

The Federal Government and the Student Aid Partnership



PATHWAYS
TO COLLEGE
NETWORK

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September 2002

1. Introduction

In March 2001, twenty scholars and policy analysts whose research has focused on higher education placed an ad in *The New York Times* titled “Just and Efficient College Finance.” The ad urged our nation and our colleges and universities “to recommit to a fundamental statement that will foster a just and efficient allocation of public and private resources for higher education...our purpose is to reaffirm public policies that will maximize the development of the individual talent of all Americans and will strengthen the nation’s economic security.”¹ The ad argued for the concentration of financial assistance on students from low- and moderate-income families. It was an important step in articulating a broad consensus on the goals and principles of higher education policy. Unfortunately, policies at the federal, state and institutional levels have all continued to develop in directions contrary to these principles.

This paper addresses the question of how federal policy can more effectively alter this path and strengthen all participants in the higher education financing process in directing their efforts towards increasing educational opportunity for those qualified students whose resources are most limited.

Our starting point need not be entirely pessimistic. Many financial barriers to access to higher education have, in fact, been diminished in important ways. Enrollment rates have increased significantly over time, low-tuition community colleges are accessible to most potential students, and an array of need-based subsidy systems exists at the federal, state and institutional levels. Nonetheless, the level of unmet need faced by low- and middle-income students is daunting, the differences in participation rates, enrollment patterns and degree completion rates across income and ethnic groups are unacceptable, and the trend toward basing subsidies on criteria other than financial need is accelerating. However one weighs the relative successes and failures of the system, one factor diminishing its effectiveness is clearly its complexity and the extent to which the diverse players and programs create conflicts and tension instead of reinforcing each other in striving to attain a common goal.

Powerful arguments support the benefits of multiple actors sharing responsibility for increasing individuals’ access to higher education. The federal government, state governments, postsecondary institutions, and both the for-profit and non-profit private sectors have important roles to play. Each of these entities, having different missions and standing to benefit in different ways from a more educated population, has a somewhat different interest in increasing access. Moreover, as long as student subsidies serve multiple policy goals, multiple policy tools are not only desirable, but necessary.

The problem is not that we have a variety of entities subsidizing students or that they offer a variety of forms of subsidy. Federal grants *should* be supplemented by institutional grants at colleges and universities with relatively high tuition levels. Grants *should* be supplemented by loans for students whose earnings will allow them to repay in the future. The problem is that we need to do a better job of articulating the overarching goals of the system, of defining the distinct roles of the federal and state governments, as well as of institutions and the private sector, and of coordinating the efforts of these different players so that they reinforce each other more effectively and maximize the benefits for students needing assistance with college costs.

Moreover, if our nation is to make meaningful progress in reaching the goal of access to postsecondary education for all qualified students, the federal government must reassert itself as a leader in this process. The failure of the federal government to adequately focus its resources on this goal undermines the national agenda, both by reducing the dollars available to low-income students and by communicating a changed value system to other participants in the higher education financing process.

This paper approaches the question of the integration of subsidy policies from an economist's perspective. It focuses on questions of equity and efficiency and on the incentives created by different policies, and provides a theoretical framework for discussions of policy initiatives designed to assure access to higher education for all qualified students. The following section presents ways of approaching the distinct roles of the various participants in financing postsecondary education. Section 3 reviews the ways in which federal policies currently induce other entities to contribute to education finance and Section 4 discusses conflicts in the existing system. The final section proposes approaches to improving the coordination of federal policy with states, institutions, and other private entities.

2. Multiple Players, Multiple Goals

Subsidies to college students have goals that involve making our society both more equitable and more efficient. In terms of equity, our main goal is to assure that individuals have access to and choice among higher education institutions without regard to ability-to-pay. There is a general consensus that denying anyone the social and economic benefits of postsecondary education because of their financial circumstances is inconsistent with the basic principles of American society. Economists frequently approach the amorphous concept of equity by focusing on two concrete aspects of fairness. Horizontal equity requires that people in similar circumstances enjoy similar opportunities, while vertical equity requires that people whose circumstances differ be treated in appropriately different ways, with those with less adequate resources having access to higher levels of subsidies. In terms of efficiency, it is critical that we not waste our valuable human resources by failing to allow each individual to develop his or her potential as a productive citizen, contributing to a strong economy and a healthy society.

Within these broad outlines, it is possible to define more specific goals for different participants in the process. Students are the primary beneficiaries of higher education and choose to participate in order to improve their individual prospects. Both private firms and non-profit foundations have a role. The business sector is particularly interested in developing a productive labor force, while the non-profit sector has a variety

of goals, frequently focusing on redressing the inequities of market outcomes. Public and private colleges and universities differ in their sources of funding, but both strive to maintain their reputations and financial stability in addition to providing high quality educational opportunities. It is the government, at both the state and the federal levels, that is charged with furthering social welfare. It is useful to look separately at the place of each of these players in the higher education financing system.

The Federal Government's Role

The federal government is the only entity with either the mission or the capacity to take responsibility for the national agenda of removing the financial barriers to higher education. While an effective and coordinated national aid policy, meeting the goals set forth in the *New York Times* ad cited above, depends on all of the actors in the system, it is the federal government that must assure that policy structures further these goals. This reality does not conflict with the primacy of the state role in funding public education. Rather, it requires that the federal government use its influence over values and priorities across the nation, in addition to both its legislative authority and the power of its purse, to direct a greater portion of both its resources and the resources of other participants in the higher education partnership towards expanding the opportunities available to those with the most limited means.

From a national perspective, the goal is to encourage enrollment and persistence in appropriate educational institutions for all qualified students. This equity goal can best be attained if policies are designed efficiently. It is generally understood that in order to be efficient, policies must accomplish their goals using no more than the minimally necessary amount of resources. More frequently ignored is the role of incentives in determining efficiency. Public expenditures are efficient if they change behavior in directions consistent with policy goals. In the case of student subsidies, the goal is to encourage those who might otherwise not enroll or persist to do so, not to increase the already significant benefits accruing to those who would make this choice under any circumstances. We should focus on finding ways to ensure that our limited subsidy dollars have the maximum impact on educational choices that matter from a national social welfare perspective.

