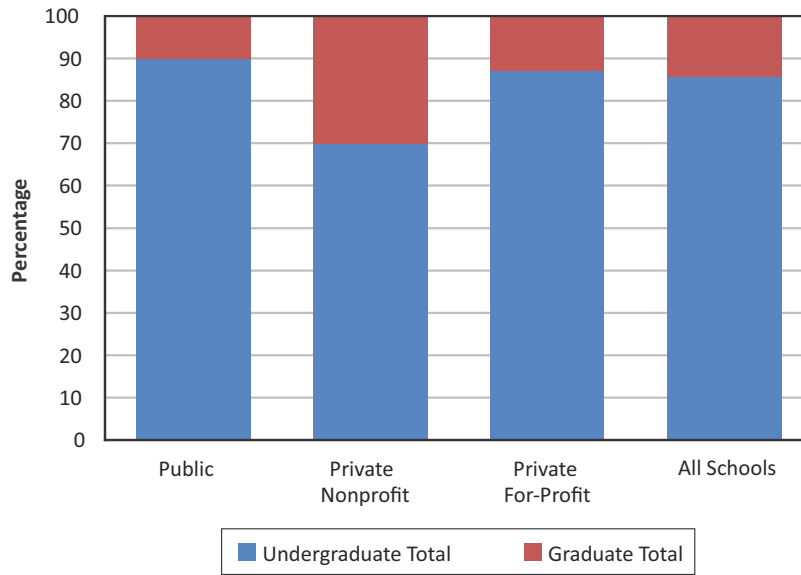
Most students enrolled in for-profit schools choose to pursue their education full time. Surprisingly, the proportion of full-time students in for-profit institutions is higher than in the traditional public and private nonprofit universities. As Figure 7 shows, 79% of student at for-profits study full time, while the proportion stands at 57% and 74% for public and private nonprofit institutions, respectively.<sup>25</sup>

### Scope of the For-Profit Higher Education Industry

The for-profit sector of higher education in the United States is in no way monolithic; there exists tremendous variety among institutions in terms of program offerings, degrees awarded, and learning venue. Institutions range from small certificate granting institutions that focus primarily on specific vocational skills to institutions that offer a wide variety of courses and traditional undergraduate and graduate degrees.

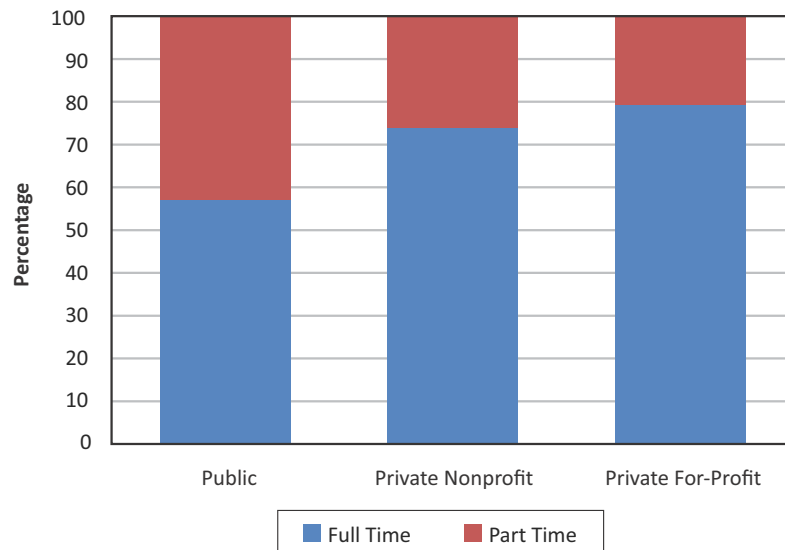
During the 2008–2009 academic year there were over 6,700 institutions of higher learning in operation in the United States of which about 2,900 were private for-profit schools.<sup>26</sup> While for-profit institutions account for more than 40% of the total schools in operation, students enrolled in these schools account for only 9.2% of the all students enrolled in an institution of higher learning. Consequently, the average for-profit school is quite small in comparison to the average public or private nonprofit institution. The

FIGURE 6  
STUDENT DISTRIBUTION BY LEVEL AND SECTOR, 2007–2008



Source: U.S. Department of Education, IPEDS; Authors Calculations.

FIGURE 7  
PERCENTAGE OF STUDENTS BY ENROLLMENT STATUS, 2007–2008



Source: U.S. Department of Education, IPEDS; Authors Calculations.



TABLE 1  
LARGEST FOR-PROFIT INSTITUTIONS

<b>Institution</b>	<b>2008-2009 Enrollment</b>	<b>% of Total For-Profit Enrollment</b>
Apollo Group	395,361	21.2
Education Management Corporation	104,547	5.6
Career Education Corporation	97,645	5.3
Corinthian Colleges	85,029	4.6
DeVry	78,544	4.2
Kaplan Education	67,897	3.7
ITT Educational Services	60,890	3.3
Strayer Education	45,491	2.4
Laureate	37,201	2.0
Bridgepoint Education	25,746	1.4
Capella Education	25,245	1.4
Lincoln Educational Services	23,403	1.3
Grand Canyon Education	22,025	1.2
American Public Education	21,729	1.2
Universal Technical Institute	15,735	0.9
<b>Total of Largest Institutions</b>	<b>1,106,488</b>	<b>59.5</b>

Source: U.S. Department of Education, IPEDS; Authors Calculations.

average for-profit institution enrolls only about 600 students, while the averages for public and private nonprofit stand at 7,000 and 2,000 students, respectively.<sup>27</sup>

Most students in the for-profit sector enrolled in a degree or certificate-granting program. Ninety nine percent of students enrolled in a for-profit school are seeking an associate's, bachelor's, or graduate degree, or a professional certificate.<sup>28</sup> Only 38% of for-profit institutions, however, actually grant traditional undergraduate or graduate degrees.<sup>29</sup>

In terms of the types of degrees offered, for-profits are well within the domain traditionally dominated by public and private nonprofit colleges and universities. The areas of study in which the degrees are offered, however, differ dramatically between for-profits and nonprofits. Because for-profit colleges and universities cannot rely primarily on public funding, they must be able to recover nearly all costs associated with the provision of their product in the form of tuition. For this reason, for-profits tend to focus on degree programs with measurable skill outcomes that are more likely to pass a costs-benefit test for students. An analysis of the disciplines in which for-profits offer the most degrees reveals that the majority of for-profit students are focused primarily on acquiring skills that will directly increase their value in labor markets. During the 2000-2001 academic year, 29.3% of all BA degrees awarded by public universities were in the arts and sciences disciplines, while only 0.3% of all BA degrees awarded by for-profit institutions fell within the arts and sciences. For the same academic year, 18.9% of BA degrees awarded

by public institutions fell within the category of Business Management and Administrative Services, while 56.1% of BA degrees awarded by for-profits were within the same category.<sup>30</sup>

As discussed earlier, the for-profit area of higher education contains a large number of institutions relative to the total students enrolled in the sector, resulting in a relatively small average institutional size. While this is true, the industry is actually dominated by a handful of very large institutions, some of which dwarf even the largest public university systems in the United States. Large multi-campus for-profit schools that offer both brick and mortar and online programs have become the driving force in the industry in recent decades. In terms of size, profitability, and corporate structure, these firms, such as the dominant Apollo Group, are similar in nature to other major US corporate powerhouses. As can be seen in Table 1, the largest 15 firms in the industry enroll nearly 60% of all students in the for-profit sector<sup>31</sup>

### Major Industry Players

While there are literally thousands of schools offering post-secondary instruction on a proprietary basis, a relatively small number of industry leaders control a significant share of the market. Three of the largest firms are discussed in more detail below.

#### *Apollo Group*

By any measure, the Apollo Group (APOL) is overwhelmingly the leading player in the for-profit education industry. APOL's beginnings can be traced back to 1973, when John Sperling founded an adult education program that worked with traditional institutions to provide educational offerings to nontraditional students.<sup>32</sup> The firm's focus on providing learning opportunities to an older demographic was a key element in its growth and dominance in the industry. In the early 1970's, Sperling conducted research on the accessibility and quality of educational offerings for working adult students. He found that the limited availability of evening classes and academic support offices that were only available during regular business hours made it difficult for working adults to earn a degree without significant hassle and in a reasonable period of time.<sup>33</sup> Sperling's research provided the motivation to establish the University of Phoenix in 1976.<sup>34</sup> The institution's initial focus was to help the working adult student who already had some undergraduate credits finish his/her degree in a reasonable amount of time.<sup>35</sup> In fact, until recently, the University of Phoenix would not admit students under 23 years of age.<sup>36</sup> By focusing on the nontraditional student and avoiding the traditional higher education demographic, the University of Phoenix was able to carve out a highly successful niche market and become a dominant force in for-profit sector.

APOL's meager beginnings stand in stark contrast to the firm's position today. During the 2008–2009 academic year, APOL's schools enrolled nearly 400,000 students.<sup>37</sup> This enrollment represents a market share of about 21% within the for-profit sector and nearly 2% of all students enrolled in an institution of higher learning in the United States.<sup>38</sup> APOL provides flexibility and accessibility for its customers, as students can choose to work towards more than 100 degree programs either online or at one of the institution's 74 campuses and learning centers located across the country in 39 states.<sup>39</sup> The firm has also performed exceptionally well financially. In 2009, APOL's revenues stood at \$4 billion and it turned a profit of \$598 million.<sup>40</sup> APOL is part of the S&P 500 index and had a total market capitalization of over \$11 billion in 2009.<sup>41</sup> As of this writing in May 2010, that valuation had declined somewhat, to above \$8.7 billion, in part because of growing concerns about federal regulatory restrictions on the industry, which will be discussed later in this report.



APOL's ascendency to the dominant position in the for-profit higher education space has not been completely smooth sailing. For example, in 2008 APOL was ordered to pay shareholders \$280 million in damages as the result of a suit filed against the firm. The plaintiffs claimed APOL had withheld information contained in a damaging Department of Education report accusing the University of Phoenix of employing deceptive and aggressive recruitment tactics.<sup>42</sup>

### *Education Management Corporation*

As measured by total enrollment, Education Management Corporation (EMC) is the second largest for-profit education company. While the firm is an undoubtedly important player in the industry, enrollment in EMC's schools (136,000 in October of 2009) is only a third of the size of total enrollment in Apollo Group schools.<sup>43</sup> Founded in 1962, EMC focuses primarily on career-focused program offerings provided in both a traditional classroom setting and online.<sup>44</sup> EMC is somewhat unique in terms of the market it serves. Almost half of the company's students are "traditional" and over 70% choose to pursue their program in a campus based setting.<sup>45</sup>

EMC serves its students through four distinct institutional brands, each with a specific focus on career training: the Art Institutes, Argosy University, Brown Mackie College, and South University. With 45 campuses and a total enrollment of 76,500 students, the Art Institutes is by far the largest of EMC's operations.<sup>46</sup> The Art Institutes offer art training that provides specific career-oriented skills such as graphic design, media arts and studies, culinary training and fashion.<sup>47</sup> With 20 campuses and nearly 24,000 students, Argosy University is EMC's second largest operation.<sup>48</sup> It too focuses primarily on career skills, specifically the growing fields of education, health sciences, business, and behavioral sciences. The rest of EMC's students are enrolled in either one of the Brown Mackie College campuses or a South University campus. These schools also focus primarily on in-demand career skills.

EMC has been successful in growing enrollment consistently, which is likely due to their specific focus on career training. In delivering these programs, however, the company has taken a somewhat unique accreditation strategy.<sup>49</sup> While many for-profit providers seek accreditation from a single source for all campuses and operations, EMC has chosen to use multiple accreditors. The Art Institutes and Brown Mackie College use multiple accreditors, while Argosy University and South University each use a single accrediting body.<sup>50</sup>

In 2006, EMC was taken private by a consortium of investors only to reemerge as a publicly traded company in 2009.<sup>51</sup> Since becoming a publicly traded company again in 2009, the firm's stock price has remained relatively flat, likely due to a more hostile regulatory environment and somewhat inconsistent profits. Despite this, EMC still has a total market capitalization of around \$3.1 billion (May 2010) and generated a profit of over \$100 million for the firm's 2009 fiscal year.<sup>52</sup>

### *Career Education Corporation*

Founded in 1994, Career Education Corporation (CECO) is the youngest of the three largest for-profit schools.<sup>53</sup> The firm was established primarily to acquire existing schools and was able to grow rapidly during the decade after its founding by employing this strategy. CECO went public in 1997 and used the proceeds from the sale of its stock to fuel its acquisition and growth strategy.<sup>54</sup> Today, the firm has 90 campuses with a total enrollment of 116,000 worldwide.<sup>55</sup> Consistent with the career-focused theme within the for-profit education industry, CECO offers degree programs in design, business, culinary arts, and health services across a variety of institutional brands such as American InterContinental University,

Colorado Technical University, International Academy of Design & Technology and Le Cordon Bleu North America.<sup>56</sup> Nearly 40% of Career Education's students choose to pursue their degree programs online.<sup>57</sup>

Along with the firm's rapid growth in the decade after its founding came a wave of scandals and controversy. CECO was sued by shareholders claiming misrepresentation in 2003 and 2004.<sup>58</sup> The company was also investigated by its accreditors and was even featured in a *60 Minutes* special that exposed unethical recruitment practices carried out by some of the company's employees in 2005.<sup>59</sup> In response to the scandals at CECO's schools, the Department of Education prevented the company from expanding or opening new branches beginning in 2005.<sup>60</sup> This restriction was lifted in 2007.<sup>61</sup> Despite the scandals that plagued the firm, CECO has continued to be profitable, although its stock has remained relatively flat since the scandals began in the middle part of the 2000's.<sup>62</sup> Nonetheless, with a \$2.5 billion capitalization it remains an important player in the industry.

At the time of this writing, there is considerable controversy relating to the accreditation of American InterContinental University by the Higher Education Commission (HEC), the accreditation division of America's largest regional accreditation association, the North Central Association. The Inspector General of the U.S. Department of Education issued a report that was scathing in its denunciation of the HEC for granting American InterContinental accreditation, arguing that practices of that institution regarding the awarding of credit were inappropriate.<sup>63</sup> The report produced shock waves both in the accreditation and for-profit higher education communities because of the harsh remedies recommended by the Inspector General, including a proposal to strip the HEC of its accreditation powers.

### *Other Leading Firms*

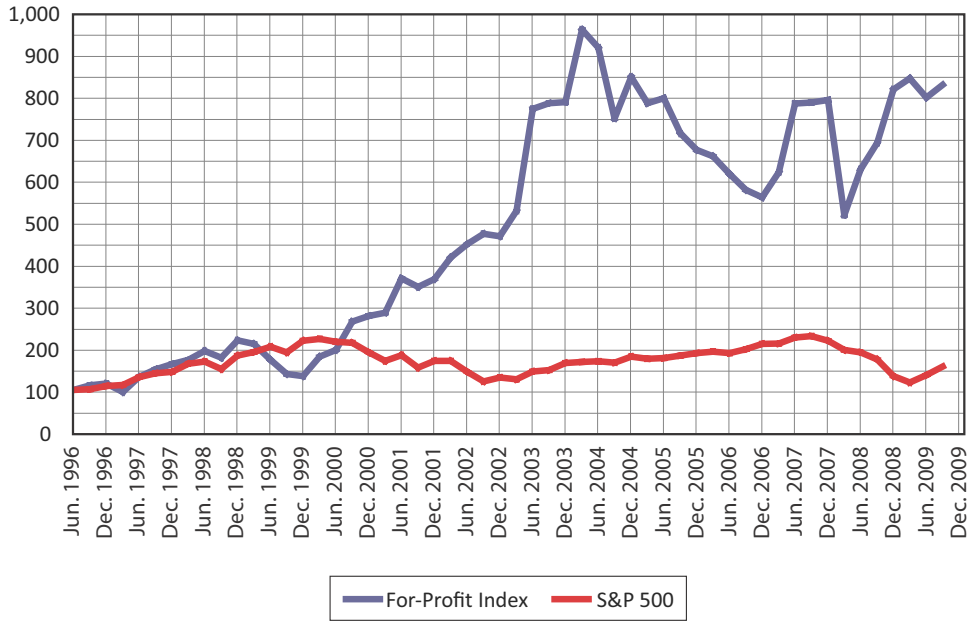
As indicated above, there are many other leading firms, several with more than billion dollar capitalizations. Strayer Education, for example, which is concentrated in the states surrounding Washington, D.C., is smaller in terms of enrollment than any of those discussed above, but is exceedingly profitable, with post-tax profits exceeding 20 percent of revenues, and a total market capitalization greater than either CECO or EMC. Several other publicly traded companies are large in size, including, for example, Corinthian Colleges, Capella Education, DeVry, and ITT Educational Services. Some large companies are part of larger corporations with non-educational operations (notably Kaplan Higher Education), or are privately held (e.g., Laureate Education).

