

## **The Department of Education’s Attempt to Hamper Productivity and Stifle Growth**

by Daniel L. Bennett

The Department of Education (ED) solidified its position on the for-profit higher education industry in early December when it released the results of its so-called negotiated rulemaking committee. Its proposals to amend the Higher Education Act (HEA), which regulates the use of Title IV funding (or federal financial aid), have the potential to reduce the competitiveness, productivity and growth potential of the for-profit sector. The resulting proposals cover a range of issues related to institutional eligibility for Title IV funds that would ostensibly apply to all segments of the postsecondary market, but there are several that appear clandestinely targeted at the for-profit sector, including proposals to eliminate the 12 “safe harbors” of incentive compensation, and to create a “reasonable relationship between the cost of the program and expected earnings.”<sup>1</sup>

Currently, incentive compensation for admissions officials based on enrollment figures is prohibited, which has been a positive for all of postsecondary education as it has helped reduced overly aggressive recruiting tactics. There are, however, twelve exceptions (so-called “safe harbors”) that permit colleges to compensate employees and investors based on performance. Employee incentives, financial rewards or otherwise, are a crucial tool in the private marketplace and an effective management practice that motivates worker performance, enhances productivity and drives profits. Career education is a highly competitive industry that relies on student tuition for survival due to the absence of direct public subsidies, mammoth endowments and research funding enjoyed by the public and private not-for-profit sectors. This means that institutions whose existence is contingent upon making a profit must meet enrollment objectives to remain financially viable, and the market-based nature of the for-profit business model suggests that incentivizing the employees is the one of the most productive methods of achieving these goals and remaining competitive.

ED wishes to abolish all incentive-based compensation in higher education, including exceptions currently permissible. I will briefly discuss three of the current exceptions and the possible implications of eliminating them. First, incentives are allowable for “recruiters based upon their recruitment of students who enroll only in programs that are not eligible for title IV, HEA program funds.” Second, profit-sharing or bonus payments that are made to “all or substantially all of an institution's full-time employees” and are “substantially the same amount or the same percentage of salary or wages,” are permitted. Third, “profit distributions to owners,” are legal.<sup>2</sup>

ED’s proposal to eliminate these exceptions is alarming and would represent an intrusion of the federal government into the private marketplace. First, the federal government doesn’t have a direct interest in programs not eligible for title IV funds because participating students are not eligible for federal financial aid. Such students pay for these programs with private funds or perhaps local or state aid. In the latter case, it should be left to local officials to decide whether incentive pay is permissible when

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<sup>1</sup> Negotiated Rulemaking for Higher Education 2009-10 – Team I – Program Integrity Issues. “Issue Paper #4: Incentive Compensation,” U.S. Department of Education, November 2009.

<sup>2</sup>Ibid

public funds are involved. Next, eliminating a private company's ability to incentivize its employees has the potential to hamper its productivity and lower its competitiveness. Lastly, when private businesses earn a profit, they generally do one of two things: re-invest the earnings or distribute them to owners. ED seeks to eliminate the latter option, ostensibly desiring colleges to squander away all of their earnings in a manner similar to the not-for-profit and public sectors. This would deter investors and their capital from the sector, stifling the innovative and transformative momentum of proprietary education

Although he did admit that "a change in employee incentives could result in a decline of counselor productivity," education analyst Ariel Sokol issued a more optimistic outlook of the committee's proposal in a Wedbush Securities' industry note, suggesting that the proposed elimination of "safe harbor" incentive compensation is a "negative in the near term," but could be a "net positive in legitimizing the sector." Sokol substantiated this claim by noting that "market-funded institutions are typically derided by the media, elements of the investment community, and consumer advocacy groups as 'boiler room operators' who seemingly vie to enroll new students regardless of student outcomes," and that the barring of the "safe harbors" has the potential to change that perception.<sup>3</sup>

Perhaps more intrusive than the elimination of incentive pay, is ED's proposition to impose what amounts to government price controls on vocational education. Many onlookers were expecting the committee to offer a definition of the term "gainful employment" of graduates of occupationally specific programs in determining eligibility for title IV funding. Instead, ED proposed that eligibility for title IV funding be tied to postgraduate earnings, offering two options for determination – a surprisingly aggressive move.

The first option would relate the cost of a program to its "value added" –defined as "the difference in annual earnings between a high school graduate and a person who completes a vocational program."<sup>4</sup> If the cost of a program exceeds more than 3 times (or some other pre-determined multiple) of the value added, then the program would not be eligible for title IV funds. The second option would utilize a debt-to-income ratio to determine if the expecting entry level salary for graduates of a program is sufficient to meet debt payments and living expenses. If not, then the program would be ineligible for title IV funds. Implementation of either method would be an "overreaching" of ED to "insert itself into the business of setting prices" of a competitive private marketplace, as Signal Hill education analyst Trace Urdan said in a *Chronicle of Higher Education* article.<sup>5</sup> Sokol described this proposal as a potentially "dangerous precedent for a regulating body to determine the appropriate price points of certain program."<sup>6</sup> The stock market reacted

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<sup>3</sup> Sokol, Ariel. "Our Thoughts on Draft NegReg Rules: Elimination of Incentive Comp Safe Harbors Manageable; Gainful Employment an Issue for Vocational Schools," *Wedbush Industry Note*, 2 December 2009.

<sup>4</sup> Negotiated Rulemaking for Higher Education 2009-10 – Team I – Program Integrity Issues. "Issue Paper #4: Incentive Compensation," U.S. Department of Education, November 2009.

<sup>5</sup> Gonzalez, Jennifer. "Officials of For-Profit Colleges See Department's Proposed Rule Changes as Aggressive," *The Chronicle of Higher Education*, 1 December 2009.

<sup>6</sup> Sokol, Ariel. "Our Thoughts on Draft NegReg Rules: Elimination of Incentive Comp Safe

negatively to the news, with publicly-traded education stocks dropping an average of two percent on the day of the announcement.<sup>7</sup>

If adopted, the proposed changes would be detrimental to the productivity, competitiveness and growth opportunities of the career college industry, as performance-based compensation would be banned and price controls exerted, effectively increasing the government's influence of a private marketplace. This would be an unwelcome endeavor that threatens a thriving sector that has shown the most innovative potential to transform postsecondary education into a service that is accessible, affordable and beneficial to all students and society.

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Harbors Manageable; Gainful Employment an Issue for Vocational Schools," *Wedbush Industry Note*, 2 December 2009.

<sup>7</sup> Ibid