There is considerable evidence to support the notion that the enrollment patterns of low-income students are much more price-sensitive than the enrollment patterns of more affluent students.² In other words, the more financially secure the recipients of aid dollars, the more likely they would have gone to college - and earned a degree - in any case. While they surely welcome the subsidy and their lives are significantly eased as a result, most qualified middle-income students and virtually all upper-income students are unlikely to actually decide to go to college just because they are given a subsidy. While 97% of high school graduates in the highest achievement test quartile and the top quartile of the income distribution enroll in college, only 77% of those in the lowest income quartile with the same qualifications continue their educations after high school. This is about the same as the proportion of the most affluent students with the lowest test scores who go to college (Advisory Committee on Student Financial Assistance, 2001, p.13). Clearly, low-income students, unlike those with more ample resources, make a decision about *whether* to go to college, not just about *where* to enroll. Federal policies designed to increase access are efficient if and only if they target those students whose behaviors they can significantly alter – students with very limited financial resources.

In addition to the correlation between low income and price sensitivity, the social welfare benefit from college education for low-income students is likely significantly higher than the benefit from educating higher-income students. In general, students themselves reap a significant proportion of the benefits of higher education in the form of increased earnings, while society benefits from increased productivity and higher tax revenues. A middle-class high school graduate who goes to college and becomes a management level business employee instead of a construction worker will attain a higher standard of living and pay more in income taxes. But a high school graduate from a low-income family in a marginal neighborhood who becomes a first-generation college student may be escaping a life of intermittent employment and even prison sentences. In addition to the standard benefits of higher education, educating at-risk students can be expected to reduce public expenditures on social welfare and criminal justice and improve the community quality of life. One indicator of the potential differential social return to college is that while the poverty rate of 3.8% for African American college graduates is over twice as high as the poverty rate of 1.7% for white college graduates, the gap for high school graduates - 20.5% for African Americans compared to 7.4% for whites - is considerably larger (U.S. Census Bureau, 2002, Table 686). Directing student subsidies at students with very limited financial resources is likely to be more effective in increasing college participation rates, and any college participation engendered is likely to have a greater social benefit than would be the case if the funds were directed towards less needy students.

The basic structure of federal student aid policy, with Pell Grants for low-income students at the core, guaranteed loans to assure liquidity, and matching funds to provide incentives for states and institutions to provide need-based subsidies to students, is compatible with the fundamental goals of the system. However, the system has not evolved to meet the increasing needs of low-income students. The reduction in the purchasing power of Pell Grants, the increasing dominance of loans in aid packages, and reliance on non-refundable tax credits all signal abdication of the federal role in assuring access to higher education for all qualified students.

State Governments

State governments are responsible for creating an equitable society and an efficient economy within their own borders. But policies at the state level designed to further the broader goals of national equity and efficiency, in addition to being beyond the primary mission at this level of government, are likely to be of limited effectiveness. States inevitably find that because of the mobility of both people and resources across state lines, generous policies may attract people from other states with special needs, while high tax rates or other strategies to increase revenues may diminish the supply of productive resources within the state. A state that increases its taxes on businesses significantly in order to make quality higher education much less expensive than it is in neighboring states could easily experience both capital flight and an influx of people hoping to take advantage of the unique educational opportunities.

In the context of the federal system, just as it is quite logical that state universities charge higher tuition to out-of-state students, whose families have not paid taxes to subsidize the institution, it is hardly surprising that states are implementing grant programs designed to keep their best students in the state. These states are working on the assumption that students who go to college in the state are more likely to stay when

they enter the labor market, contributing to the state's economy. It is not obvious that this is an efficient policy at the state level, given the high cost of educating students and depending on how successful the policy is at decreasing long-term mobility.³ But it is consistent with the mission of the state government. However, even if they are efficient for states, student aid policies designed to keep students close to home are not efficient from a national perspective. A policy that causes a student to enroll in Georgia instead of Alabama successfully changes behavior. But from a national perspective, this doesn't constitute a meaningful change in behavior. Social welfare is unlikely to be affected by this decision.

The contrast between state and federal agendas is also apparent in relation to equity concerns. Policies that are clearly inequitable from a national perspective may be quite consistent with equity from the standpoint of states or institutions. The absence of state need-based grants in North Dakota creates no horizontal inequity to be grappled with by the state legislature. But from the national perspective, the wide variation in subsidies for college students in different states is a major violation of the principle of horizontal equity. The reality is that U.S. citizens face very different levels of access to higher education, depending on their state of residence. Two reports recently attempted to rank the states according to their success in making higher education affordable. The methodologies employed by the National Center for Public Policy and Higher Education and by the Lumina Foundation are very different and the conclusions about the best and the worst states in this regard are not entirely consistent. Nonetheless, both studies highlight the vast differences in access to college facing Americans, depending on where they live. Although the historical role of the states in supporting higher education and the different state cultures dictate that policies and outcomes will never be the same all across the U.S., one role for the federal government is clearly to diminish this horizontal inequity resulting from current policies.

States are also limited in their ability to improve the vertical inequities inherent in the increasingly unequal U.S. distribution of income. States and public institutions can subsidize their neediest students, but cannot significantly redistribute income because of mobility across state lines. Moreover, they can do nothing to address the differences between the more affluent residents of Connecticut and the lower-income residents of West Virginia. Only the federal government is in a position to generate tax revenues and distribute subsidies that will allow the nation as a whole to significantly reduce disparities in economic opportunities.

Students and Families

Unlike the government, students and families, private for-profit and non-profit entities, and institutions – including public colleges and universities – have primary goals other than general social welfare. Students and their families should and do have significant responsibility for paying for higher education. This is reasonable on both equity and efficiency grounds. Students reap a high percentage of the benefits of their education, both in terms of lifetime earnings and in terms of the short-term consumption and long-term non-pecuniary benefits of higher education. Moreover, without significant contributions to the cost of education from families with adequate financial resources, the threat from under-funding to both accessibility and quality would increase.

The Private Sector

Private businesses have an interest in nurturing a skilled labor force. They may award scholarships to students who demonstrate particular skills or interests or pursue fields of study that will prepare them for particular careers. From the industry perspective, the policies may well be efficient, whether or not those careers are in areas where there is a significant national need. From the perspective of the social welfare goals of national aid policy, however, this type of career change incentive is not efficient. A goal of federal policy should be to influence the incentives provided by private subsidies.

It is hard to argue that it is inequitable for the private sector to direct its funds towards those students most likely to fill their long run needs. General social welfare is likely to be more central to the mission of most private philanthropies than of for-profit firms, but foundations may still be expected to direct their funding towards students who fit their particular missions. In other words, while they are quite likely to make a positive contribution to educational opportunity for individual students, these private entities are unlikely to be the motivating force for a higher education funding system that has equity and opportunity for all students at its core.