## Financial Performance of the For-Profit Industry

In an era when many public and private nonprofit universities have struggled financially, for-profit institutions of higher learning have, for the most part, been financially successful. Further, this financial success has come in the absence of direct government appropriations to for-profit institutions, something upon which traditional colleges and universities are heavily reliant.

The equity shares of most of the top players in the for-profit industry are traded on major U.S. stock exchanges. These are not insignificant stocks; in late 2009, the combined market capitalization of the twelve largest firms stood at \$30.6 billion.<sup>64</sup> Investors have been extremely confident in the industry's viability and continued success, as evidenced by the performance of many for-profit education stocks. CCAP has constructed a stock index that includes the largest twelve for-profit education companies. The CCAP For-Profit Higher Education Index (FPHEI) is market capitalization weighted, just as the S&P 500 Index. As seen in Figure 8, for-profit education firms have significantly outperformed the market. The FPHEI increased in value by over 700% from June 1996 to December 2009, a period during which the S&P 500 Index increased by 56 percent.

FIGURE 8  
 CCAP FOR-PROFIT HIGHER EDUCATION INDEX, JUNE 1996–DECEMBER 2009



Source: SEC forms 10-K and 10-Q filed; Yahoo! Finance Historical Prices; Authors calculations.

The FPHEI grew relentlessly until peaking in 2004. Until 2004, many of the for-profit stocks were viewed by investors as strong growth companies that had nowhere to go but up. This is due, in part, to continued profitability as well as strong enrollment growth in the industry. Since 2004, the index has seen much more volatility. This can be explained by questions raised by some observers about recruitment and other practices in the industry and a subsequent fear of increasing government scrutiny and regulation as for-profits continue to grow more dominant in higher education. Nevertheless, an investment in the index in 1996 would have vastly outperformed the broad market.

Strikingly, during the precipitous decline of broad stock indices induced by the global financial crisis, the FPHEI has grown. For almost the entire period that the S&P 500 was on a downward trajectory during 2008 and into 2009, the FPHEI was on an upward trajectory. During that period, the S&P 500 was cut almost in half, while the FPHEI grew by nearly 60%. The FPHEI tends not to correlate highly with the broad market, and in recent years it has become somewhat countercyclical. This counter-cyclicality is likely explained by the nature of the product offered by these firms. During an economic downturn, many workers may take the opportunity to pursue additional education to increase their value in the labor market in anticipation of an economic rebound. Interestingly, for-profit institutions are uniquely positioned to respond to this demand since the firms are able to cover their operational expenses primarily from tuition revenues. The same can certainly not be said for public universities, whose budgets are often significantly affected by state governments during recessions.

The performance of for-profit education stocks represents the culmination of a transformation of the proprietary education industry. Historically, for-profit education was dominated by small independent



trade schools, while in recent decades the industry has come to be dominated by large publicly traded corporations that offer educational programs once the domain of only public and private nonprofit colleges and universities. This transformation is simultaneously indicative of a growing demand for an alternative to the traditional higher education model and the engine that fueled the capacity growth necessary to satisfy the growing demand.

While the shift of for-profits towards large corporate structures has been vital to the growth of the industry, some observers have raised concerns about how the trend may negatively affect the quality of the educational offerings these firms provide. Some argue that a harmful culture of growth permeates the management of the largest players in the industry and that by focusing primarily on short-term profits the product could suffer.<sup>65</sup> It is not inconceivable that there exists an incentive to admit and push through as many students as possible regardless of qualifications and the likelihood that the students will be able to complete the degree program. Such practices could certainly increase short-term profits. However, such actions also represent an unsustainable business model. Students are ultimately only willing to pay tuition or incur debt to do so if the benefits of the degree outweigh the cost, or at least there is a perception that such is the case. If for-profit institutions were to consistently provide watered-down and low quality offerings, the customers would simply not be there.

Standing as a testament to the viability of the sector are two for-profit education firms that went public during the depths of the global financial crisis when only a handful of companies were able to stage successful Initial Public Offerings (IPO). Grand Canyon Education, Inc. (LOPE) went public in November 2008 at an initial share price of \$12. At the time of this writing, its shares were trading around \$25.<sup>66</sup> LOPE is a non-denominational university based in Phoenix that enrolls more than 22,000 students in both classroom-based and online courses. Bridgepoint Education (BPI) was the most recent pure play higher education IPO. The firm enrolls more than 25,000 students in its Ashford University and University of the Rockies operations. It went public in April of 2009 at an initial share price of \$10.50. At this writing, BPI was trading for around \$24 per share.<sup>67</sup>

The success of these two IPOs during some of the most extreme financial turmoil in decades is further proof of the confidence investors have in the for-profit education industry. The companies were almost the only significant new IPOs during the financial crisis, yet not only were they successfully launched as public companies, their stock has risen sharply at a time of investor pessimism. Both have market capitalizations today exceeding one billion dollars.

While no two for-profit education firms are exactly alike and the industry is comprised of institutions that vary in size, scope, and program offerings, most of the largest firms in the industry are consistently profitable. This fact is the primary reason that investors have shown such faith in the equities of the major players in the sector. An analysis of the four largest firms in the sector as measured by total market capitalization (Apollo Group, ITT Educational Services, DeVry, and Strayer Education) indicates this trend of profitability.

For the past four years, all four firms have generally seen double digit revenue growth ranging from a low of around 8% to a high of nearly 34% year-over-year growth. Profits have also grown consistently in recent years. All four firms have been able to turn a significant portion of their revenues into profits. Profit margins for the firms range from 11% to 23% for their 2009 fiscal years. The return on equity the managements of these firms have been able to generate has also been impressive. At this writing, return on equity ranges from a low of 24% for DeVry to a high of 184% for ITT Education services.

Economic theory would suggest that where rates of return on investment are high and demand is growing rapidly, the lure of profits will draw new entrants into the field, ultimately lowering abnormally



high rates of returns to existing dominant companies. The Grand Canyon and Bridgepoint experiences are examples of this theory playing out, as well as many privately held companies that are new but relatively well established (e.g., the companies controlled by Dallas merchant banker and entrepreneur Randy Best), or are beginning to emerge (e.g., Yorktown University). The relatively high stock valuations investors place on the for-profit companies are consistent with the view that investors believe that growth for these companies will continue to be robust, implicitly suggesting they will continue to gain market share at the expense of traditional colleges and universities.

## Revenues and Expenditures: For-Profits Employ a Different Strategy

Among the many differences between for-profit institutions of higher learning and traditional public and private nonprofit institutions, perhaps the most striking is the source of their revenues and expenses. In contrast to the traditional sectors of higher education, for-profits exist to provide their owners with returns. Further, for-profits are subject to taxes and scrutiny by regulatory agencies such as the Securities and Exchange Commission (SEC) and the Federal Trade Commission (FTC), and receive little, if any, direct appropriations from governments. These differences between for-profits and traditional institutions of higher learning lead to very different revenue and expense management strategies.

### Revenues

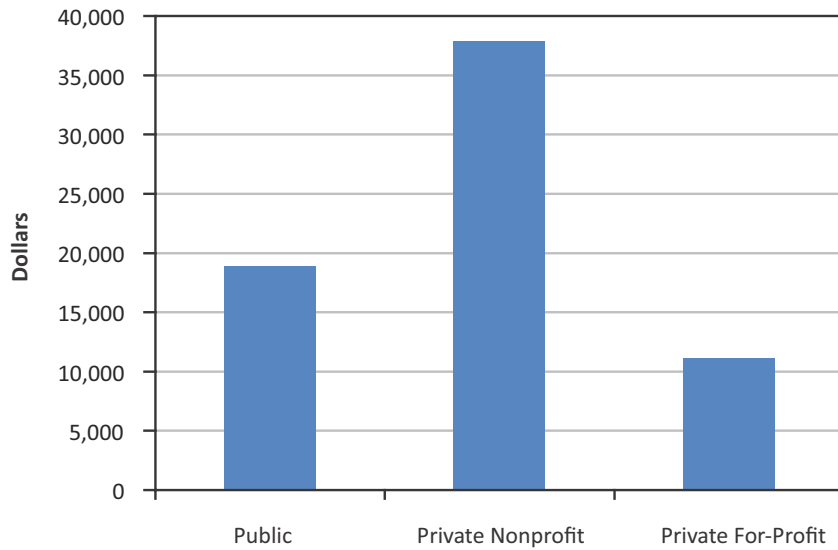
Private for-profit institutions receive far less revenue per student than do public and private nonprofit colleges and universities. As Figure 9 shows, for-profits received, on average, \$11,130 in revenues per student in 2008–2009, while public universities collected \$18,922 per student and private nonprofit colleges received a staggering \$37,869 per student.<sup>68</sup> Since spending per student closely parallels revenues, this difference suggests that the total resources that society expends per student are much lower at the for-profit institutions.

In addition to extreme variation in the amounts of funds received per student, the relative proportions of funding sources also differ markedly. In contrast to their public and private nonprofit counterparts, the primary source of revenues in for-profit institutions is tuition. Over 85% of for-profit revenues are derived directly from tuition, while at public and private nonprofits, tuition only accounts for 17% and 36% of total revenues, respectively.<sup>69</sup>

For-profit institutions receive very little direct government support, while at public and private nonprofit institutions government appropriations represent a much more substantial portion of total revenues. Government appropriations, grants, and contracts represent about 7% of for-profit revenues, or about \$775 per student. These funding sources account for about 12.5% of total revenues at private nonprofits, or around \$4,700 per student, and nearly half of total revenues at public institutions, or about \$9,400 per student.<sup>70</sup>

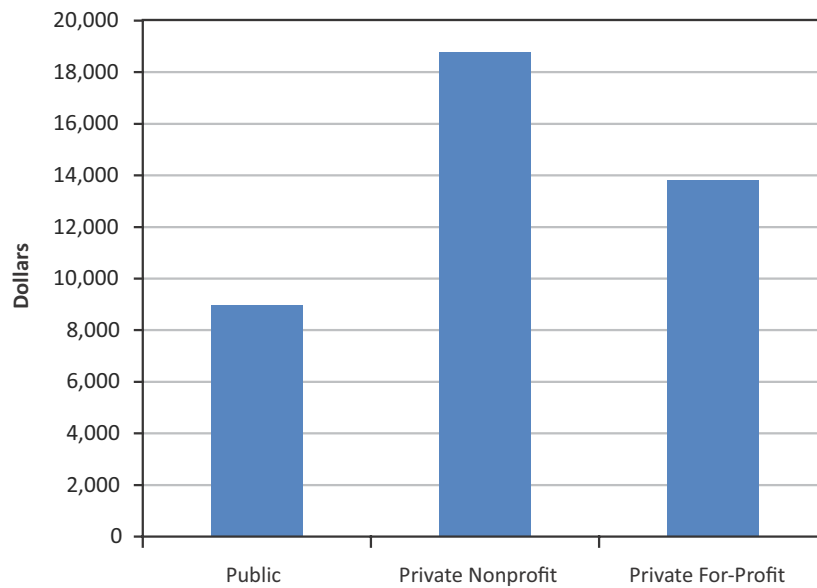
One might infer that, with little direct government support at for-profits, tuition must be extremely high to finance their operations. In fact, this is not the case. As shown in Figure 10, average tuition at for-profits is higher than what a public school would charge an out-of-state student, but it is still lower than the average tuition charged by a private nonprofit institution. In spite of little government support, taxes, and reasonable tuition, for-profits are generally able to remain profitable. This is all the more impressive when one takes into account the fact that for-profits' competitors rely much more heavily on government appropriations and are exempt from taxes. Again, this feat is possible only by operating at much lower total costs per student than traditional institutions.

FIGURE 9  
AVERAGE REVENUE PER STUDENT, 2008–2009



Source: U.S. Department of Education, NCES; Authors Calculations.

FIGURE 10  
AVERAGE OUT OF STATE TUITION AND FEES, 2008–2009



Source: U.S. Department of Education, IPEDS.

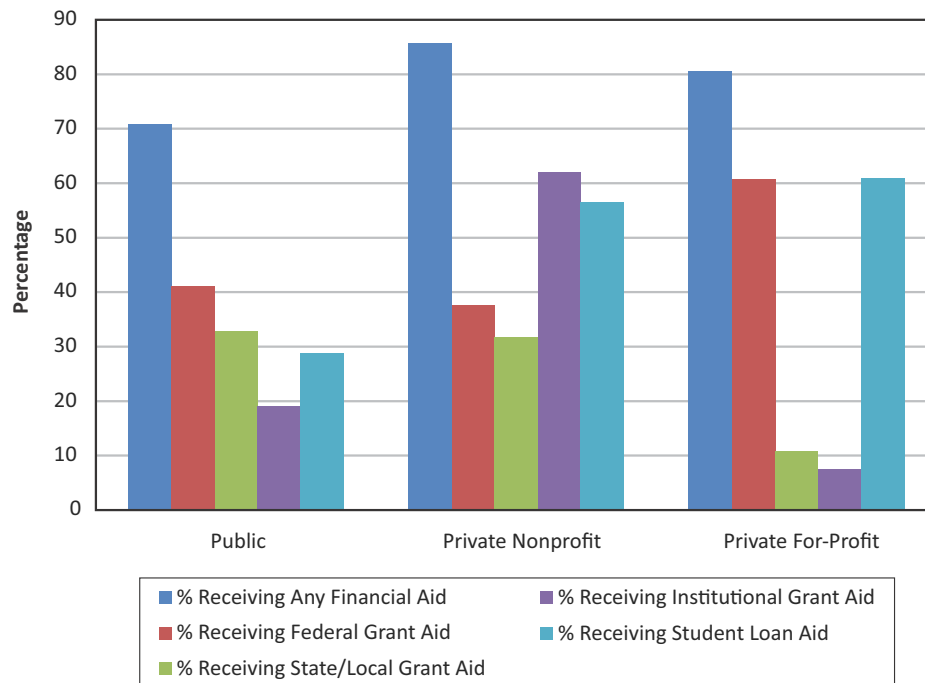


It should be noted that while for-profits receive very little in direct government appropriations, they importantly benefit from government grants to students, such as the Pell Grant. Further, since the majority of for-profit revenues are derived from tuition and the majority of students in for-profit schools finance their education through student loans, for-profits are ultimately reliant on federal student loan programs. Federal student loan money is the lifeblood of the for-profit education industry. Without the reauthorization of the Higher Education Act in 1972 that allowed the students at for-profits to qualify for federal student aid, it is unlikely that the for-profit industry would have been able to achieve the growth and profitability it has displayed.

A breakdown of financial aid received by students across sectors further illustrates the importance of student loan aid in the for-profit business model. Not only are students at for-profit schools the most likely to use student loans to finance their education, but the average student loan aid received per student is the highest in the for-profit sector. During the 2006–2007 academic year, the average amount of student loan aid received by students in for-profit institutions stood at \$5,491, while in public and private nonprofits the average student borrowed \$3,468 and \$4,971, respectively.<sup>71</sup> For the same academic year, nearly 61% of students at for-profits received student loan aid, while 29% and 56% of students used loan aid at public and private nonprofits, respectively.<sup>72</sup> This can be explained, in part, by the fact that the average student at a for-profit school is much less likely to receive institutional, state or local grant aid than the typical student in the traditional sectors, as can be seen in Figures 11 and 12.