Colleges and Universities

Similar logic applies to the motives of individual educational institutions. Public higher education as a whole has a fundamentally different mission from private higher education, but the underlying goal of making education accessible to all students does not motivate individual public colleges and universities in the same way that it should define state policies. Two-year colleges may function with access for individuals as their primary goal. But, much as we like to think of colleges and universities fulfilling the social mission of providing access to opportunity for all, from each institution's perspective it is efficient to use funds to attract those they view as the most valuable potential members of their student bodies. This is increasingly true of public four-year colleges and universities, in addition to privates. From a social perspective, whether George Bush's niece enrolls at Yale or Princeton is hardly worth the time to check the website. Similarly, devoting considerable resources to convincing a prominent scientist to move from the University of Michigan to Berkeley is unlikely to have a significant pay-off in terms of the general welfare. But it is hardly surprising that from the campus view, this is simply not the case.

Colleges currently engaged in potentially destructive competition for a finite group of desirable students or for a limited pool of faculty stars are not likely to change course on the basis of arguments about social welfare and a national policy agenda. Institutional decision-makers are both aware of and sympathetic to the goals of increased access and opportunity. Cognizant as they might be of the reality that scarce resources are being dissipated with no increase in the pool of qualified students and no increase in the opportunities faced by those students, left to their own devices, they will likely continue to adopt policies that appear to be in the best interest of the institution as they perceive it.

The problem, then, may not be that states and institutions are behaving irrationally, inefficiently or inappropriately. The problem is that the perceived interests of these parties are different from the interests of the nation as a whole. A goal of federal policies should be to change the incentive structure of states, institutions, and other

participants in higher education finance in order to redirect funds in directions consistent with national goals. This is not a new idea and it is embodied in some of our existing policies. It may be useful to examine the current non-federal education subsidies that are generated by federal policies.

3. The Positive Impact of Federal Policies

States and Institutions

The most straightforward way in which the federal government can increase state and institutional funding for low-income and under-represented students is through matching grants. The State Student Incentive Grant (SSIG) program, introduced in 1972 and now known as Leveraging Educational Assistance Partnerships (LEAP), is a classic example of federal policy in this category. LEAP provides incentives to states to fund state-level need-based postsecondary student grant and community service work-study programs. Requiring a dollar-for-dollar match of state funds, this program is widely believed to have succeeded in motivating most states to implement or increase need-based grant programs for college students.

There is strong theoretical grounding for the idea that the SSIG/LEAP policies would increase state support for low-income students. The price of aiding needy college students is lowered for states because for every \$1 they spend, they get \$2 of benefits to students. Because the price of need-based student aid is lowered for the states, they are likely to “purchase” more of it. Aiding students in the form specified by LEAP is cheaper than aiding students in other ways – such as non-need-based assistance - so they would be expected to substitute need-based aid for other forms of state expenditures.

On the other hand, it is quite likely that state need-based aid would have grown even in the absence of SSIG during the 1970s and 1980s, since national consciousness about the need for student subsidies was increasing and the idea of public responsibility for access to higher education was becoming entrenched. As indicated in Figure 1, examination of the time trend in matching funds compared to the trend in state funding suggests that state funding had started its upward trend before SSIG dollars were available and that trend was not visibly altered by the introduction of federal matching funds. Moreover, the upward movement in state need-based grant aid has not ceased in response to declines in SSIG/LEAP funding. Even in recent years, with the dominance of merit-based state aid programs, need-based aid has grown without particular encouragement from the federal government. These observations are certainly not conclusive, and it is likely that there is measurably more state need-based aid for college students than there would be in the absence of federal matching dollars. But in-depth analysis should precede opting for considerable increases in funding for these particular programs, as opposed to modification and innovation in the matching fund approach to incentives for states.

Long before the advent of matching grants for student aid, the federal government provided a direct incentive for states to provide higher education opportunities for their residents. The Morrill Act of 1862 provided land grants for states to establish or sustain public universities. A succession of later Congressional acts brought more federal money to campuses.⁴ As is the case with matching grants, it is

likely that both the federal dollars *and* the message about priorities sent by federal policies play a role in shaping state public policy.

In addition to its impact on the states, the federal government has been successful in inducing postsecondary institutions to contribute their own funds to help students pay for college. Under the Perkins Loan program, students with financial need receive low-interest loans from revolving funds. Institutions are required to provide one dollar of their own funds to match each three dollars of federal funds for Perkins loans. This policy towards institutions is exactly parallel to LEAP for states. Colleges and universities spend their own dollars to make enrollment more accessible to students they wish to assist. The price of attracting these students is lower because the federal government turns each dollar into four dollars. But if the institutions had no interest in subsidizing the students, they would not participate, even at the lower price.

Another example of federal matching funds to institutions is the work-study (FWS) program, under which the government pays 75 percent of the wages of student workers. This matching program is parallel to LEAP and Perkins, in the sense that institutions would not participate if they did not value both student aid and student workers. Again, it is reasonable to believe that more students have on-campus jobs than would be the case in the absence of FWS. However, since campuses require a significant amount of low-wage labor, it is not clear how many fewer campus workers there would be in the absence of the federal program. What the program clearly does is give the schools the incentive to hire students with federally determined financial need instead of other students who might apply for the jobs. If a non-needy student would cost \$6.00/hr, a student eligible for FWS will cost only \$1.50/hr. The FWS program is surely effective in directing institutional funds towards students with financial need. Whether the level of matching is optimal, higher than necessary, or lower than the optimal amount is not immediately obvious. But the principle that the federal government can use matching funds to modify institutional choices about the beneficiaries of funding is clear.

In addition to the Perkins Loan and Federal Work Study programs, the federal government provides matching funds for institutional grants to students with need in the form of Supplemental Educational Opportunity Grants (SEOG). Like FWS, SEOG requires a 25% contribution from institutional funds. Although it is again unclear whether the institutional grant dollars would be present even without the SEOG matching incentive, the program is the source of an important subsidy for students with financial need. It also reinforces the federal/institutional partnership, highlighting the need for all parties with an interest in access to higher education to work together to improve access for students.

The \$280 million of FWS funds from institutions, the \$219 million of institutional funds for SEOG, and the \$33 million of institutional Perkins dollars, combined with the \$80 million dollars of state funding generated for the LEAP program (NCES, 2002, p.13), added up to \$612 million dollars generated by the federal government, but not on the federal budget, in 2001.⁵ While some portion of these funds would have been forthcoming without federal incentives, matching funds represent a logical approach to effective federal policy.

Lenders

In contrast to the situation where the federal government is making student aid policies that are in and of themselves valuable to states and institutions less expensive to fund, the Federal Family Education Loan (FFEL) program subsidizes an activity that is of no inherent interest to the for-profit financial sector. The federal government has succeeded in generating large-scale participation of the private sector in providing funds for college students. While private lenders are not subsidizing students, it is very clear that the liquidity provided by student loan programs is vital to broad access to higher education. Understanding the ways in which federal policy has induced both non-profit and for-profit organizations to provide capital that enables students to pay for college is an important part of understanding the interaction between the federal government and other actors in the process.⁶

Under the FFEL program, 4100 private lenders provide loans to students, most of whom would not be credit-eligible in the absence of federal guarantees. In other words, banks and other financial entities participate extensively in student finance because the federal government subsidizes this activity. The on-going debates about the details of subsidies for guaranteed loans highlight the fact that it is difficult to determine exactly how much of the subsidy to lenders is necessary to assure adequate liquidity for students and how much is an unnecessary subsidy to banks. In other words, it is not clear whether all of the subsidy dollars represent efficient use of federal funds, changing the behavior of the private sector in socially beneficial ways, or whether a significant part of the federal expenditure is actually a pure subsidy to lenders that would find it profitable to participate in the program even with a lower rate of profit. But it is clear that the federal government has found an effective way of leveraging private dollars. From 1999 through 2001, about \$4 billion of federal outlays for FFEL generated about \$75 billion in private loan funds (College Board, 2001 and NCES 2002), making college more accessible and more affordable for many students.

The federal government's matching funds are effective because they reinforce state and institutional priorities. This is clearly distinct from FFEL, where the lenders place no particular value on lending to students. The lenders require a competitive rate of profit – not just a lower price – in order to participate in student financing. The magnitude of the funds generated raises the question of whether it might be possible to apply the principles of the FFEL program to increase the supply of grant funds to students. We will return to this issue after a brief discussion of the conflicts between participants in higher education finance generated by current policies.

4. Weaknesses of the Federal Role

The federal government has succeeded in providing incentives for the private sector to provide a large amount of funding for student loans, for state governments to provide a significant amount of need-based grant aid, and for institutions to allocate funds to grant and work aid for students with federally documented need. Before turning to the question of ways in which these incentives could be strengthened, it is important to note the ways in which current federal policy interferes with other participants in financing higher education and makes it more difficult for students with real financial need to be adequately subsidized. The federal need analysis system and the relationship of the federal aid system to state funding policies are two areas that create strains in a system that should increase access for students. Moreover, the recent trend in federal policy towards focusing on affordability for the middle class rather than on

access for low-income students reinforces movement in the same direction by both states and institutions.

The Need Analysis System

Some aspects of the federal government's rules for allocating student aid diminish its ability to target funds on the students with the greatest need. The current Federal Methodology (FM) for determining eligibility for federal need-based grants and subsidized loans is widely recognized as a rationing system, rather than a true measure of economic need. The treatment of assets in FM prevents it from more accurately measuring ability-to-pay because it excludes all home equity and family farm value and ignores all assets for families with incomes below \$50,000. It is impossible to distinguish between an applicant with an income of \$45,000 per year and a \$300,000 home and an applicant with the same income who rents and has no net worth. Another significant shortcoming is the failure to collect any data on the income and assets of non-custodial parents, making a student with a mother who is a homemaker and a non-custodial father who is very wealthy look identical to a similar student who has no father at all. At first glance, it might appear that the problem created by these aspects of the FM is just that some students who are not truly needy are eligible for federal aid. However, because of the scarcity of need-based funding and the role of FM in rationing, the result is that adequate funds are not available to those who truly need them.

This shortage of federal funding makes it imperative that states and institutions, as well as other private parties, be able to fill in the gaps. Many institutions use their own (or the College Board's) need analysis formula in order to more accurately determine which applicants are most in need of subsidies and how much aid will allow them to enroll. However, they frequently find that the federal regulation prohibiting "over-awards" prevents them from meeting students' documented need. This occurs when the alternative methodology indicates a higher level of need than FM does. While the FM characteristics mentioned above work in the other direction, other details such as less accurate determination of state and local tax allowances and failure to account for savings for siblings' education mean that FM sometimes calculates a lower level of need than other methodologies. This becomes a problem because students may lose their federal need-based aid (other than Pell Grants) if their total aid package exceeds the FM measured need amount.

The recent controversy over the federal rules for GEAR-UP funds illustrate the related problem of determining in which order aid awards are packaged. The federal government's goal of assuring that institutions not reduce their aid awards when students receive additional federal funds sounds reasonable. But in addition to being impossible to enforce without imposing significant penalties on students, this rule constrains institutions attempting to allocate their limited aid dollars to students whom they determine need them most.⁷ The treatment of Hope and Lifetime Learning Tax Credits creates a similar problem. Clearly, the government's goal is to increase the disposable income of those who take the tax credit by the amount of the credit – not to reduce the federal or institutional grant aid for which these students are eligible. However, a reliable need analysis system based on after-tax income cannot ignore the difference between a student who pays lower taxes because of the credit and another student whose circumstances are similar except for the absence of the credit. This type of coordination problem between different entities funding students creates unfortunate complication in the aid system and diverts resources from their most important use.

The FM also interferes with students' efforts to fund their own educations. The 50% tax rate on student income, especially in the absence of a minimum student contribution, is problematic in terms of both equity and efficiency. Students who work diligently in an effort to earn the money to fund their expected family contributions find that half of their dollars disappear in the form of higher expected contributions. For non-traditional students and students from low-income families, work is not a choice. The high marginal tax rates on student income in the need analysis system are punitive, which is clearly inequitable. These marginal tax rates are also inefficient, since they create a disincentive for work among dependent students who are in the position to make choices about whether and how much to work. The stringent treatment of student assets in FM exacerbates the problem. A student who earns a significant amount during high school and saves the money in anticipation of paying for college finds that not only is her income taxed at 50%, but the same earnings are also taxed at the rate of 35% as an asset.

Another perverse incentive created by the need analysis system relates to the treatment of outside scholarships and pre-paid tuition plans. Treating these funds as resources and reducing federal aid eligibility dollar-for-dollar when they are present means that students have absolutely no incentive to acquire them. If these funds were treated like other assets, they would free up some federal funds, but would also benefit the students, providing them with an incentive to save and to search for private funding. In the case of pre-paid tuition plans, there is no good argument for treating this form of saving any differently from any other form of saving. Under the current system, families who save by paying off their mortgages are eligible for much more aid than are families who save in the form of these plans. Savings disincentives in the need analysis system can hurt even those students whose limited resources do not allow them to save at all. The less prepared the middle class is to finance higher education, the more political pressure there is to direct limited public funds towards this group, rather than towards the truly needy.