FIGURE 11

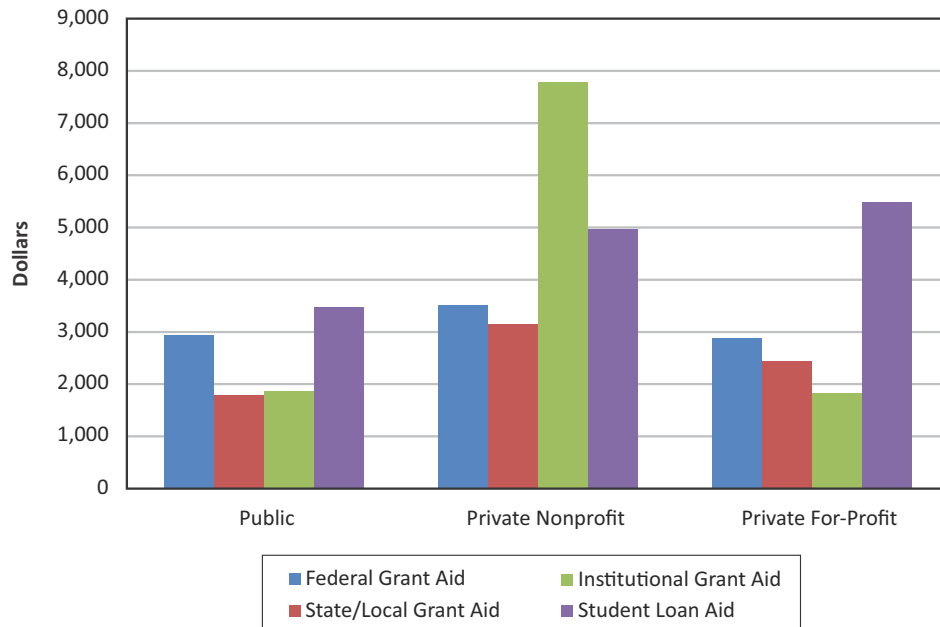
PROPORTION OF STUDENTS RECEIVING FINANCIAL AID BY TYPE AND SECTOR, 2006–2007



Source: U.S. Department of Education, IPEDS.

FIGURE 12

AVERAGE AMOUNTS OF FINANCIAL AID RECEIVED PER STUDENT BY TYPE AND SECTOR, 2006–2007



Source: U.S. Department of Education, IPEDS.

## Expenses

For-profit institutions also differ markedly from traditional higher educational institutions in how they decide to spend their money. As seen in Figure 13, for-profits spend the least amount per student among the sectors of higher education. For-profits spent, on average, \$9,758 per student in 2008–2009, while public colleges spent almost double that amount and private nonprofits spend nearly four times as much per student.<sup>73</sup> Based on these data, one might surmise that the quality of education at for-profits is necessarily poor when compared to the traditional sectors because of lower spending per student. A more likely explanation is that for-profits focus primarily on educating students unlike the traditional sectors, which along with student education, produce research, entertainment and arts programs, and generally maintain more extensive facilities. Additionally, it seems probable that for-profit schools operate at a higher level of efficiency, however measured.

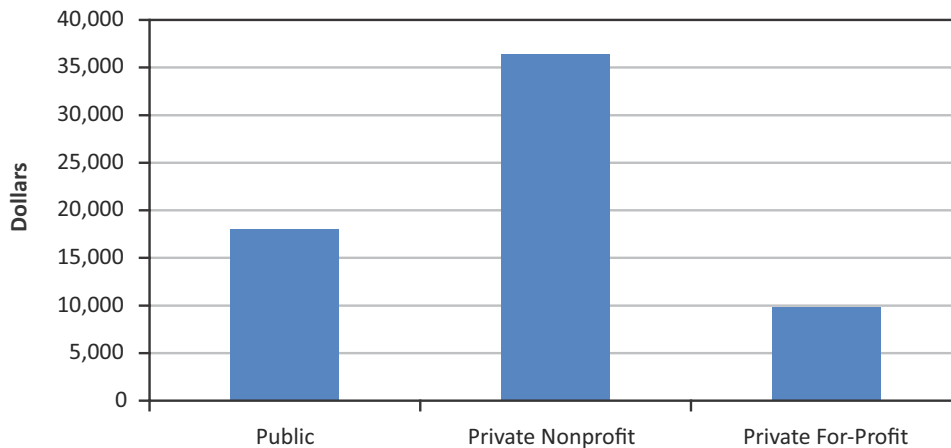
An examination of overall spending per student is interesting, but does not fully illustrate the differences between sectors. The primary mission of higher education is to provide educational services to students. For this reason, it is important to look at how spending per student breaks down by category. In terms of instructional spending per student, for-profits lag behind the traditional sector. On average, for-profits spent \$2,512 on instructional expenses per student, while public universities spent more than twice that amount, and private nonprofits spent nearly five times as much per student.<sup>74</sup>

It should be noted that these figures do not necessarily provide an accurate assessment of the actual amount of money that contributes to the education of each student. Some instructional expenses listed by





FIGURE 13  
AVERAGE SPENDING PER STUDENT BY SECTOR, 2008–2009



Source: U.S. Department of Education, NCES; Authors Calculations.

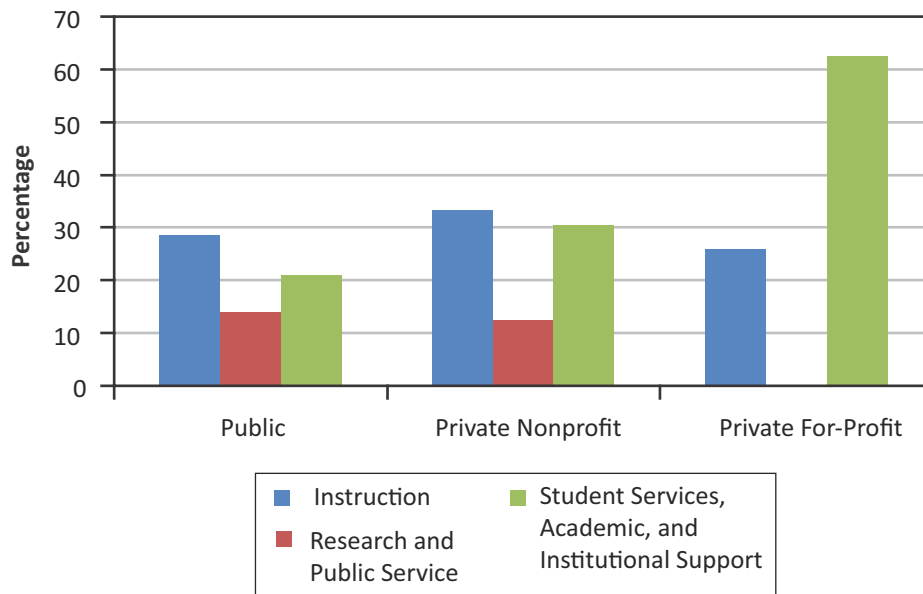
traditional institutions appear to actually be research support. For example, faculty salaries are typically considered part of instructional expenses, even though the faculty may spend as much of their time on research as instruction. That caveat aside, higher spending by nonprofit schools is not surprising, since both public and private nonprofit schools generate more revenue per student.

An analysis of spending by category as a percentage of total expenses further illustrates differences between the sectors. As Figure 14 shows, for-profits and the traditional institutions are relatively similar in terms of the percentage of total spending going to instruction at about a quarter to a third of their total budgets. The sectors differ dramatically, however, in spending on research and public service; and student services, academic, and institutional support. As would be expected, for-profits spend virtually nothing on research and public service, while these categories account for 14% and 12.5% of overall spending in public and private nonprofit universities, respectively.<sup>75</sup> For-profit universities spend a much larger portion of their budgets on student services, academic, and instructional support than do the traditional sectors (see Figure 14).

Unfortunately, due to the way in which all postsecondary institutions report their expenses, even an analysis of spending by category can be misleading. For example, for-profits report spending on student services, academic, and institutional support in one category, which stands at a full 62.5% of total spending by the sector.<sup>76</sup> The institutional support component of this category includes spending on activities that do not directly contribute to a student's education, such as marketing and lobbying. Marketing expenses can account for a large portion of a for-profit institution's total budget. For example, for the firm's 2009 fiscal year, Apollo Group spent nearly 33% of its total budget on selling and promotional activities.<sup>77</sup>

The case could be made that advertising provides valuable information to potential students about what is available that ultimately helps them decide on the best school for their needs. The same could not be said about spending on lobbying within the higher education space. Unfortunately, all sectors of

FIGURE 14  
PROPORTION OF TOTAL SPENDING BY CATEGORY AND SECTOR, 2008–2009



Source: U.S. Department of Education, NCES; Authors Calculations.

higher education, not just for-profits, spend money to engage in rent-seeking behavior that produces nothing of value to society and is necessarily a waste of society’s resources. A 2005 survey of 336 private nonprofit institutions revealed that the schools spent a total of \$34.7 million on lobbying, while surveyed for-profit institutions reported spending \$2.1 million on lobbying.<sup>78</sup>

A major caveat is in order here. It can be argued that the profits of the proprietary institutions represent a measure of capital costs—compensation for the use of capital resources. Typically, nonprofit institutions disguise a portion of their capital costs. For example, for-profits must depreciate capital investments according to strict rules set out by agencies such as the Securities and Exchange Commission and the Financial Accounting Standards Board. A typical nonprofit institution largely does not set aside funds for depreciation, and relies on occasional gifts from private donors, state appropriations, etc., to finance new facilities and to renovate old ones—and these funds are not typically counted as costs in the standard data provided to the U.S. Department of Education. We believe the strict use of comparable accounting practices would lead to an increase in the cost per student differential between the proprietary and non-proprietary institutions.

Prior to concluding this section, we must discuss an important caveat that was stated earlier: the tax environment of for-profit institutions is quite different from the tax environment of the traditional sector. As businesses, for-profits must pay a portion of their income to the government. The traditional sector, in contrast, is almost entirely tax-exempt. Consequently, and perhaps perversely, the government tends to give more money to the traditional sector as they increase enrollment, yet takes away money



from for-profits as they increase enrollment. The tax environment also affects the ability of institutions to raise capital. Money given to the traditional sector can be written off as charitable donations, even if the donation goes exclusively to non-educational activities such as athletics. When for-profits raise capital by selling securities, their investors are subject to capital gains taxes. Consequently, for-profits are at disadvantage when it comes to funding their educational endeavors.

## Operational Differences between For-Profit and Nonprofit Education

How is it that in an era when many traditional colleges and universities are struggling financially, for-profit institutions are able to generate profits? This phenomenon can be explained partially by operational differences between the sectors, but, in a broader context, it can be explained by the fact that the missions of for-profit and traditional institutions are fundamentally different. It is true that there is overlap between the activities of for-profits and traditional institutions, especially in the area of providing instruction to students. The similarities end there, however.

### *Student as Customer*

The mission of a typical public or private nonprofit university is first to provide instruction to students, but also to produce research, provide public service, and generally contribute to society's understanding of the world. In so doing, the traditional sector must employ far more resources than the for-profit sector. The mission of a for-profit institution of higher learning is, like any other profit-making firm, to maximize shareholder wealth. For-profit schools do this by selling a product to customers. The product in this case is education. For-profits are thus forced to focus their efforts on selling educational products that the student/customer wants to purchase. One observer wrote, "A for-profit board has an obligation to *get out* of a bad business while a nonprofit board may have an obligation to *stay in*, if it is to be true to its mission."<sup>79</sup>

In traditional institutions of higher learning it is often unclear who the primary customer is. In contrast, for-profits are narrowly focused on providing a product for the student/customer because in so doing these institutions are able to increase their bottom lines. A customer service orientation does not mean however, that for-profits give in to every student's preferences, because to do so would devalue the product.<sup>80</sup> The customer service orientation does mean that for-profit institutions have strong incentives to keep tuition reasonable in order to attract students, all the while trimming excess costs by minimizing administration, maintaining a competitive work environment and keeping wages at a market clearing level.

One might argue there is an inherent conflict of interest that for-profit providers face. By making students happy—for example, by giving them degrees they do not deserve, grades that they do not earn, etc.—for-profits can increase revenues and profits. By accepting students that are highly unlikely to graduate, revenues and profits are enhanced but students are ill-served. Yet there are two problems with this argument. First, in the long run if universities develop a reputation for offering a shoddy product, that will lower demand, or, at the extreme, cost the institution its accreditation. Second, the problem of accepting marginal students applies equally to nonprofit schools, some of which have extremely low graduation rates and end products with dubious academic accomplishment.

To a larger extent than in a traditional university, for-profits must continually strive to keep their students satisfied. Nonprofits only get a fraction of their funding from students and consequently can afford to be dismissive of some student needs, since students who leave school out of anger do not impose a

high cost on the university. For-profits, however, derive nearly all their revenue from students and thus are more inclined to see their students as valuable paying customers. As a result, for-profits tend to be more responsive to the needs and demands of their students.<sup>81</sup>

In addition to the incentive to keep tuition reasonable to maintain student business, it is also necessary that for-profits offer programs that clearly pass a cost-benefit test for the student. Such programs are typically career focused and have measurable skills outcomes.<sup>82</sup> Examples include information technology, medical services, business management, education, and other vocational skills programs. Providing degree programs in areas such as these are generally profitable. These programs often require few capital resources, and can be effectively taught by industry practitioners instead of higher paid research PhDs.<sup>83</sup>

Few for-profit schools emphasize training in the liberal arts such as the humanities and social sciences. Many persons, including us, believe that such learning, while not directly tied to vocational training, is nonetheless beneficial to the development of good citizenship and in some cases improved critical learning skills that facilitate learning on the job after graduation. It will be interesting to see if in the future the for-profits expand upon their current vocational orientation to more studies in these less vocationally oriented areas of “general education” that often form the core of learning at many nonprofit schools.

### *Resource Utilization*

Other significant cost advantages for-profits have over traditional universities come from their use of resources. Traditional public and private nonprofit universities are extremely capital intensive. The typical traditional university owns large tracts of land in addition to a collection of classroom buildings, libraries, recreational facilities, and stadiums. Along with these facilities comes a high level of fixed costs including maintenance, utilities, and grounds keeping that can use up a significant portion of a school’s budget. In contrast, for-profit universities tend to run much leaner and less capital intensive operations. For example, classroom space is often leased in office buildings. This allows the firms to be more flexible in terms of physical capacity and frees them from the fixed cost burdens under which many traditional universities suffer.

For-profits and traditional college also differ markedly in their use of human resources. While no two for-profits are exactly alike in their operations, it is much more likely to see classes taught by adjuncts in a for-profit university than in a traditional university. However, full-time faculty members also play a significant role in the operations of many for-profits. For-profits do not gain a cost advantage by paying their full time faculty less than the traditional sector would.<sup>84</sup> They do gain a cost advantage, however, in terms of the teaching loads of those faculty members. Most faculty members at a for-profit university teach far more classes than their public and private nonprofit counterparts since their primary duty to the organization is to teach, not produce research.<sup>85</sup>

One efficiency enhancing tactic employed by most for-profits that affords them another cost advantage over the traditional sector is the use of standardized curricula. Economics courses, for example, would cover the same material and use the same text across all branches of a for-profit university. By leaving the course design up to professional curriculum specialists, instructional staff can reduce the amount of time spent on preparing courses and increase the amount of time teaching and meeting with students.<sup>86</sup>

Delivery methods also differ across the sectors of higher education. Increasingly, for-profits are using a traditional bricks and mortar classroom to deliver the educational product to students. However, online courses and even online supplements for traditional classes are also widespread in the industry.<sup>87</sup> From a cost perspective, online courses make sense. The tuition a for-profit school can charge for an online

class typically far exceeds the marginal cost per student, which is essentially zero. What this means in economic terms is that there are tremendous economies of scale in on-line education, suggesting in the long run the possibility that a few dominant providers may prevail, not unlike the automobile industry of nearly a century ago. Online education is an extremely profitable line of business. With the profits earned from their online operations, many for-profits can essentially subsidize their bricks and mortar operations. This makes sense from a business perspective; industry insiders claim that a traditional campus is of tremendous marketing value that can increase the perceived legitimacy of an institution.