The Role of State Budgets

A discussion of the relationship between the federal government and its partners in the higher education funding process cannot focus entirely on student aid. The federal/state partnership must be viewed in the context of reality that over 90 percent of state higher education dollars are in the form of subsidies to institutions,⁸ and that about 95% of the subsidy received by students in public colleges and universities is indirect, through low tuition levels (Baum and Sjogren, 1996). Public attention has recently been drawn to the cyclical nature of this state funding, with appropriations growing when the economy is strong and tuition levels rising most rapidly when state budgets are tight and family incomes are stagnant (NCPPE, 2002). While this may at first appear to be a problem to be confronted only by state legislatures, the federal government's role as primary guarantor of access to college requires that it provide incentives to states to assure consistent educational opportunity.

The national policy concern with access requires attention to state funding policies as they relate both to tuition levels and to need-based aid available at public higher education institutions. Despite the public focus on gross tuition levels, access depends on the net price of college, which is a function of both tuition levels and available student aid. Economists have long argued that a high tuition/high aid policy is

the most efficient way of targeting limited state funds on those students who need them most. High levels of state subsidies to state universities, where family income levels are higher than average, and frequently higher than those at private colleges, are pure subsidies to students who would enroll in college on their own. They do not change behavior in socially significant ways. In contrast, need-based aid – and low tuition levels at two-year public colleges and other institutions serving primarily low-income and first-generation college students – allows students who would otherwise not participate in postsecondary education, to enroll.

A major objection to high tuition/high aid policies is that high sticker prices discourage enrollment, even if aid is available. Because the aid system is less than transparent, it is far from clear to at-risk students and their families that they will be able to afford college when the time comes. Another, more intractable problem is that the political process of state budgeting makes it unlikely that student aid budgets will grow as needed in the face of rising tuition levels driven by tight budgets. The unfortunate reality is that state funding for need-based grant aid is least likely to grow rapidly in difficult economic times, when public tuition levels are growing most rapidly.⁹

Current federal policy has no explicit relationship to the approach of states to educational subsidies. Public sentiment certainly favors low tuition policies and the attention given to sticker prices in both public policy arenas and the press fosters this view. However, it is possible to argue that the current system contains incentives for states to raise tuition. Some observers of the higher education financing system have argued that federal aid does, in fact, cause institutions to charge higher tuition levels, not just during difficult economic times, but in general. The basic argument is that schools raise tuition to capture the dollars the federal government provides to students. Empirical evidence, however, suggests that within the non-profit sector, only low-cost public colleges increase their charges in response to the increased availability of federal student aid.¹⁰

Another way of looking at this issue is to recognize that federal student aid is based on need, measured as the difference between cost of attendance and expected family contribution. When states raise tuition levels during recessions, as family incomes are falling, measured need increases and eligibility for federal grants and need-based loans increases. If federal funding were more generous, the federal government would be compensating for the problems created by the states. Students would be held harmless, but states would have every incentive to allow student need to grow, knowing that the federal government would assure access. This system would have the advantage of placing responsibility for access to college for those with limited resources where it belongs – with the federal government. Unfortunately, federal grant aid is far from being generous enough to fill this role. The reality is that cyclical state funding creates cyclical access to higher education.

When designing federal policy, it would be irresponsible not to keep in mind the potential for states to reduce their funding for education if more federal funds are available. But the idea that providing adequate financial aid can transfer more of the fiscal burden to the federal government and increase demand for college should be viewed as a success, not as a failure in the design of the system. Restricting funds and relying on deprivation to provide the states with incentives to hold tuition down is poor public policy. Rather, the focus should be on the reality that given the inadequacy of federal funding, students are certainly not held harmless by cyclical state policies. A

focus on incentives leads to the conclusion that, in addition to providing more adequate aid dollars, federal policy should be designed to encourage states to allocate their funds more consistently over the business cycle.

5. Strengthening the Partnership

Complements or substitutes?

Finding ways that the federal government can more effectively coordinate its efforts with those of other participants in an effort to increase access to higher education for low-income and under-represented students does not necessarily require that all available funding be directed towards this goal. While it is tempting to view any funding directed towards other groups of students as diverting resources from the goal of access – and while this is surely accurate in many instances – it is not clear that non-need-based funds are always substitutes for need-based funds, as opposed to complements, with both types of funding growing together.

Certainly, if the federal government, states, and institutions converted all of their grant programs based on academic merit or other non-need-related criteria into need-based funds, access to higher education would be increased. If state legislatures decreased their funding for public colleges and universities and used all of the newfound dollars to provide need-based aid for students to pay the new, higher tuition levels, more students would be able to afford higher education. In this sense, the programs are clearly substitutes. However, it is an obvious political reality that much of the funding would be directed to other public expenditures or to tax reduction.

Generous public subsidies and relatively low tuition at public colleges and universities make those institutions very important to the middle-class. They do not view this part of the budget as an anti-poverty policy, but as the provision of a vital service to all citizens. Their support for education spending would surely diminish if a full-fledged high-tuition/high-aid policy were implemented. Similarly, non-refundable tax credits, which provide over half of their benefits to filers with incomes of \$50,000 or higher (IRS, 1999) are far from the most effective way for the federal government to assure access to higher education. But again, this policy generates broader support for a federal role in making college more affordable.

Pell Grant funding grew 43 percent faster than the rate of inflation between 1997 and 2001, compared to 1% real growth over the four preceding years and a 21% real increase over the entire decade before the tax credits were put in place (The College Board, 2002). (See Figure 2.) The recent growth in Pell Grant funding may be attributable to other factors and perhaps Pell would have increased even more rapidly without the Taxpayer Relief Act of 1997, but the coincidence of events is strong circumstantial evidence for the complementarity of the two policies. At a minimum, it provides a warning about how we should react to policies that do not immediately appear to efficiently further our goal of increased access.