This point was made abundantly clear to us by Andrew Clark, the chief executive officer of Bridgepoint Education, and Jane McAuliffe, president of Ashford University, the largest school in the Bridgepoint system. Speaking in an interview with us from their traditional Iowa campus (a former Catholic liberal arts college), they pointed out that many attending this year's graduation ceremony were on-line students who wanted their families to see them receive a diploma.

### *Competition with the Traditional Sector*

As discussed earlier, the missions of for-profits and traditional institutions are fundamentally different with some degree of overlap that occurs in the area of providing students with instructional services. The “market” for higher education is vast and not monolithic. There exist a number of segments within the market based on student age, geography, course offerings, and degree offerings, just to name a few. While it is common to think of for-profits as being in direct competition with the traditional sector, and this is certainly true in some areas, the reality is that for-profits and traditional universities are typically focused on different segments of the total higher education market.<sup>88</sup>

This focus on specific segments of the market is another reason for-profit institutions are able to generate profits, as these areas are generally underserved by the traditional institutions, thus removing the threat of competition from government subsidized institutions. As mentioned earlier, the typical student in a for-profit university is older than the typical student in a traditional university. These students are generally focused on career opportunities gained from education and would like to finish their degrees in the most efficient manner possible. For-profits are well suited to serve these customers. Year-round classes, evening and weekend classes, online offerings, and convenient locations allow for-profits to more easily serve the older working student. Some observers argue that for-profits in fact possess a competitive advantage over traditional schools in providing services to the older student.<sup>89</sup>

Related to the notion that for-profits have a competitive advantage in the provision of education to an older student demographic, is the ability of for-profits to respond to demand conditions in a way that public and private nonprofits cannot. For example, during economic downturns, the demand for the services of a for-profit university may increase since the skills they provide are often valuable to displaced workers.<sup>90</sup> For-profits are particularly well suited to respond to such an increase in demand since they are not reliant on direct government funding for their operations. Public institutions, however, are likely less able to accommodate the increase in demand since their budgets are often curtailed during an economic downturn.<sup>91</sup>

At least three other factors work to the advantage of for-profit schools with respect to redeploying resources quickly in response to changing economic conditions or the demand for higher education services. They generally do not have fixed costs in a tenured faculty, and can add and subtract instructional resources faster and more comprehensively than most traditional institutions. Second, they have fewer resources tied up in buildings and equipment because they typically lease their facilities, which allows them to expand or contract space more readily, and even open facilities in new locales. Third, they do not follow

the shared governance model common in most of higher education, where major decisions often have to go through a complex series of committees and negotiations, which tends to slow decision-making down and lead to compromises to appease powerful campus interests that are perhaps not optimal.

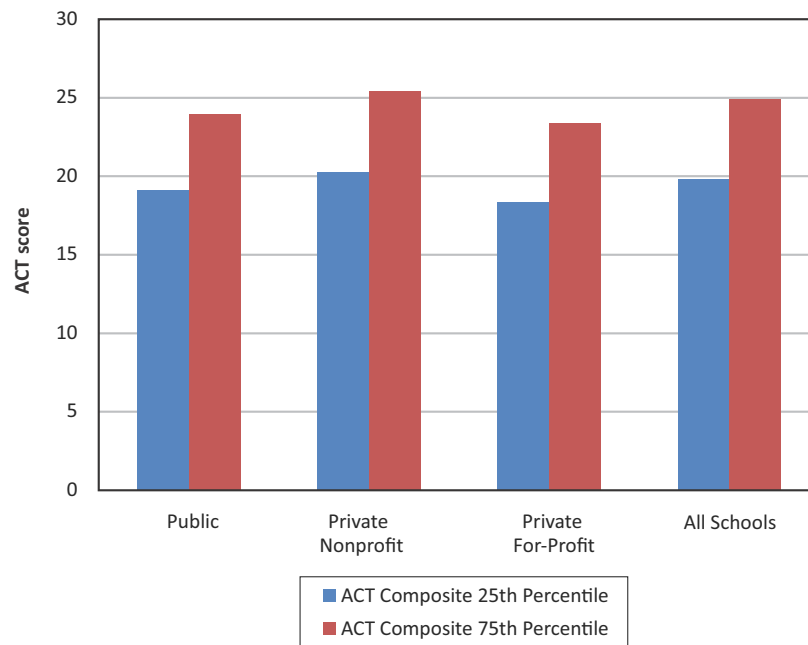
The ability of for-profit institutions to quickly and effectively respond to the changing demands of their customers is one of the most important factors that allow for-profits to be profitable. The ability to adapt to changing market conditions gives the for-profits a significant advantage over the traditional sector. If a new or growing market is identified, the for-profits are well positioned to respond. Whereas traditional universities are often reluctant to adapt to changing market conditions or the bureaucratic decision making process within these institutions is simply too slow and cumbersome to respond quickly enough.

## Academic Inputs and Outputs: A Cross-Sector Comparison

### Inputs

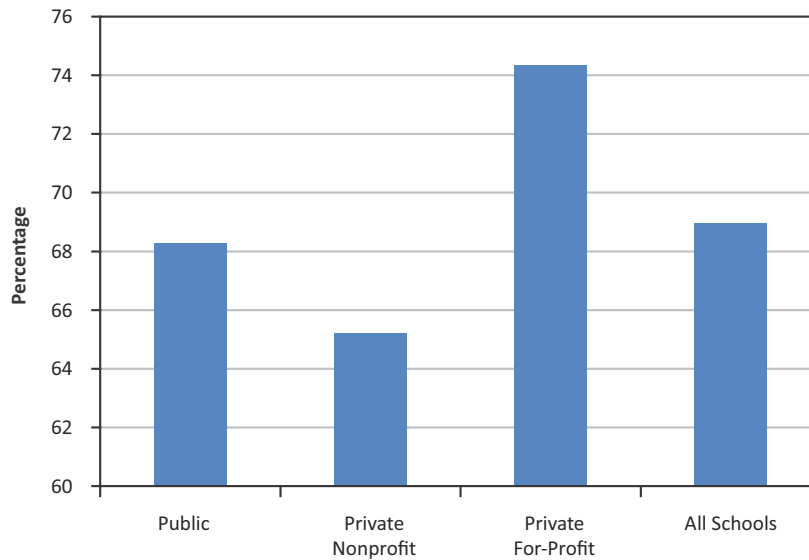
As mentioned earlier, the demographic characteristics of for-profit and traditional university students is quite different. It is also useful to compare the academic qualifications of incoming students by sector. One proxy for this is to examine their average ACT scores. It should be noted however, that a far smaller proportion of applicants to for-profit schools submit these scores than do applicants to traditional universities. Around 20% of applicants to for-profits submit the scores, while in the traditional sector over half of

FIGURE 15  
AVERAGE ACT SCORES BY SECTOR, 2007–2008



Source: U.S. Department of Education, IPEDS.

FIGURE 16  
AVERAGE ADMISSIONS RATES BY SECTOR, 2007–2008



Source: U.S. Department of Education, IPEDS.

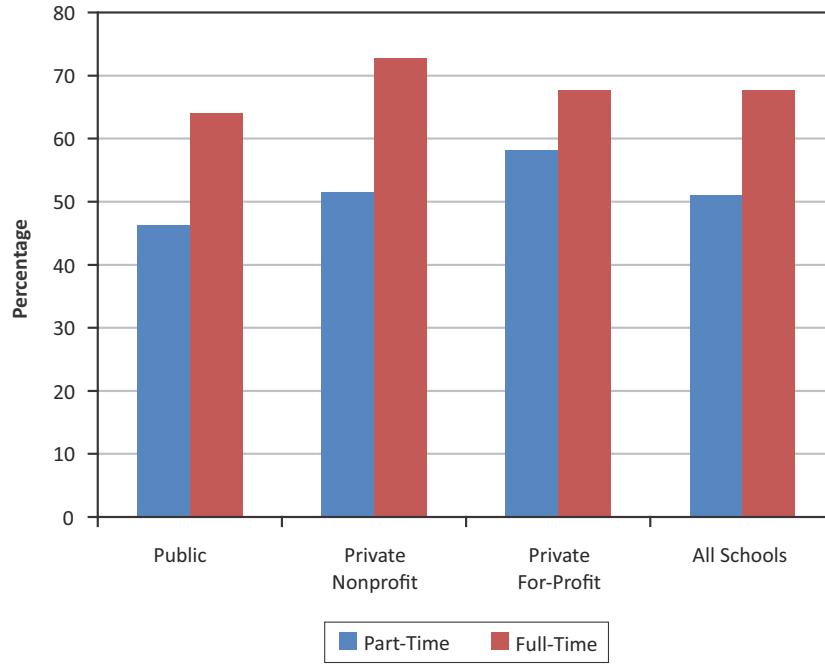
all applicants submit them.<sup>92</sup> That caveat aside, as Figure 15 shows, the ACT scores of applicants to for-profits are only slightly lower than the scores of applicants to public and private nonprofit institutions.<sup>93</sup>

For many traditional public and private nonprofit colleges the percentage of students turned away is viewed as a source of prestige. The same cannot be said about for-profits, as they generally have less stringent admissions requirements. Thus, to a certain extent, it is up to the potential student to assess whether they are able to pass academic muster after beginning a course of study. In a sense, for-profits are willing to give a chance to many students that would likely be turned away from a traditional college or university. The perception however, that for-profits have virtually no admissions standards and will admit anyone who can pay is incorrect. This is illustrated by the variation in admission rates across the sectors. As Figure 16 shows, admissions rates at for-profit institutions are the highest among all of the sectors, although the margins of difference are relatively small.<sup>94</sup>

One way to assess the quality of an educational program once a student has been admitted is to examine student retention rates. As Figure 17 demonstrates, the full-time retention rate of for-profits falls squarely between the retention rates of public universities (lowest retention rate) and private nonprofits (highest retention rate).<sup>95</sup> The fact that the average retention rate of for-profit schools is on par with the retention rate of the traditional sector also partially dispels the criticism that for-profits will push any student through a program in order to collect more tuition revenue. Further, Figure 17 shows that for-profits achieve the highest retention rate among the sectors for part-time students.

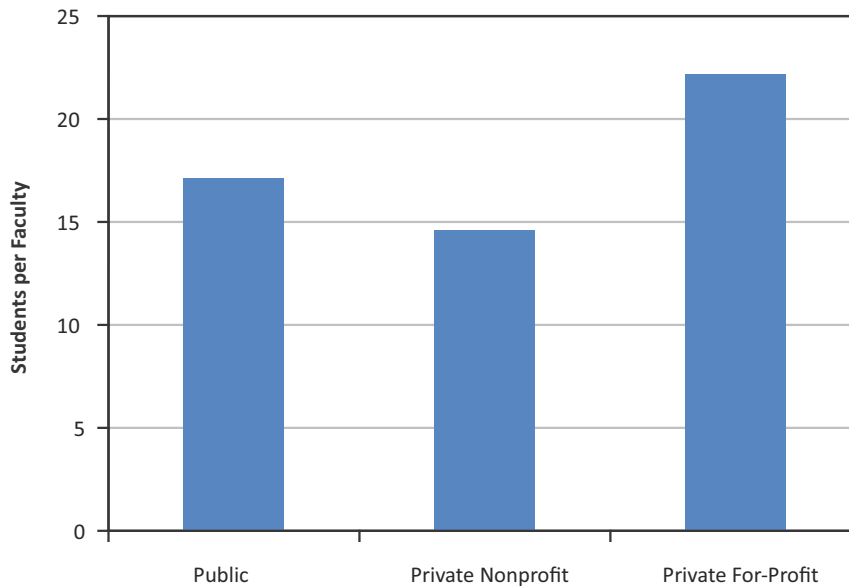
Another metric commonly used to assess the quality of an educational program is the student to faculty ratio. The logic is that fewer students per faculty member should, on average, mean that each student will receive more individualized attention and thus have better educational outcomes. The average student to

FIGURE 17  
AVERAGE RETENTION RATES BY ATTENDANCE STATUS AND SECTOR, 2007–2008



Source: U.S. Department of Education, IPEDS.

FIGURE 18  
AVERAGE STUDENT TO FACULTY RATIO BY SECTOR, 2008–2009



Source: U.S. Department of Education, IPEDS.



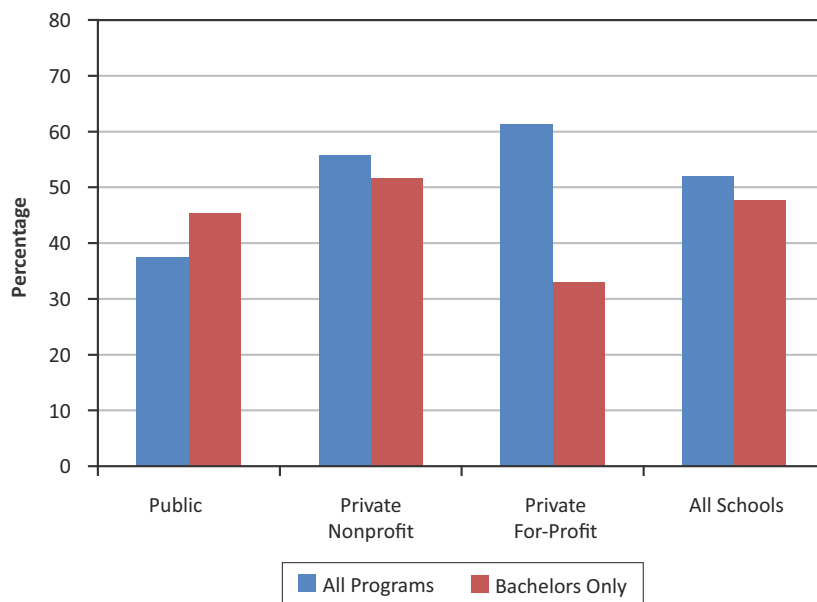


faculty ratio at for-profits is the highest among the three sectors of higher education (see Figure 18).<sup>96</sup> These figures may not perfectly illustrate the individual attention each student receives, however. For example, it is common practice at many large universities to provide introductory courses in large lectures with hundreds of students, while simultaneously offering extremely small specialized, seminars to only a few students at a time. Such a large variation in class size is less common in for-profit universities. For-profits typically attempt to enroll 30 to 40 students in each class, as they have identified this size to provide the best learning environment and to optimize the use of institutional resources.<sup>97</sup>

### Outputs

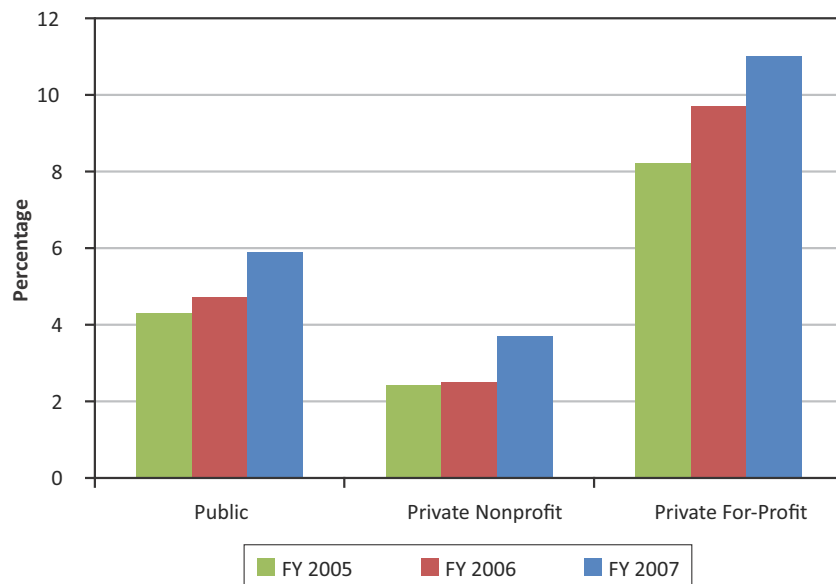
Perhaps the most important assessment of the quality of an educational program would be a measure of the value added by completion of a degree program. Unfortunately, measures of outcomes are lacking in all areas of higher education. Despite this, there are a few statistics one might examine to assess the quality of educational outcomes. One of these is the rate at which students are able to graduate from a program within a reasonable period of time. As Figure 19 shows, graduation rates across all sectors of higher education in the U.S. are atrocious. For-profit institutions have the highest graduation rate within 150% of normal time among the three sectors when all programs are considered. However, for-profit institutions have the lowest 6-year graduation rate among the sectors when only bachelor’s degree programs are considered.<sup>98</sup> These data suggest that for-profits may be better than the other sectors at helping their students complete short degree programs, but are not as successful in their ability to help students see a bachelor’s degree program through to the end.

FIGURE 19  
AVERAGE GRADUATION RATE WITHIN 150% OF NORMAL TIME BY DEGREE TYPE AND SECTOR, 2007–2008



Source: U.S. Department of Education, IPEDS.

FIGURE 20  
 INSTITUTIONAL STUDENT LOAN DEFAULT RATES BY SECTOR, FY 2005–FY 2007



Source: U.S. Department of Education, National Student Loan Data System; Authors Calculations.

It is reasonable to assume that most students entering a higher education program do so to increase their employability and wage prospects upon completion. For this reason, it is helpful to look to data that indicate how likely a student is to be employed upon graduation. Unfortunately, little such data is available industry-wide. However, some for-profits self report the placement rates of their graduates. These placement rates are generally quite high. For example, DeVry, Education Management Corporation, ITT Educational Services, and Strayer Education report placement rates of 96%, 87%, 90%, and 79%, respectively.<sup>99</sup>

Related to the issue that students at for-profits are very likely to borrow to finance their education is the issue of student loan default rates, which are particularly high among former students of for-profits. As shown in Figure 20, former students of for-profit institutions have the highest federal student loan default rates among the sectors of higher education. Eleven percent of former for-profit students defaulted on their student loans during the schools’ 2007 fiscal year, while the default rates for public and private nonprofit students stood at 5.9% and 3.7%, respectively. As figure 20 indicates, default rates across all three sectors have increased since 2005. Although default rates grew the most among for-profit institutions in terms of absolute change, the percentage change in default rates was actually lowest among for-profit institutions, increasing by 34.1% since 2005, whereas public and private nonprofit default rates increased by 37.2% and 54.2%, respectively.<sup>100</sup>

Opponents of the for-profit education industry contend that the high default rates are a signal that for-profit schools push their students to borrow too much and then provide them with an education of dubious quality that leaves them unable to achieve the career success necessary to keep up with their student loans. Industry insiders claim that the default rates are primarily a function of a less privileged student



demographic that does not have the financial backstop many students in the traditional sectors are able to use in times of personal financial turmoil.<sup>101</sup>

The reality of the situation is likely much more nuanced than either extreme point of view would suggest. Better measures of student outcomes upon graduation could shed some light on the issue of educational quality as a contributor to student loan defaults. Unfortunately, there has been little effort by either the for-profit sector or the traditional sectors of higher education to accurately measure the educational outcomes and career skills gained during a course of study.

## The For-Profit Higher Education Regulatory Environment

### *Introduction*

The for-profit postsecondary education industry has the distinction of being regulated as both a profit-seeking business and as a provider of educational services. The former subjects it to licensure and consumer protection laws, while the latter subjects it to a certification process that involves the same scrutiny over institutional quality that is often applied to nonprofit educational institutions. This presents the industry with a daunting challenge to overcome the burdens imposed upon it by a multitude of regulatory agencies at various levels of government as well as non-governmental associations. This has not always been the case, however, as for-profit colleges were historically regulated primarily at the state level, with an emphasis on the “rudimentary protection of the public.”<sup>102</sup> It was not until the federal government began crafting student aid policies in the mid 20th century that the industry became subject to regulatory pressures from the national government. The federal government’s entrance in the student aid arena subjected the industry to the rule of yet another authority, non-governmental accrediting agencies. The three-pronged regulatory approach has been referred to as the regulatory triad.

The for-profit postsecondary education industry has struggled to gain academic legitimacy in the eyes of the public due primarily to the transgressions of some opportunistic businessmen who have sought to profit from the federal government’s generosity with taxpayer funds to support college education. Allegations of rampant fraudulent behavior in the era of federal student aid have led some to suggest that the for-profit education “must continuously fight the specter of illegitimacy arising from the academic world’s disdain for their profit-seeking and straightforward occupational-training orientation.”<sup>103</sup> In an address to the 28th National Conference on Higher Education in 1973, Jack Jones suggested that the public image of for-profit institutions is based largely on the lowest common denominator, implying that the entire industry is identified according to the misdeeds of a few bad apples that are part of a much larger and healthy orchard.<sup>104</sup> In a 1974 paper, David A. Trivett likened this personification to “basing the image of all colleges and universities on knowledge about Harvard or Oxford.”<sup>105</sup>

Today, the for-profit industry continues to try and mend its public image as most institutions play by the rules that have been established by their myriad of regulators, and has become involved in shaping policy initiatives that affect it. Despite being subject to considerably more regulations than its public and private nonprofit counterparts, the for-profit industry can now boast that it produces similar and in some cases better outcomes in terms of retention and graduation rates, especially when it comes to at-risk students.<sup>106</sup> Additionally, a report from the Parthenon Group indicated that “most private sector providers do a better job graduating students, deliver superior income gains, and do so at a societal cost comparable to public institutions.”<sup>107</sup> Yet critics of the for-profit industry continue to demand even

stricter regulations, often in the name of protecting students and the use of public funds, but also often due to philosophical differences in their view of education as a public good that confers benefits beyond the level of the individual to society in general, a view in which profit does not have a role.<sup>108</sup> Such complexity makes for a challenging regulatory environment to navigate. In the pages that follow, we'll briefly review the history of the regulatory environment before discussing the current challenges facing the for-profit postsecondary education industry.

### *Regulatory History of the For-Profit Industry*

As indicated above, regulation of the for-profit college industry has historically been a function primarily of the states. It was not until the middle of the 20th century that the federal government became significantly involved in regulating the industry. Before then, state-level regulation was rather lax, as most states historically employed a laissez faire attitude toward private educational enterprises.<sup>109</sup> In fact, very little state regulation of the sector, other than recognition as a business enterprise, occurred until the 1950s when, according to an account by Kevin Kinser, only “seventeen states had any provision for the licensing, approval or registration” of profit-seeking institutions of education.<sup>110</sup> In other words, the state-level regulation of the for-profit industry has generally been limited to colleges having to register with the state in which they operated as a business.

The for-profit industry faced minimal government oversight of educational quality or practices for the first half of the 20th century. This started to change once the federal government entered the picture, beginning with the 1944 GI Bill of Rights, which was administered by the Veterans Administration (VA) and provided veterans with \$500 a year for educational costs and a \$50 a month living stipend to attend a postsecondary education institution of their choice.<sup>111</sup> While the VA disbursed the stipends to the students, it distributed the tuition fee funds directly to institutions. The funds could be used at any institution approved by its state education agency.<sup>112</sup> Many veterans thus utilized the benefits made available by this program to seek vocational training at a state-approved for-profit college. It has been estimated that “nearly twice as many veterans chose enrollment in a vocational school than in a college or university.”<sup>113</sup>

As there was very little regulatory oversight of the for-profit industry at the time, the institutional distribution method created an incentive for opportunists to engage in fraudulent behavior. Many observers have speculated that there was widespread abuse of the program. This suspicion led to at least five reports being issued between 1950 and 1952 by various federal entities, including the VA, the General Accountability Office (GAO), the Bureau of the Budget and two special committees appointed by the House of Representatives,<sup>114</sup> that condemned “alleged incidents of fraud and abuse by for-profit” institutions.<sup>115</sup> As a result, some researchers have suggested that because the original GI Bill produced an unintended outcome in which “proprietary institutions became major beneficiaries” of the funding,<sup>116</sup> that the later 1952 Korean War GI Bill, which provided single veterans with up to \$110 a month for education and related expenses (higher amounts for those with dependents),<sup>117</sup> established a method for determining institutional eligibility that restricted participation to colleges accredited by a federally-approved accreditation agency.<sup>118</sup> In addition, these funds were distributed directly to the students, rather than being administered through the institutions, as the previous GI Bill had done.<sup>119</sup>

Prior to the federal government’s involvement in providing financial aid for college, accreditation was a voluntary process in which colleges opted to participate as a means of distinguishing themselves as an institution of high quality. Beginning with the 1952 GI Bill, accreditation by a recognized agency became a prerequisite to gain access to the federal aid programs, and hence became a much more attractive

proposition for colleges. Initially, only the so-called regional accreditation agencies were recognized. These agencies were hostile to the for-profit schools, essentially prohibiting them from gaining regional accreditation and thus, access to the funds available for veterans to attend college. The implication of this hostility was that it disallowed most for-profit providers from being eligible for the new Korean War GI Bill program, since accreditation was not yet common among for-profit institutions.<sup>120</sup> In response, the national accreditation agencies emerged and began to adapt their practices to the newly implemented federal requirements in order to seek recognition by the then U.S. Office of Education as approved accrediting bodies and thus, member institutions become eligible to access federally provided financial aid.<sup>121</sup> Among the first national accrediting agencies to be recognized were The Accrediting Commission for Business Schools in 1956 and the National Home Study Council in 1959.<sup>122</sup>

Gaining access to accreditation would prove increasingly crucial to the for-profit industry as the federal government would later expand its financial assistance for students with passage of the 1965 Higher Education Act (HEA), which created Title IV funding programs such as the Educational Opportunity Grant (EOG) program that provided scholarships to students based on need, and the Guaranteed Student Loan (GSL) program that made federally guaranteed and subsidized commercial loans available to low- and middle-income families.<sup>123</sup> The EOG and GSL (as well as the work study) programs were the precursor to the current hallmarks of federal student aid policy. These programs were initially supply-side in nature, meaning that they were provided directly to institutions and were to be disbursed to students with demonstrated need.<sup>124</sup> Most for-profit institutions were denied access to the Title IV programs because—similar to the 1952 GI Bill—program funds were restricted to institutions accredited by a federally recognized agency.<sup>125</sup>

The 1965 HEA marked the beginning of the financial aid system that remains largely in place today and relies on a public-private partnership between the accreditation bodies and the Department of Education to determine institutional eligibility. Despite being excluded from eligibility for the 1965 HEA, Congress passed the National Vocational Student Loan Insurance (NVSLI) Act of 1965, which provided a “program of direct lending and federal loan guarantees to students in various types of postsecondary vocational, trade and technical, and business schools,” at about the same time. Similar to the HEA, NVSLI required that schools be recognized by a federally recognized accrediting agency, or state agency or advisory committee recognized by the commissioner of education. In addition, for-profit colleges were required to provide a program of training that prepares students for *gainful employment* in a recognized occupation. A short time later, NVSLI was found to be essentially duplicative of the GSL program, and the two programs were merged in the 1968 re-authorization of the HEA, which also extended eligibility for the College Work Study and National Defense Student Loan programs to for-profit institutions.<sup>126</sup>

With the federal government playing an increasingly important role in the financing of postsecondary education, the for-profit colleges and their accreditation agencies acted quickly to get in on the action. The national accreditation agencies—those providing accreditation services to the vocationally-oriented and for-profit institutions—moved swiftly to become recognized by the federal government, and accreditation became more prevalent among for-profit institutions in response to the accreditation agencies being appointed gatekeeper responsibilities of the federal aid programs. It was not until later however, with the 1972 reauthorization of the HEA, that accreditation became prevalent among for-profit schools. Prior to this reauthorization, it is estimated that less than 15 percent of proprietary institutions were accredited.<sup>127</sup> By 2005, nearly all degree-granting and approximately half of non degree-granting for-profit institutions were accredited.

The 1972 HEA reauthorization expanded scholarships for financially needy students with the Basic Educational Opportunity Grant (precursor to the Pell Grant) and State Student Incentive Grant programs. The bill was vitally important to for-profit institutions in that it substituted the term “postsecondary education” for “higher education” in an effort to broaden the range of educational options for students beyond the traditional four-year academic bachelor’s degree. Institutions offering career, technical or vocational training programs would become eligible for the programs so long as they were accredited by a recognized agency.<sup>128</sup> The bill would place the for-profit sector on equal footing with the public and nonprofit sectors in that federally provided grants and loans for college students with demonstrated need could be used at any institution accredited by a recognized agency.<sup>129</sup> As noted above, most of the current national accreditation agencies had already acted to become approved bodies to determine institutional eligibility for Title IV student aid programs.

Before passage of the 1972 HEA reauthorization, state regulatory oversight of the for-profit sector was relatively minimal, as most states provided institutional oversight mainly for their public institutions, often ignoring oversight of the for-profit sector despite having legal responsibility for authorizing educational activities within their borders. This lack of adequate oversight, combined with the availability of newly implemented federal student aid money, is believed by many to have been a major contributing factor to the for-profit diploma mill endemic that occurred in the late 1960s and early 1970s.<sup>130</sup> The reauthorization of the Higher Education Act (HEA) in 1972 “forced the states to take the for-profit schools seriously as educational institutions,” by mandating that states create new commissions that “specifically included representatives from the for-profit sector.” In response to the diploma mill crisis and HEA, many states began to “develop new laws, regulations, and standards to review private degree-granting institutions.”

By 1972, forty-one states employed regulatory laws related to the operation of for-profit schools;<sup>133</sup> however, in most of the states the regulations pertained to “business codes rather than education authorities,” often geared towards “rudimentary protection of the public” from fraudulent and/or misleading business practices in lieu of concerns over the quality of education or vocational training.<sup>134</sup> The states with a consumer protection mentality generally followed a licensing model by granting school owners a permit to operate with few substantive requirements regarding ethics, fiscal responsibility and advertising; whereas there were only a few states with regulatory environments concerned with educational quality, and they generally followed a certification model similar to that used by the accreditation community in which “greater scrutiny of curriculum, finances, and academic policies” was employed.<sup>135</sup>

It was not long after becoming eligible for federal aid programs, the for-profit sector came under attack for alleged widespread consumer abuses. The Federal Trade Commission (FTC) launched a full scale assault on the private career school industry that lasted more than six years through 1976, with numerous hearings and testimony from more than 900 witnesses regarding violations such as deceptive sales and recruiting practices, a lack of reliable information, inadequate refund policies, false promises of job placement and postgraduate earnings, and other consumer rights malpractices.<sup>136</sup> The FTC concluded that there were several factors to blame for the abuses. One was a lack of adequate information available to students to help them discern the reliability of claims made by institutions. Another was the availability of student aid, which seemed like “free money” to students and led them to make misguided enrollment decisions. The FTC also claimed that the student aid programs “provided schools with an incentive to enroll students regardless of their ability to benefit from the training.”<sup>137</sup>

The U.S. Office of Education joined in on the for-profit denigration party in 1975 when it hired the American Institutes for Research (AIR) to investigate the nature of student consumer abuse in postsecondary

education. AIR studied thousands of student abuse complaints and identified fourteen types of abuse related to “institutional policies, practices, or conditions that had clearly misled students, deprived them of the opportunity to obtain educational services that they had been led to expect prior to enrollment, or failed to provide relevant facts that should have been disclosed.” In a separate survey of 45 schools of various types, AIR found that “almost no school is totally free of some potential for abuse,” as the “overall level of occurrence was relatively low in all schools visited,” but that the proprietary vocational schools had a “significantly higher potential for abusive practices...than did nonprofit or public vocational schools.”<sup>138</sup>

Ultimately, the government was unable to fully impose its federal and state coordinated trade regulations upon the for-profit industry that would have required such schools to “provide students with information about graduation rates, establish policies for prorated refunds of tuition, and implement a process by which an enrollment agreement would automatically be cancelled unless it were reaffirmed,”<sup>139</sup> as well as “disclosure and advertising substantiation.”<sup>140</sup> In the end, only a few of the rules were put in place, including a mandate for all school types to publish graduation rates and a contract cancellation provision. This was due to a combination of evidence that was based primarily on anecdotal information that failed to prove that abuse was pervasive among or limited to for-profit schools, and the ability of industry representatives to fend off the severe rule proposals by successfully making the argument that they “would punish all schools for the transgressions of a few”<sup>141</sup> However, many proprietary schools “went out of business in the face of increased scrutiny of their business methods.”<sup>142</sup>