Similarly, before we urge the abolition of state merit-based grant programs, we should think carefully about whether limited programs of this sort increase the political will to make college affordable for all academically prepared students. During the 1990s, when the portion of state aid based on merit rather than need grew at an

alarming rate, from 11 percent to 24 percent, state need-based grants increased by 60% in real terms. In contrast, need-based state aid rose only 28% above the rate of inflation during the 1980s (NASSGAP, 2001). (See Figure 3.) A recent report from the Civil Rights Project at Harvard University finds evidence that state merit-based grant programs are likely to increase the income-based enrollment gap (Heller and Marin, 2002). Others argue that low-income students receive significantly more aid dollars in the presence of these merit-based policies than without them (Selingo, 2002). A more definitive, objective understanding of the realities of this situation will improve our efficacy as advocates for access to college for the most at-risk students.

This argument surely does not mean that the current division between need-based and non-need based public funding for college is optimal. In recent years, all levels of government, as well as institutions themselves, have tilted the balance heavily away from need-based subsidies. Our goal should be finding the appropriate balance in order to maximize the support we are able to give students who otherwise cannot enroll in college.

The Message

The implementation of non-refundable education tax credits by the federal government and of generous non-need-based grant programs by state governments signals a dangerous trend. But the growing sense of these trends among advocates for college access and policy analysts, as well as in the popular press, does not seem to incorporate the reality that both Pell Grant funding and state need-based grant funding have risen rapidly over the last few years. The visibility and the political appeal of the new programs, combined with the insurmountable gap between financial aid and college costs facing many low-income students, have obscured the progress that has been made.

No message about priorities can substitute for dollars. But greater focus on the availability of need-based aid and on the national priorities underlying this funding could serve to reinforce their value. Supporting access to college *is* a vital and active part of the national agenda. The federal government should conspicuously set an example to create an environment in which the expectation is that all participants in the higher education financing process will work toward increasing access for low-income students.

Simplification/transparency

Federal policy should simplify the student aid system and make it more transparent to the students who are most dependent on it. Rather than engaging in a counter-productive debate about whether lack of preparation and aspirations or lack of resources explains a greater portion of the differential in college participation rates by income, we should search for innovative ways of diminishing both problems. Simplification addresses both issues. Students and parents should know early on that college will be affordable and should have straightforward information about available subsidies and expectations for contributions from families in their circumstances. While additional funding is surely necessary, universal access to the funding that is available requires that the system not be so difficult to navigate.

In addition to mentoring and information programs, the aid application and allocation systems must be simplified.¹¹ As it stands, understanding the aid system,

filling out the necessary forms accurately, and taking advantage of all available opportunities is virtually impossible for students who do not have assistance from knowledgeable adults. Our acquiescence to the standard bureaucratic complexities of government processes is simply unacceptable in the case of student aid, since it defeats a significant part of the purpose of the entire program.

The federal government could make real progress in this direction by acknowledging that FM is an allocation formula, not a true need analysis system. Complex as it is, it is not a measure of true financial capacity. As long as the grant funds that are being distributed are so limited, it is wasteful to devote considerable resources to perfecting and administering the system. A simple formula based on income, with easily predictable levels of grant aid associated with family income levels, would be much more efficient public policy. The current treatment of income in the Federal Methodology should be reviewed with an eye to diminishing earnings disincentives to the extent this is possible without sacrificing the concentration of grant funds on low-income applicants.¹² Basing aid eligibility on a combination of income tax returns and eligibility for other need-based public subsidies would mean that families would not have to fill out complicated forms in order to be eligible. Student aid eligibility could essentially be automatic, and would not depend on parents having the ability and the will to help students navigate the system.

The restrictions imposed on institutions dispersing federal aid should also be carefully reviewed with an eye to maximizing access, rather than maximizing federal control. The federal partnership with students and their families would be strengthened by this system.

Matching Funds

Another non-revolutionary step that has the potential to improve the federal government's effectiveness in motivating its partners to increase their subsidies to students with inadequate resources is to increase the funding and effectiveness of the LEAP, SEOG and Work Study Programs. As discussed above, further research is needed to determine the actual effectiveness of these matching programs in generating additional funding. Thorough study of the optimal design and level for matching programs would provide solid grounding for modifying and strengthening this approach to leveraging funds from non-federal participants in higher education funding. How much are states and institutions likely to respond to subsidies aimed at increasing college enrollment among low-income students? Would increases in the federal matching rate increase state and institutional contributions because of the decrease in the price of enrolling low-income students, or would increased federal funds replace the funds of states and institutions, maintaining the current level of low-income enrollments? Lowering the price to states and institutions of providing aid to the most needy students is a promising foundation for assuring that they target their funds in socially beneficial directions.

Tuition/Aid Balance at Public Institutions

The extensive subsidies going to affluent students in the form of subsidized tuition levels at public colleges and universities should be a target of federal policy. As discussed above, assuming that higher tuition levels will be accompanied by more generous need-based state grant aid is unrealistic. Rather, the federal government

should assume responsibility for providing sufficient need-based grant aid to students to allow them to enroll in public institutions that charge tuition high enough to cover the cost of providing education.¹³ The unique position of the federal government in representing equity and efficiency for the nation as a whole, combined with the power of the federal government to generate revenues, dictates that they not delegate this responsibility to the states. If federal grant aid is adequate, states will have an incentive to raise their tuition levels enough for their students to enjoy the full benefits of the federal programs. Well-designed programs can reward states that use a significant portion of their new tuition revenues to supplement federal subsidies to low-income students.

Incentives for Potential Employers

The federal government can also design policies to increase the role of the for-profit sector in subsidizing college students. Despite widespread acknowledgement of the need for an educated workforce, firms have been slow to develop programs to encourage higher education among traditionally under-served groups. Federal incentives, in the form of matching funds or tax allowances, should be carefully designed to encourage the targeting of private funding for college students, consistent with national equity and efficiency goals. Generating more private grant aid to supplement the active participation of the private for-profit sector in loan funding will require creative policymaking, but is certainly a viable goal.

Tuition Discounting at Private Institutions

While the majority of private institutional aid dollars are still distributed based on need, the trend toward discounting tuition based on non-need criteria as a competitive measure has accelerated over the last decade. Aside from a small number of the wealthiest and most selective private colleges and universities, most institutions are finding that they must base their discounts on willingness-to-pay, rather than on ability-to-pay, in order to maintain the size and quality of their student bodies. Schools are spending more and more dollars in an effort to affect the enrollment choices of desirable – and frequently affluent – students. It is difficult to imagine how this competitive struggle can be derailed without action by the federal government. Unless institutions are allowed to discuss and agree upon ways to redirect their funds towards assuring access and meaningful choice to low-income students, these students are likely to be increasingly shut out of the private sector. The destructive competition has mushroomed since the Justice Department's interference a decade ago into the pricing and aid policies of private colleges. Currently, only those institutions that are wealthy enough to follow totally need-blind admissions policies are exempt from anti-trust restrictions on coordinating their need-based aid policies. Congressional broadening of this exemption to allow all colleges and universities to pursue policies designed to increase access for needy students would be a significant step allowing institutions to further the national goal of access to higher education for all qualified individuals.