There were several significant amendments made to HEA during the 1976 reauthorization. Congress added financial incentives to entice states to create loan guarantee agencies in an attempt to spur banks to lend money for college education. The bill also extended eligibility for financial assistance to any high school graduate with the *ability to benefit* from postsecondary education, although the term was rather ambiguous. In 1978, Congress passed the Middle Income Student Assistance Act, which expanded eligibility for the Pell Grant and made subsidized GSLs available to all students, regardless of financial need.<sup>143</sup> The alterations made in the latter half of the 1970s expanded the pool of students eligible for the federal financial assistance programs, propping up demand for postsecondary education and benefiting the proprietary sector. In fact, college enrollment grew by 8.1 percent between 1975 and 1980 (11.2 to 12.1 million), while it only increased by 1.2 percent over the following five years (12.1 to 12.2 million).<sup>144</sup> Meanwhile the number of federal GSLs increased by 134 percent, and the loan volume grew by 146 percent (in real, inflation-adjusted dollars) between 1975 and 1980.<sup>145</sup>

The first half of the 1980s experienced some volatility in federal aid policy as inflation and interest rates soared under the Carter administration, which liberalized and shielded student aid programs from austerity measures. The Reagan administration took office seeking to tame federal spending, and subsequently pared back loan eligibility and subsidies. Overall, however, federally guaranteed loan volume continued to grow during the period, albeit at a slower pace than before.<sup>146</sup> There were no major changes to the for-profit regulatory environment during this time, although the FTC attempted to revive its earlier failed rule proposals several times in the 1980s, but was ultimately “unsuccessful in establishing the broad regulatory authority over the for-profit sector that it had sought.”<sup>147</sup>

There were, however, signs of increased regulatory efforts at the state-level during the 1980s, albeit not very well functioning ones. By 1985, the number of states with regulatory procedures in place for private, for-profit degree granting institutions would increase to 43 (including Washington DC), with all but Utah having procedures on the books for non-degree granting schools.<sup>148</sup> The emphasis of state regulation would remain on consumer protections, although there was a growing interest in establishing some

measures of institutional standards and objectives. However, many states continued to exclude the for-profit sector in their higher education planning in the 1980s, often assigning regulation duties to agencies (in many states, multiple ones) different than those overseeing the public and nonprofit sectors.<sup>149</sup> An analysis by Bruce Chaloux in 1985 noted that, “The number of state agencies...charged with some aspect of regulating postsecondary education in their state compound confusion about state practices and deflects any form of comprehensive state planning,” indicating that the problem is particularly true for profit-seeking institutions.<sup>150</sup>

The U.S. Department of Education (ED) resumed its efforts to police the for-profit sector in the late 1980s, issuing a series of reports declaring that the “regulatory structure for the for-profit sector was weak and unable to address the significant problems endemic to these institutions.” ED based its resolution on findings related to questionable recruiting and admission practices, as well as problems related to federal aid such as the awarding of aid to ineligible students, low completion and high loan default rates.<sup>151</sup> Congress joined ED by investigating allegations of fraud and abuse in the student aid programs.<sup>152</sup> The for-profit sector would not fair so well in this round of intense scrutiny, as student loan default rates, instances of abuse and fraud in the student loan programs, and higher education accountability were the three hotbed issues in the late 1980s and early 1990s.<sup>153</sup>

The first piece of legislation that would affect the for-profit industry was a rule established in The Omnibus Budget Reconciliation Act of 1990 that would terminate “institutions with unacceptably high *default rates* from participation in the federal loan program.” The default rate threshold was set at 35 percent for fiscal years 1991 and 1992, and 30 percent for 1993. If an institution met or exceeded the threshold for three consecutive years, then it would become ineligible to participate in the federal loan program. This threshold would be lowered to 25 percent in the 1992 HEA reauthorization.<sup>154</sup> The resulting legislation, which was precipitated by the initial negotiated rulemaking committee, would include a number of new regulatory rules that affected the for-profit industry. The 1992 HEA included a requirement specifically aimed at the for-profit sector that stipulated that no more than 85 percent of a school’s revenue come from federal student aid (the 85/15 rule), but it also included a number of other measures applicable to all colleges that especially affected the for-profit sector. These rules included one that would limit distance education by requiring students to spend at least 50 percent of their course time seated in a classroom (50 percent rule), a ban on *incentive compensation* for admissions officials, restrictions on the establishment of new branch campuses, and the creation of short-lived State Postsecondary Review Entities (SPREs), among others.

The cumulative effects of the new regulatory rules on the for-profit industry were immediate and significant, as many profit-seeking schools closed up shop, particularly those located in inner cities.<sup>155</sup> In fact, the number of for-profit schools accredited by one of the six major national accrediting agencies declined by 5.1 percent the year after the 1992 HEA, and by 13.9 percent by 1995. In addition, the for-profit sector’s share of Title IV funds declined in the wake of the legislation. The for-profit sector’s share of Pell grant dollars declined from 23 to 18 percent between the 1989–90 and 1992–93 academic years. Its share of subsidized Stafford loans declined from 22 to 10 percent during the same period. The rules did, however, have a positive impact on default rates in the for-profit sector, as they declined from 36 to 24 percent between 1991 and 1993. The rules seemed to have little impact on the default rates of the public and nonprofit sectors, as they remained relatively unchanged, while the share of Title IV funds flowing to the nonprofit sectors increased.<sup>156</sup> In this regard, the rules imposed by the 1992 HEA disproportionately affected the for-profit schools whose “reliance on federal aid money exposed them to the regulatory authority they had avoided for many years.”<sup>157</sup>



Subsequent HEA reauthorizations would loosen some of the restrictions that had reigned in the growth of the for-profit sector. Perhaps the most significant of which was the 85/15 rule becoming the 90/10 rule in the 1998 HEA, meaning that an institution must earn at least 10 percent of its revenue from non Title IV sources, rather than the previous 15 percent. The new rule also explicitly stipulated that cash basis of accounting be used in determining whether an institution met the requirement of the 90/10 rule.<sup>158</sup> Other significant changes in the 1998 HEA pertained to distance education due to advances in technology and growing support for its use in education. For one, the law required that distance education programs be subject to the same accreditation criteria as all other programs. The legislation also created a new Distance Education Demonstration Program, which allowed selected institutions to experiment with waivers of federal rules to expand student aid access to previously ineligible distance learners. In return, participating institutions were required to “demonstrate in their applications their prior consultation with recognized accreditors on quality assurance,”<sup>159</sup> and agree to be evaluated annually on their measures of quality assurance. In addition, the 1998 HEA would officially repeal the previously created and defunct SPREs, which were by and large a failed attempt to instill better consumer protections and state oversight in post-secondary education.<sup>160</sup>

There is however some evidence that states have begun to apply similar criteria for evaluating for-profit institutions as is used for the public and nonprofit sectors, although regulatory bodies for the two sectors remain separate in many states, and for-profit institutions remain subject to the regulatory authority of a multitude of entities. A survey of 11 states conducted by Education Commission of the States in 2000 concluded that “for-profit institutions are not singled out in the regulatory process,” and that institutions in both the for-profit and nonprofit sectors undergo similar application reviews.<sup>161</sup> Although there are some methodological issues with the ECS survey, as noted by Kevin Kinser, it does nonetheless suggest that states are increasingly integrating the for-profit sector into the higher education regulatory structure.<sup>162</sup> As of October 2007, Rhode Island was the only state that specifically prohibited proprietary institutions of any type from operating within its borders, although a number of states still did not have an approval or licensing authority for private, profit-seeking degree-granting institutions.<sup>163</sup>

## Current Regulatory Challenges

The loosening of regulation in the late 1990s allowed the for-profit industry to grow remarkably. Between 1998 and 2008, the for-profit sector grew its undergraduate enrollment by 271 percent (annual growth rate of 14 percent) while total postsecondary enrollment only grew by 32 percent (2.8 annual growth rate). This growth enabled the for-profit sector to increase its market share from 2.7 to 7.6 percent of total undergraduate enrollment. In fact, more than 23 percent of the total growth in undergraduate postsecondary education during the period occurred in the for-profit sector. If these growth rates were to continue over the next 10 years, then the for-profit sector would have a 21.3 percent undergraduate market share by 2018.<sup>164</sup>

This growth has not come unabated, as scrutiny of the industry by critics and federal regulatory bodies has steadily intensified. Investigations of the for-profit space in the 21st century have become commonplace from a myriad of federal agencies such as the Federal Trade Commission (FTC), General Accountability Office (GAO), the Securities and Exchange Commission (SEC), and the Department of Education (ED). Federal scrutiny, in addition to the rules at the state level and standards of accreditation, has resulted in an uncertain and complex regulatory environment for the players in the for-profit indus-

try to navigate. The current regulatory challenges fit into four general categories: consumer protections, use of public funds, operational issues and educational issues.

### *Consumer Protections*

Government has a long record of enacting regulations on private enterprise, often intended to protect consumers. The idea is to constrain certain types of behavior or practices that are seen as unsafe or predatory in nature. Such consumer protections are often adopted in response to instances of unsound business practices. In for-profit postsecondary education, consumer advocates are fired up over the growing student loan debt levels and default rates on those loans. Advocates attribute these alarming trends to a combination of corporate greed, lax regulation, misleading advertising and high pressure sales tactics. One such advocate is Steve Eisman, who compares the for-profit sector lending boom to the recent sub-prime housing market, asking “We just loaded up one generation of Americans with mortgage debt they can’t afford to pay back. Are we going to load up a new generation with student loan debt they can never afford to pay back?”<sup>165</sup> At the time of this writing, the main mechanisms being touted to protect consumers are a revision of gainful employment, elimination of the 12 safe harbors for incentive compensation, and thwarting misleading advertising. Protecting the interests of investors in the publicly traded for-profit market is also an area of regulatory concern.

**Gainful Employment.** The HEA requires that for-profit colleges provide “an eligible program of training to prepare students for gainful employment in a recognized occupation” in order to qualify for Title IV student aid programs. Yet the HEA’s definition of gainful employment at the time of this writing is very ambiguous, only defining it in terms of a job placement rate. The ambiguity of the rule has attracted much scrutiny amid calls for revision. Gainful employment was one of the main issues during the recent 2009 negotiated rulemaking session; however, the committee failed to reach an agreement on a revision to the definition of gainful employment. In the aftermath of the rulemaking session, ED still plans to revise the rule and is expected to release draft rules regarding gainful employment and other issues sometime in summer 2010, with final rules to be set by November 1 and to take effect by July 2011.<sup>166</sup>

One of the ED’s earlier proposals was to define gainful employment with a formula to link expected earnings in a given field to the price of a program, but this was refuted harshly by the education community as an attempt to exert control over tuition pricing. ED’s latest proposal seeks to restrict the median student debt payment to 8 percent of the expected entry-level earnings for graduates of a given program. ED proposes to develop its debt-to-expected earnings ratio using the median debt payment (based on a standard 10-year repayment plan) of a program’s last three years of graduates in the numerator, and the national Bureau of Labor Statistics (BLS) occupational earnings data (specifically the 25th percentile of annual earnings of people in occupations for which the program prepared students) in the denominator. Programs with a ratio exceeding 8 percent would lose eligibility for Title IV funds, unless they were able to meet one of the following 3 alternatives:

- Proof that graduates’ actual annual earnings are higher than the BLS’s 25th percentile, with the debt to actual income ratio remaining below 8%
- Documentation that students have at least a 75 percent repayment rate on federal loans
- Evidence of both a program completion and in-field employment rate of at least 70 percent<sup>167</sup>

TABLE 2  
 MAX STUDENT DEBT FOR 10 OCCUPATIONS IF GAINFUL EMPLOYMENT WERE IN PLACE PRIOR TO 2003

Occupation	25th Percentile Earnings		Total Max Debt		Change in Real Max Debt	
	2003	2008	2003	2008	Amount	%
Registered nurses	\$49,449	\$51,640	\$28,907	\$30,188	\$1,281	4.4%
Home health aides	\$18,254	\$17,710	\$10,671	\$10,353	\$ (318)	-3.0%
Carpenters	\$31,184	\$29,990	\$18,230	\$17,532	\$ (698)	-3.8%
Truck drivers, heavy and tractor-trailer	\$30,540	\$29,560	\$17,853	\$17,280	\$ (573)	-3.2%
Nursing aides, orderlies, and attendants	\$20,571	\$20,210	\$12,025	\$11,814	\$ (211)	-1.8%
Medical assistants	\$23,835	\$23,700	\$13,934	\$13,855	\$ (79)	-0.6%
Maintenance and repair workers, general	\$26,433	\$25,880	\$15,452	\$15,129	\$ (323)	-2.1%
Licensed practical and licensed vocational nurses	\$32,682	\$33,360	\$19,105	\$19,502	\$397	2.1%
Bookkeeping, accounting, and auditing clerks	\$26,187	\$26,350	\$15,309	\$15,404	\$95	0.6%
Executive secretaries and administrative assistants	\$32,553	\$32,410	\$19,030	\$18,946	\$ (84)	-0.4%

Source: Bureau of Labor Statistics; Authors Calculations.  
 Note: Figures are in Constant 2008 Dollars.

Criticisms of the ED's latest proposal contend that the measure is overreaching. Congressman John Kline stated that it would "have a devastating effect on the whole industry," with the potential for individual colleges and entire programs to "be wiped out."<sup>168</sup> An analysis by Charles Rivers Associates estimated that 18 percent of current for-profit programs would not satisfy the proposed metric, which could displace up to 1/3 of the students currently attending for-profit institutions.<sup>169</sup> Financial aid expert Mark Kantrowitz suggested that the 8 percent ratio "would be so strict that it would preclude for-profit colleges from offering Bachelor's degree programs," that even nonprofit colleges "would find it difficult to satisfy the standard if they were subjected to [it]," and that it is "biased towards lower income data... [and] discriminatory against colleges located in regions with lower than average income and/or higher unemployment." Kantrowitz estimated that a more realistic ratio would be somewhere between 10 and 15 percent.<sup>170</sup>

We analyzed what the effect of ED's gainful employment metric would have been if it were in place prior to 2003 by calculating the maximum total student debt that one could have borrowed in both 2003 and 2008 for 10 high growth occupations<sup>171</sup> for which career colleges offer training, using BLS 25th percentile wage data. The results are included in Table 2. The figures are in constant 2008 (adjusted for inflation) dollars, with the last 2 columns reflecting the change in the inflation-adjusted maximum debt that students could borrow to pursue training in the respective occupations between 2003 and 2008. What we find is that for 7 of the 10 growing occupations, students would have been able to borrow less in 2008 than they would have in 2003 (inflation-adjusted) to pursue training in them.

If we were to apply the same metric to prospective lawyers, the maximum total amount of student loans that a potential law student could borrow for 3 years of law school (including any debt incurred as an undergraduate) would have been \$43,832 in 2008, a slight inflation-adjusted increase of 2.3 percent of the amount that could have been borrowed in 2003. This would hardly be sufficient to cover the \$27,830 average yearly tuition that law schools charged in 2007–2008, thereby limiting access to the field to those with the means to pay out of pocket. This demonstrates the substantial impact that the ED’s gainful employment proposal would have on the ability of colleges to set prices and offer programs in demand by the labor market.

The proposal has additional shortcomings. First, it would severely limit the ability of for-profit colleges to offer non career-specific fields of study. Second, it fails to account for total compensation or the possibility that workers will receive a promotion or pay increase over time. In addition, the rule could result in a reduction of educational options and access for those most in need, and a shortage of qualified employees to meet the demands of the labor force.<sup>172</sup> A more realistic metric would account for the net present value of all compensation over the life of the loan of actual graduates, rather than using arbitrary statistical averages.

It should therefore come as no surprise that the for-profit industry ramped up its lobbying and public relations efforts, spending at least \$620,000 lobbying Congress, ED and the Office of Management and Budget in the five months since ED first announced its gainful employment metric.<sup>173</sup> At the time of this writing, the lobbying and PR efforts seems to be making a difference, although the jury is still out. The Obama administration has issued draft rules that require institutions to “provide data on students’ debt levels and job placement and graduation rates, both to the department and for public disclosure on their own websites,” but has delayed the release of a specific debt-to-income metric for further study because, as Arne Duncan declared, ED wants to get it right.<sup>174</sup>

**Incentive Compensation.** The negotiated rulemaking session held in 2001–2002 proposed to create 12 so-called *safe harbors*, or exceptions to the ban on incentive compensation. Despite failure by the committee to reach a consensus on the provision and opposition from the higher education associations and the ED’s Office of Inspector General, the 12 safe harbors were enacted in the Code of Federal Regulations in November 2002. The exclusions for incentive-based pay included:

- Adjustments to employee compensation—restricted to twice a year
- Recruitment into programs not eligible for Title IV funds
- Payments for securing contracts with employers
- Profit-sharing or bonus payments
- Compensation based on program completion
- Payments to employees for pre-enrollment programs
- Compensation paid to managerial and supervisory employees not involved in admissions of financial aid
- Token gifts
- Profit distributions
- Internet-based recruiting activities
- Payments to third parties for non-recruitment activities
- Payments to third parties for recruitment activities<sup>175</sup>

Some critics, such as admissions officers from traditional colleges, want the 12 safe harbors eliminated, arguing that the exceptions permit colleges to “pay enrollment-based commissions under certain circumstances,” encouraging “recruiters to sign up unqualified students.”<sup>176</sup> ED took up the issue in late 2009 during its negotiated rulemaking session, with the committee once again failing to reach agreement on the issue. Some committee members cited numerous “complaints from students and enrollment advisors about the high-pressure sales tactics of some postsecondary institutions” in arguing that “tying staff compensation to the number of students enrolled is an inherent conflict of interest and that the safe harbors undermine the statutory ban on incentive compensation.”<sup>177</sup>

Despite the criticism, a 2010 investigation by the GAO revealed that the number of schools found to be in violation of the rules on incentive compensation actually declined to 14 in the seven years following enactment of the safe harbor regulations, whereas there were 18 schools found to be in violation during the five years prior to implementation of the new rules. Of the 32 total violations, 19 were from for-profit schools, while 12 were from private nonprofit schools, and even one was from a public school. Only four of the violations reported illegal compensation being paid that was greater than \$25,000. Although the report does note that its analysis does not reflect the “total number of schools for which reviews and audits were initiated by Education and outside auditors for potential violations of incentive compensation,”<sup>178</sup> the GAO’s findings don’t seem to suggest that enactment of the safe harbors have created a pervasive problem of abuse among for-profit institutions.

At the time of this writing, the Obama administration recently released a set of draft rules that would eliminate the 12 safe harbors entirely, with the ED stating that it “has determined that these safe harbors do substantially more harm than good, and believes that institutions should not look to safe harbors to determine whether a payment complies.” Instead, ED suggested that all compensation plans be put to a “two-part test” to determine whether a payment violates the ban on incentive pay. If the answer to both of the following questions is a “yes”, then a payment would be considered in violation of the ban:

1. Is the payment given to a person or entity for services rendered?
2. Is it provided “directly or indirectly upon success in securing enrollments or the award of financial aid, which are defined as activities engaged in for the purpose of the admission or matriculation of students for any period of time or the award of financial aid.”<sup>179</sup>

**Misleading Advertising.** It has been estimated that for-profit schools spend approximately 15 percent of their revenues on sales and marketing, with about half of this going towards promotions such as advertising and the other half towards a combination of enrollment management, marketing and direct-sales expenses. One of the most common criticisms of the for-profit sphere is that schools use high pressure sales tactics and misleading advertising to attract unqualified low-income students and the federal aid dollars that follow them.<sup>180</sup> Some of the common allegations against for-profit recruiters include guarantees that credits earned will transfer to other schools, suggestions that government grants will cover costs, and promises that the program will lead to a certain job and/or salary.<sup>181</sup> One critic of the sector, Steve Eisman, recently stated that for-profit schools have “billboards lining the poorest neighborhoods in America and recruiters trolling casinos and homeless shelters...[they] have become increasingly adept at pitching the dream of a better life and higher earnings to the most vulnerable.”<sup>182</sup>

Harris Miller, President of the Career College Association, has defended the industry, stating that “When you have a system that’s this complex, with over 2 million students, with close to 3,000 institutions,

once in a while you're going to have a rogue employee," and suggesting that "Any admissions officer who is misleading students should be fired...and if his or her supervisor told them to do so, that person should be fired."<sup>183</sup> Although the pervasiveness of misleading advertising and improper sales tactics in the industry is uncertain, most observers agree that there are instances of abuse and that stronger consumer protections are in order. ED recently proposed new rules concerning misrepresentation that would give it "greater authority to take action against institutions that appear to be employing deceptive advertising and sales practices."<sup>184</sup> This regulatory proposal, along with the proposed consumer disclosure requirements mentioned above, address the practice of misleading advertising.

**Investor Protection.** In the era of publicly traded for-profit education, consumer protection has become an issue for investors as well. The SEC has conducted investigations of the industry fairly regularly since the 1980s, often focused on misleading statements made by corporations to investors regarding enrollment and/or the financial viability of expansion plans. Since 2003, the SEC has investigated Career Education Corporation for "accusations of misrepresentation and inflation of stock values," Apollo Group for shareholder misrepresentation regarding the "material nature of a Department of Education inquiry into the University of Phoenix," Corinthian Colleges for "allegations by shareholders that they were misled about the financial status of the company," and ITT Educational Services for "allegedly falsifying records on grades and attendance." Some scholars have described the regulatory power of the SEC as a "double edged sword," due to the regulators charge to protect the interests—profitability and market penetration—of investors, while largely ignoring the interests of students and taxpayers regarding educational quality and societal value.<sup>185</sup> As the publicly traded for-profit education companies continue to grow, SEC investigations are likely to continue. Regulations intended to protect the interests of students and taxpayers will need to originate elsewhere.

### *Use of Public Funds*

As mentioned previously, much of the federal government's regulatory authority over the for-profit education industry has been related to the use of taxpayer funds made available via federal student aid programs. With the for-profit industry capturing 21.1 percent of all Pell Grant, and 21.3 and 22.4 percent of all subsidized and unsubsidized Stafford Loan dollars, respectively, during 2007–08 despite enrolling only about 7.7 percent of all postsecondary students, it should come as no surprise that some observers have suggested that the for-profit industry is shaped by federal aid policy more than any other force due to its reliance on tuition that is paid largely by federal student aid dollars. Two of the major regulatory challenges facing for-profit institutions are tied to the use of public funds: the 90/10 and cohort default rate rules.

**The 90/10 Rule.** As mentioned previously, an institution cannot receive more than 90 percent of its revenues from federal grants and loans and remain eligible for Title IV funds. The formula used to calculate an institution's ratio to determine its compliance with the 90/10 rule is:

- (i) Title IV funds used for tuition, fees, and other institutional charges, excluding Leveraging Educational Assistance Partnership (LEAP) and Federal Work Study funds.

Divided by

- (ii) Sum of revenues generated by the school from: (1) tuition, fees, and other institutional charges for students enrolled in Title IV-eligible training programs, and (2) institutional activities necessary

for the education or training of students enrolled in those Title IV-eligible programs.<sup>188</sup> Income from institutional grants and scholarships, books and supplies (unless specifically included in tuition), state tuition savings plans, and certain federal contracts cannot be counted.<sup>189</sup>

In order to comply with the 90/10 rule, institutions must either enroll at least some students who are not completely dependent on federal aid or charge tuition that is higher than the limits of federal aid. Either way, critics of 90/10 believe that the rule is harmful to low-income students because it “forces institutions to take actions that are not in the best interest of [such] students, such as raising tuition, ...and discouraging high need students from applying,” according to the Career College Association. In other words, the rule “creates disincentives for [for-profit] institutions to serve those most in need of student financial assistance,” according to David Moore.<sup>190</sup>

However, the rationale given for the 90/10 rule is two-fold. First, it is to safeguard Title IV funds from fraud and abuse of the federal aid programs by requiring schools to offer an educational product that students are willing to put a little skin in the game to pay for. Second, proponents of the rule suggest that if an institution is unable to generate 10 percent of its support from nonfederal sources, then it does not deserve federal funding at all, and have defended it with statements such as that made by NAICU’s David Warren: “It was meant to ensure than an educational institution offered a product that consumers were willing to pay for, instead of avoiding the discipline of the marketplace by being totally reliant on student-aid funds.”<sup>191</sup> Steve Eisman added, “The government, the students, and the taxpayers bear all the risk and the for-profit industry reaps all the rewards.”<sup>192</sup>

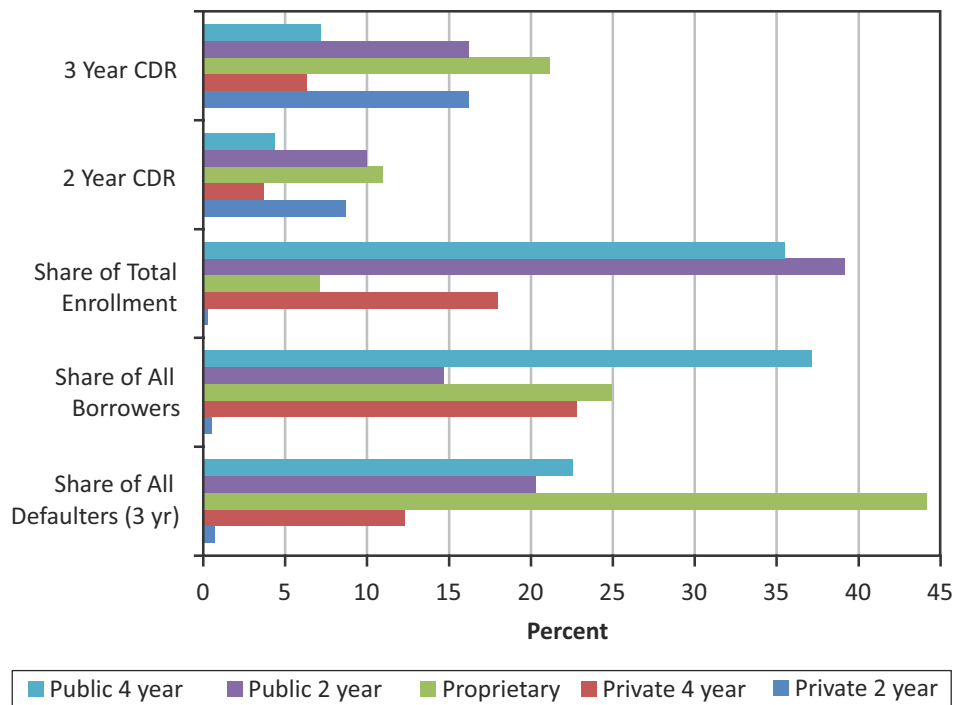
**Cohort Default Rates (CDR).** A CDR is the ratio of the number of students who defaulted on their loan within a given period to the number of students who entered repayment during that same period.<sup>193</sup> To be considered in default, a borrower must not have made a loan payment for 270 days if monthly payments are required, or 330 days if payments are scheduled on a less frequent basis.<sup>194</sup> This generous definition gives students in repayment a considerable buffer against defaulting, yet CDRs have risen considerably in recent years and are highest in the for-profit sector. CDRs play a vital role in postsecondary education because institutions must meet certain CDR standards to remain eligible for Title IV federal aid programs. In other words, if an institution fails to meet the established standards, then its students will not be eligible to receive federal grants or loans to finance their education. This would be the kiss of death for most institutions.

Currently, 2-year cohort default rates are used and an institution will lose eligibility for federal financial aid programs if its CDR is greater than 40 percent in a given year, or exceeds 25 percent for three consecutive years. If an institution has a CDR above 25 percent in a single year, then it is placed on provisional status, meaning that it needs to clean up its act quickly. Beginning in 2012, 3-year CDRs will be used, with the 40 percent single year rule remaining intact; however, an institution’s CDR will have to exceed 30 percent for three consecutive years to lose Title IV eligibility, with single year provisional status kicking in with a showing of 30 percent.<sup>195</sup> In December 2009, in anticipation of the upcoming regulatory change, ED released trial data on 3-year CDRs for the 2005–2007 fiscal years. Although these data will not be used to determine official eligibility for federal aid programs, they were intended to provide institutions with a perspective of where they would stand if the changes were to be implemented now.

The trial 3-year CDR rate for the for-profit sector was 21.2 percent—much higher than the rates reported for the other sectors: 16.2 percent for both public and private nonprofit 2-year schools, and 7.1 and 6.3 percent for public and private nonprofit 4-year schools, respectively. These figures prompted Ben

FIGURE 21

3-YR AND 2-YR CDRs, SHARE OF ENROLLMENT, BORROWERS AND DEFAULTERS BY SECTOR, FY 2007



Source: U.S. Department of Education, National Student Loan Data System; Authors Calculations.

Miller to criticize the for-profit sector, stating that it enrolls “substantially more borrowers and defaulters than [its] share of enrollment would suggest.”<sup>196</sup> Miller was right, the for-profit sector’s share of borrowers to share of enrollment ratio was 3.52, far exceeding the other sectors whose ratios ranged from 0.37 at public 2-year to 1.85 at private 2-year nonprofit institutions; whereas its share of defaulters to share of borrowers’ ratio was 1.77, exceeding that of the other sectors whose ratios ranged from 0.54 at private 4-year nonprofit to 1.38 at public 2-year institutions. Figure 21 shows the 2- and 3-year CDRs, share of total enrollment, share of all borrowers and share of all defaulters by sector for 2007.<sup>197</sup>

Critics of the for-profit sector have a right to be upset about these data, with some contending that the open admission policies of many for-profit schools have resulted in unqualified students enrolling who get little benefit from the education, leading to onerous debt loads and high default rates,<sup>198</sup> and that such high-risk students are accumulating a heap of debt and would be better served enrolling in less expensive public institutions.<sup>199</sup> A closer examination of the evidence, however, suggests that for-profit sector’s high CDRs may not be merely attributable to negligence on the part of the institutions. An August 2009 report from the GAO indicated that high borrower default rates are closely linked to low family income, parental education, student age, and loan amounts.<sup>200</sup> Statistical models developed by Bridgespan Financial indicate that the most important factor in explaining the variation in CDRs is mainly “the degree to which





an institution collected and reported information about its student body.” This variable was found to account for more than 1/3 of the variation in CDRs. Other important explanatory variables (in order of influence) included the percentage of students receiving a Pell Grant, degree-levels offered and institutional factors such as profit status.<sup>201</sup>

Overall, for-profit students have much lower family incomes, parents with lower levels of education, tend to be older, and take out more debt than their public and private nonprofit counterparts—making them more likely to default on their student loans regardless of the type of institution they attend, according to the analyses mentioned above.<sup>202</sup> In addition, there are many examples of for-profit institutions performing at or above par with respect to their public and private nonprofit counterparts. In fact, 373 for-profit institutions had a 3-year CDR less than or equal to the overall postsecondary rate of 11.8 percent, with 198 of these having a CDR less than the public 4-year sector rate of 7.1 percent. Several for-profit institutions with large enrollments, such as Grand Canyon University, Walden University and American Public University, have around a 3 percent CDR, and Capella University exhibits a 5.5 percent CDR. All four of these for-profit institutions have a CDR equal to or less than the highly regarded and public Ohio State University.

Nonetheless, the fact that more than 1 in 5 proprietary education students defaulted on their loans within 3 years does not rest well with the American public or policy makers. For-profit institutions should take the initiative to improve their educational value so that students, especially those who are most likely to default on loans, can afford to undertake career training opportunities that will provide them with the skills needed to earn a decent standard of living and make a contribution to society. Continued poor performance in this important policy metric will result in some schools losing eligibility for federal financial aid, but it may also lead to policy makers being pressured to impose stricter regulations aimed to protect both consumers and taxpayers alike.

### *Operational Issues*

Regulations that affect the operations of for-profit institutions have the potential to be significantly harmful and restrictive. That’s because such institutions have invested huge amounts of time and money setting up their operations to do business in a way that complies with the laws that govern them. Two of the biggest challenges facing the for-profit industry today relate to interstate commerce and responsibility for authorization.