Strengthening Loan Programs

Given the dim prospects for dramatic increases in federal funding for student grants, it is important that we not ignore the model provided by federally guaranteed student loans. Whatever ambivalence it may generate, a federal program that induces the private sector to provide access to so many dollars for so many students without a proportionate impact on the public budget has much to recommend it. Developing

specific strategies for improving the conditions under which the funds are available to students with high levels of need and assuring the appropriate division of subsidy between students and lenders are important tasks. But rejecting either loans for students or reliance on the private sector as routes to increasing access is counterproductive. Strengthening the federal government's role in guiding a partnership to provide educational opportunity must include rethinking the distinction between liquidity constraints and insufficient resources over the long term, improving the balance between basing need on circumstances immediately preceding college and measuring long-term ability to pay, and determining manageable debt levels for students in different circumstances. Most students will not be able to afford college without borrowing and the federal government should assure both that the funds are available on favorable terms and that students understand the logic of paying over time for the considerable benefits higher education will bestow upon them. Providing insurance for the eventuality that repayment will be infeasible is a much more constructive direction for federal policy than unreasonably restricting the amount students can borrow.

6. Conclusion

The problem of unequal educational opportunities will not be solved by expecting individuals, private organizations, educational institutions or state governments to set aside their own interests in order to further social goals. Important as it is to increase understanding among all parties of the vital equity and efficiency concerns related to reducing financial barriers to college, the solution also involves understanding market forces and the role of incentives and designing federal policies to harness those forces. It is the responsibility of the federal government to set the agenda, and to vigorously pursue that agenda through its own policies and through the visible promotion of the values underlying those policies, as well as by providing incentives that will increase the level of participation of other entities in assuring access to postsecondary education for all qualified students.

Promoting the national agenda for equity and efficiency

The priority of access to higher education on the national agenda must be clearly articulated and reinforced. Increased attention to both the importance of this goal and the policies in place to support the goal should accompany increased funding.

1. The federal government should reverse the trend of increasing the ratio of non-need based to need-based student aid and should substantially increase its commitment to the Pell Grant program.
2. The aid application and distribution systems should be simplified and clarified so that they serve their target population more effectively. Increased mentoring efforts and the provision of more complete information must be accompanied by a guarantee for low-income students that the aid needed to allow them to successfully pursue postsecondary education will be available.
3. Reliable research is needed to ascertain the extent to which it is possible for policies directing funds to students other than those with the most restricted opportunities to strengthen subsidies to low-income and under-represented

students. Some such policies may increase support for devoting increased resources to access, while others are simple diversions of limited funds.

4. Research must also measure the effectiveness of federal matching funds in generating incremental state and institutional funding and determining optimal design for these policies.

Focus on incentives

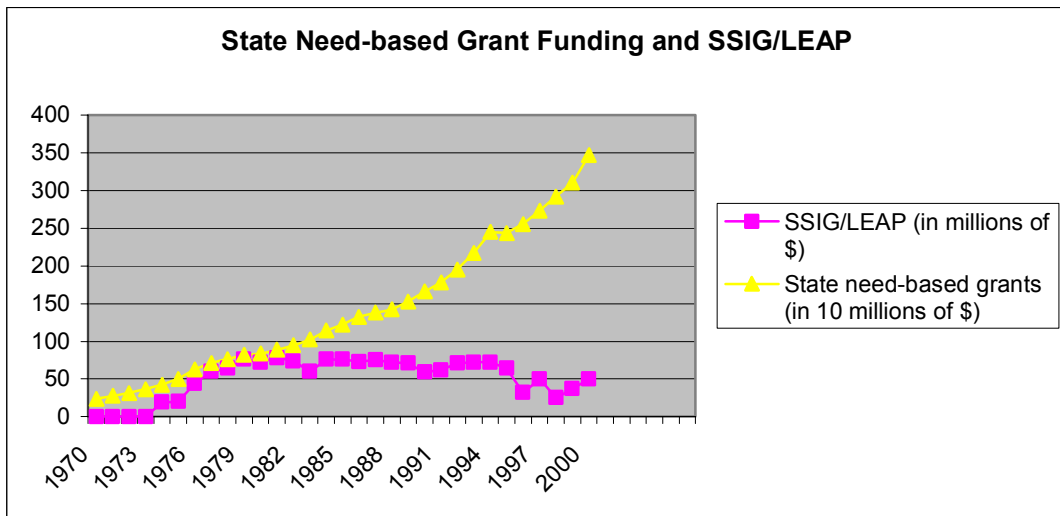
Increased funding for Pell Grants should be accompanied by greater emphasis on programs providing more positive incentives to students, institutions, states and other partners in higher education financing.

1. Augment matching funds to institutions and states. Expand on this approach by rewarding institutions that enroll Pell-eligible students.¹⁴
2. Minimize disincentives for work and savings in the need analysis system.
3. Lift restrictions on the ability of institutions and states to target their funds effectively, by broadening anti-trust exemptions and eliminating counter-productive regulations such as over-award policies.
4. Design incentives for state policies to provide consistent funding, allowing increased access throughout the business cycle.
5. Assure adequate access to liquidity and favorable loan terms by optimizing the incentive structure for lenders.
6. Design incentives for the private sector to subsidize students with high levels of need. Foundations and other non-profit organizations, banks, and businesses requiring skilled labor will all respond to federal incentives to direct their efforts towards furthering national goals of equity and efficiency.

Lowering the price to states, institutions, and private industry of subsidizing students facing the most restricted opportunities, reducing the disincentives for constructive action inherent in the current system, and simplifying and clarifying the process through which funds are available to students are important steps in the process of increasing access to higher education. The need for increased funding for need-based grants at all levels should not be under-emphasized, but the federal government must also find efficient ways to target existing funds and generate new funds for educational opportunity from non-governmental sources.