**Interstate Commerce.** Perhaps the state-level issue with that will prove to be the biggest challenge in the future is related to interstate commerce. Historically, for-profit colleges have only needed to be licensed to operate and comply with the regulatory environment in the state in which they are headquartered. This has limited the state-level regulatory burden that colleges operating across states lines have been subjected. More recently, as many profit-seeking colleges have been pursuing growth opportunities across state borders, there is increasing pressure to impose regulatory burdens on such colleges in multiple states. One of the regional accrediting bodies, the North Central Association of Colleges and Schools (NCACS), has established a policy which states that “all of its accredited members to be authorized to operate in all the states where they have students either in online or traditional courses.”<sup>203</sup> ED appears to be heading in a similar direction in creating regulatory language that would require colleges with multiple state locations to be authorized to operate in all such states in order to qualify for federal student aid programs.<sup>204</sup>

Such a law would impose additional regulatory burdens on for-profit colleges. This would apply to

both traditional bricks-and-mortar and online colleges that operate, or seek to operate, in multiple states. It is perhaps the online colleges that would be most adversely affected by such a rule though, as the latter compete for online students nationwide and may enroll relatively few students from a given state. The president of the online Yorktown University, Richard Bishirjian, estimated that it would cost his institution “a half million dollars or more annually to pay the licensing costs and legal fees of doing business in the 10 to 15 states where Yorktown has students,” and that the costs would likely be passed on to students. Bishirjian contends that “the proposed rule is meant to preserve the status of traditional universities and would unfairly affect all but the largest and wealthiest online-only education companies.”<sup>205</sup> Whether this allegation is true or not, the rule would significantly hamper competition in the online education market by making it very costly for small online colleges to attract students from multiple states, despite the fact that one of the benefits of online college is that students can attend from anywhere with an internet connection and that this often leads to greater economies of scale and thus, lower costs.

**Responsibility for Authorization.** Another state-level issue that also has national implications is related to determining responsibility for authorization of institutions to operate within a state. As mentioned above, the HEA requires that an institution must have evidence that it is authorized to operate in a state in order to be eligible for federal student aid programs; however, there remains ambiguity as to which regulatory or oversight body is responsible for authorization. While federal law implies that state agencies are the responsible party, some states have deferred the decision making to the accreditation agencies by exempting institutions from the licensing process that are already accredited by a federally approved agency. ED has suggested that this undermines the checks and balances system of accreditation and state authorization.<sup>206</sup>

In a related issue, ED found an apparent loophole in the mid 1970s when it determined that “institutions were authorized by the state by virtue of the state’s decision not to have any oversight over them,” suggesting that institutions technically not authorized to operate in a state may still remain eligible for student aid programs. This unlikely scenario came to fruition temporarily recently when California dismantled its agency responsible for oversight, the Bureau for Private Postsecondary and Vocational Education. California would later create a new oversight body, but during the time in which there was no official oversight authority, for-profit institutions maintained their eligibility for federal student aid programs.<sup>207</sup>

In response, ED has proposed regulatory language that would require states to maintain written documentation of an institution’s legal authorization to operate within its borders be obtained by a government agency or entity that is specifically responsible for licensing, chartering or otherwise approving education programs. In other words, ED intends to eliminate supposed loopholes that permit an avoidance of oversight such as authorization made by entities that are also responsible for approving non-educational entities, state authorization based on the age of an institution or its association with a non-state entity, or authorization that is not subject to review or revocation for cause such as failure to comply with consumer protection laws.<sup>208</sup>

### ***Educational Issues***

Although the majority of regulatory efforts are somehow related to federal aid programs, there are a few efforts focused on educational issues, although they too, are intermingled with federal student aid. Accreditation is the de facto monitor of institutional quality in addition to serving a gatekeeper function. With the proliferation of the internet, online distance education has becoming increasingly popular, spurring a debate over the quality of such education.

**Accreditation.** Accreditation became much more attractive to colleges when the accreditation agencies began serving as gatekeepers to the federal coffers with passage of the 1952 GI Bill and the later 1965 HEA. Although accreditation technically remains a voluntary process today, many students rely on federal aid programs to help pay for college and as such, most institutions, including those in the for-profit sector, must comply with the standards and oversight of the accreditation associations if they wish to enroll such students. It is not difficult to understand why accreditation became so prevalent among not only for-profit, but all postsecondary institutions since passage of the original and subsequent reauthorizations of the HEA. The incentive is quite attractive, as accreditation is essential to access federal aid money, which totaled nearly \$117 billion in 2008–2009. This figure represents a real, inflation-adjusted increase of nearly 540 percent, or a real growth rate of 5 percent since 1970–1971.<sup>209</sup> With an ever growing federal treasure chest, all institutions have become eager to get it in on the action, including the for-profits. Traditionally, most for-profit institutions have been accredited by the national accreditors, but increasingly, they are seeking to gain regional accreditation.

It is a common perception that regional accreditation is a better indicator of quality than national accreditation. This is likely due to a misguided guilty-by-association mindset in which any college that is accredited by the same association that accredits what may be considered a substandard institution, is also substandard. Similarly, a college that is accredited by the same association that accredits the most reputable institutions is perceived as also being reputable. The diploma mill endemic of the past has tainted the public image of the national accreditation associations and the for-profit industry in general by painting an ugly image of it that has struggled to fade. Likely for this reason, many for-profit colleges now seek to obtain regional accreditation so that they may be perceived as reputable by association. The University of Phoenix, for instance, has boasted in its marketing that it is accredited by the same association that accredits the top research universities in the world.

The majority of institutions, however, remain accredited by a national agency, as the regional agencies remain somewhat hostile to the for-profit sector<sup>210</sup> despite an antitrust case brought by the U.S. Department of Justice against the American Bar Association (a specialized accrediting agency for law schools) that prohibited the ABA from “refusing to accredit schools simply because they are for-profit” operators.<sup>211</sup> This essentially made it illegal for an accrediting agency to base accreditation decisions on profit status. Despite remnants of hostility, some highly capitalized for-profit colleges have managed to obtain regional accreditation, although by a somewhat roundabout way that some critics of the industry argue should not be permitted. Such colleges have been able to acquire regional accreditation by purchasing financially struggling colleges that already possess regional accreditation or by starting a new program at a college that is already regionally accredited. Entrepreneur Michael Clifford has suggested that regional accreditation has a market value of around \$10 million to an acquirer, as that is the amount that it would take to start a regionally accredited college, a “process that could take up to ten years and has only a 50-50 chance of success.”<sup>212</sup>

Although accreditation through acquisition and association appears to be feasible at this point, it is an area that may eventually become susceptible to more government regulation. At the time of this writing, there is evidence of this, which has sparked great concern in the for-profit industry. ED’s Office of Inspector General (OIG) has launched an attack on the Higher Learning Commission (HLC) of the NCACS over its decision to accredit American Intercontinental University, an online for-profit school (we will discuss this case again in the online learning section). The fear is that “HLC is not likely to escape sanctions unless it radically changes policies and promises never again to accredit a for profit distance learning institution,” implying that institutions such as the University of Phoenix and Kaplan University risk losing

their regional accreditation if the OIG successful instills fear in the regional accreditors that deters them from accrediting for-profit schools with significant online offerings.<sup>213</sup>

**Online Learning.** Following a report by ED calling for the repeal of the 50-percent rule in an attempt to, as Congressman John Boehner stated, “increase access to higher education through innovation and technology,”<sup>214</sup> the Higher Education Reconciliation Act of 2006 eliminated the rule, paving the way for colleges to offer more distance courses and validating online institutions.<sup>215</sup> Although demand for online courses had been growing for several years, the number and percentage of students taking an online course has soared since abandonment of the 50-percent rule. Between fall 2006 and 2008, the number of students taking at least one online course has increased by 32 percent (3.5 to 4.6 million), while the percentage of all students taking at least one online course increased from 19.6 to 25.3 percent.<sup>216</sup> This rule change has benefited all sectors of postsecondary education, but it has been especially beneficial to the for-profit sector, which has a 42 percent online higher education market share.<sup>217</sup>

Despite the rule change, there are still critics of online education, and particularly that provided by for-profit institutions. One such critic is ED’s Office of Inspector General (OIG). It released a report in May 2010 condemning the HLC of the NCACS, which happens to accredit the greatest number of for-profit schools among the regional accreditors, for not defining “what constitutes a credit hour for a course” or establishing “minimum requirements for program length or the assignment of credit hours,”<sup>218</sup> suggesting that this “allowed the university to inflate course value and, consequently, award students too much in federal student loans.”<sup>219</sup> OIG’s criticism of the accreditor was sparked by HLC’s decision to accredit American Intercontinental University, an online for-profit school. In its subsequent investigation, OIG also examined Kaplan University and the University of Phoenix, both for-profit and largely online institutions.<sup>220</sup>

Many skeptics of online learning espouse the view that traditional education is more effective than online, presumably because greater value is placed on face-to-face instruction than the actual content being delivered. This *social interaction argument* assumes that physical classroom interaction is needed to engage the students in learning and that this experience is not replicable in a virtual classroom—even ones that make use of advanced communication tools such as email, forums and social networking that encourage even bashful students to participate. There is a growing body of evidence that suggests this argument is misguided—that online education is as effective if not more effective than traditional face-to-face instruction.

The National Center for Academic Transformation (NCAT) has developed a course redesign model that stresses the implementation of information technology into an institution’s 25 most common courses. It has been tested at 30 institutional locations thus far, with significant improvements in student learning, retention, and course completions. In fact, improvements in student learning were reported by 25 of the 30 projects, with the remaining 5 indicating equivalent learning; and 18 of 24 institutions that measured retention reported “a decrease in drop-failure-withdrawal rates, and an increase in course completion rates.”<sup>221</sup> A similar effort is underway at Carnegie Mellon Universities’ Open Learning Initiative (OLI), which has developed a prototype for how online courses can be designed to respond to individual student needs. Early testing of OLI suggests that, “students in a traditional classroom introductory statistics course scored no better than similar students who used the open-learning program and skipped the three weekly lectures and lab period,”<sup>222</sup> implying that online courses are just as effective as traditional ones, with room for improvement. The positive results reported by NCAT and OLI are indicative of the overall effects of online education as reported by ED and the National Survey of Student Engagement (NSSE).



ED released a meta-analysis in 2009 that examined more than 1,000 empirical studies of the effectiveness of online learning, finding that “students who took all or part of their class online performed better, on average, than those taking the same course through traditional face-to-face instruction,” with the effect being greater for blended (online combined with elements of face-to-face) than for purely online instruction, relative to face-to-face instruction only.<sup>223</sup> The report noted that “online learning is much more conducive to the expansion of learning time than is face-to-face instruction.” Online learning can be enhanced by giving learners control of their interactions with media and prompting learner reflection.<sup>224</sup> The results of the ED report were enough to persuade some skeptics, such as University of Wisconsin sociologist Sara Goldrick-Rab, to conclude that “I’m a bit more convinced that online ed is a reasonable way to move forward.”<sup>225</sup>

The 2008 NSSE, which randomly surveyed nearly 380,000 students at 722 U.S. baccalaureate-granting institutions, found that “courses delivered primarily online seem to stimulate students’ level of intellectual challenge and educational gains,” adding that “relative to classroom learners...online learners reported more deep approaches to learning in their coursework.” The NSSE report did note that students who pursue online courses may be those “who embrace the spirit of independent, student centered, intellectually engaging learning,” with online learners more likely than their counterparts to very often “participate in course activities that challenge them intellectually and to discuss topics of importance to their major.”<sup>226</sup>

Despite evidence that online education is a reliable medium, ED appears to have taken the OIG’s report into consideration, as it recently proposed a rule that would for the first time in federal policy history define a credit hour as “one hour of classroom or direct faculty instruction and a minimum of two hours of out of class student work each week for approximately fifteen weeks for one semester or trimester hour of credit, or equivalent amounts of actual instruction for quarters or other time periods.” In an effort to avoid suppressing efforts by institutions to develop alternative methods to measure educational content and student work, ED’s proposal did carve out an exception that would permit institutionally “established reasonable equivalencies for the amount of work required in [the previous definition] for the credit hours awarded, including as represented in intended learning outcomes and verified as evidence of student achievement.”<sup>227</sup>

## Conclusion: On the Economics of For-Profit Higher Education

The single characteristic that most sets for-profit institutions of higher learning apart from the traditional sectors of higher education is the profit motive. Some observers contend that profit has absolutely no place in the sacred endeavor of education. They argue that for-profit colleges and universities are akin to snake oil salesman. For-profits, they claim, do nothing more than sell students the notion that all their problems can be solved through receipt of a diploma (sometimes reflecting a dubious amount of true education), and ultimately leave them with nothing of value and a mountain of debt.

Traditional economic theory, however, can be used to paint a vastly different picture of education as a profit making enterprise. In this context, profit is not an evil of society, but rather the engine that ultimately provides consumers with the things they want and need. The concept of consumer sovereignty asserts that the consumer ultimately determines how a society’s resources will be allocated based on their decisions of what to buy and what not to buy. Profits will only be generated in markets in which the product is in high demand. Profit creates the incentive for firms to provide more of the product, thus automatically drawing resources into productive activities that satisfy consumers’ wants and needs.

Ultimately, the concept of consumer sovereignty is just as applicable to education as it is to any other product. But this assertion also points to the resistance to such an argument: education viewed as a product. For many, classifying education as a product and a student as a customer elicits a negative response. Education is more than a “business,” it is a calling, an endeavor that enriches society and furthers the development of western civilization. However, the classification of colleges as businesses is highly defensible. The student will pay in one manner or another for the services of the college or university and further, they are the primary beneficiary of the education. This view of education as a product can explain the unprecedented growth of the for-profit education industry and perhaps partially silence some of the industry’s critics. Economics would suggest that for-profits can only make a profit by providing educational services that are in high demand. Those educational services would not likely be in high demand for long if they were of dubious quality or did little to increase a student’s employability. The track record of for-profit education is long enough at this point that if the industry were providing a product of little value, the customers would be aware of this and simply go away. They have not. Demand at for-profits is as strong as ever. If demand for a product is strong, the product must be providing something of value for the customer.

The perception that the explosive growth of the industry in the past decade is no short term phenomenon is shared by investors and entrepreneurs in the industry. Governments are strapped for funds, not only temporarily as a result of the current economic downturn, but long term because of the rising liabilities associated with rapid increases in the elderly population. If higher education participation is going to rise substantially, private resources are almost certainly going to be needed to finance enrollment expansion. The for profit sector, at the margin, is already serving a large minority of incremental students, and that portion will probably continue to rise, particularly if increasing numbers of students are adult learners that historically have used for-profit institutions to a great extent to meet their educational needs. Any attempt to expand participation of Americans in higher education would do well to seriously include for profit institutions in planning, and public policy should encourage, not discourage this sector’s continued growth. As a general proposition, that means providing a level playing field, where the for-profits are treated no differently than traditional institutions with respect to regulatory matters.

Also, we are of the opinion that the for-profits provide a useful function in many ways. They increase competition for the traditional universities, leading many such schools to do things that are desirable but have been previously resisted—offering more weekend and evening classes, reaching out more to adult learners, etc. The for-profits often use standardized curricula in ways that lower costs without any loss in student learning, a point that may eventually become more acceptable in traditional universities where suggestions for curricular innovation are often resisted by faculty who assert their academic freedom is being violated. They make vastly better use of facilities, a lesson traditional universities can learn, and may be compelled to learn in order to remain competitive.

The continued rise in tuition fees at rates greater than family incomes is not sustainable indefinitely, and a reformation of higher education is necessary to deal with that reality. One element of that reformation is moving toward more efficient, market-based service providers such as for-profit schools. These schools, like any set of institutions, are not all perfect, and indeed there are no doubt some real issues relating to educational quality, the financing of students and the like, but these issues often exist for traditional providers as well. In any case, the for-profit schools are increasingly important in the higher education landscape and we see nothing to fundamentally alter that. It is time to accept that fact and use this reality constructively to improve American higher education.

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