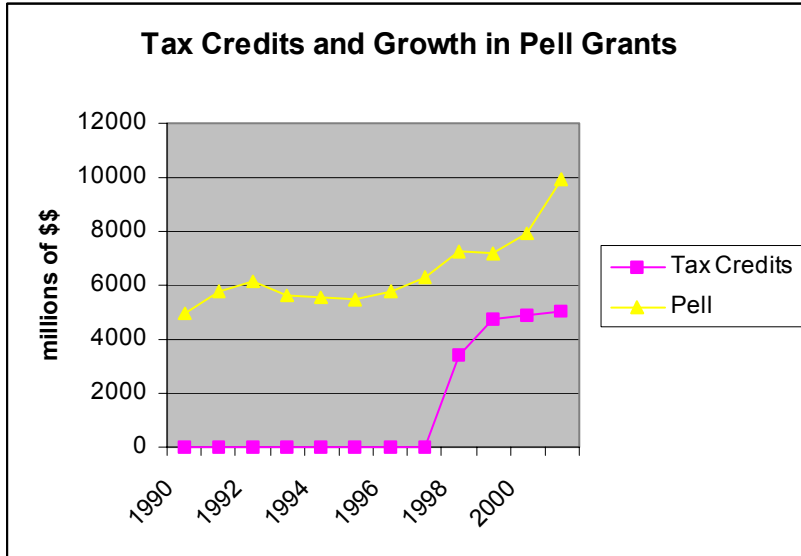
A concerted national effort is required to reinstate the fundamental values underlying the agenda for increased educational opportunity. As a prerequisite to closing the current insurmountable gap between financial aid and college costs facing many low-income students, the federal government must establish and solidify its role as the leader, both in terms of dollars and in terms of setting the priorities, of a strong partnership that assures access to postsecondary education for all qualified students.

Figure 1:



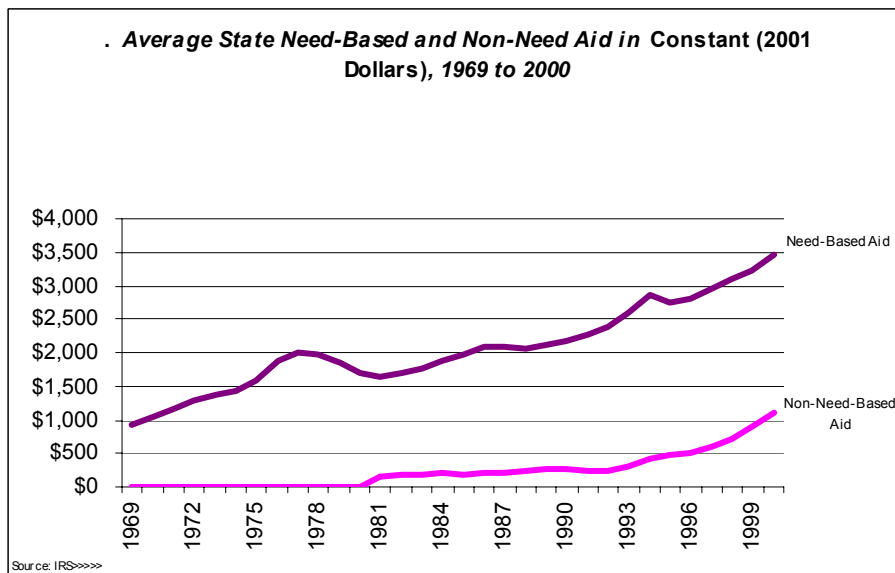
Source: National Association of State Student Grant and Aid Programs, *Annual Surveys, 1994-2000*; The College Board, *Trends in Student Aid, 1963-83, 1993, 2002*; National Center for Education Statistics, *Federal Support for Education, 1980 to 2001*.

Figure 2



Source: Internal Revenue Service, *Statistics of Income, 1999*; College Board, *Trends in Student Aid, 2002*

Figure 3



Source: National Association of State Student Grant and Aid Programs, *Annual Surveys, 1994-2000*

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Endnotes

¹ *The New York Times*, March 7, 2001. The signers of the ad, supported by the Ford Foundation and the Nellie Mae Foundation, were Sandy Baum, David W. Breneman, Patrick M. Callan, William R. Chance, Joni E. Finney, Lawrence W. Gladieux, Donald E. Heller, D. Bruce Johnstone, Dennis P. Jones, Thomas J. Kane, Glenn C. Loury, Mario C. Martinez, Michael S. McPherson, Jamie P. Merisotis, Thomas G. Mortenson, Michael Nettles, Michael A. Olivas, Gary Orfield, Morton Owen Schapiro, and Robert Zemsky.

² See Heller (1997) for a review of the relevant literature.

³ A recent study suggests that marginal students who attend college in-state are between 8 percent and 10 percent more likely to reside in the state 16 years after graduation than are those who leave the state for college (Groen and White, 2001).

⁴ See Finn (1978, pp.7+) for a detailed discussion of the history of this federal support for higher education.

⁵ Capital funds for the Ford Federal Direct Student Loan program are off-budget, as are the tax expenditures resulting from the Hope and Lifetime Learning Credits. However, these policies involve federal funds and the differences are accounting differences. They are not included in this part of the discussion, which focuses on the federal government's success in generating funds from other sources.

⁶ For a detailed discussion of non-federal funds for postsecondary students generated by federal policies, see National Center for Education Statistics, 2002b.

⁷ A perfect federal system might determine levels of need accurately enough to make state or institutional conflicts with this determination undesirable. However, under the current system – or the proposed simplification of the current system – discouraging more accurate determination of need is problematic.

⁸ In 1996 –97 state appropriations to public colleges and universities were approximately \$42 billion, while state grants to students totaled about \$3b (NCES, 2002a, Table 339 and NASSGAP, 1997).

⁹ Mortenson (2002) contains a detailed analysis of the relationship between tuition levels at public institutions and state need-based grant funding over time.

¹⁰ McPherson and Schapiro (1998) present empirical evidence. Baum (1998) and Hauptman (1998) present opposing perspectives on the relationship between tuition and federal loans.

¹¹ An on-going experiment in the Boston area designed by Tom Kane provides some evidence for the role of mentoring and potential for progress even without significant additional funding (Burd, 2002).

¹² The punitive treatment of income and the work disincentive created by the need analysis system are most serious in relation to student income. Since it is parental income that is most important to the targeting of subsidies on truly low-income students, lowering the tax rates on student income should not significantly affect the target-efficiency of the system.

¹³ McPherson and Schapiro (1991) have proposed that federal grants cover the cost of education at two-year public institutions.

¹⁴ Bob Shireman, Program Director for Higher Education at the James Irvine Foundation, proposed providing incentives to colleges and universities for enrolling Pell Grant recipients in recent testimony before the Blue Ribbon Panel of the College Board's National Dialogue on Student Financial Aid, August 2002.