

BEYOND TAX RELIEF:
LONG-TERM
CHALLENGES IN
FINANCING HIGHER
EDUCATION

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Abstract - *The Administration has proposed an increase in Pell Grant spending and a new tax credit and deduction for college expenses, ambitious initiatives that are estimated to cost approximately \$48 billion over the next five years. The primary weaknesses of the tax proposals are that they are not very well targeted and could be abused for leisure-oriented coursework. On the other hand, the potential for "tuition inflation" has probably been overstated by the plan's critics: the primary effect of the plan is to raise families' income and will do little to reduce the cost to families of future tuition increases. It is, perhaps, more problematic that the plan does little to resolve the deeper structural problems in how we pay for college—with a complex morass of financial aid programs and a financial aid formula that taxes income and savings at high rates. That financial aid system will be put under increasing strain in the coming years, as larger cohorts reach college age and seek to maintain the currently*

high rates of college going. The paper concludes by recommending greater reliance on income-contingent loan forgiveness as an alternative way to help families pay for college.

INTRODUCTION

In his 1997 State of the Union address, President Clinton declared educational reform the top priority of his second term. Indeed, the Administration's agenda for higher education is unabashedly ambitious, to "...make the 13th and 14th years of education—at least two years of college—just as universal in America by the 21st century as a high school education is today."¹ To fulfill that promise, the Administration has proposed two major initiatives for higher education: an increase in federal grants to low-income undergraduates and various forms of tax relief for those with family members in college. Beyond evaluating the narrow strengths and weaknesses of the Administration's proposal, the goal of this paper is to assess how well the proposal meets the

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long-term challenges in financing higher education.

Declining labor market prospects for those without college training have led more families to seek out a college education for their children. Yet such investments are costly to parents, students, and other taxpayers, amounting to roughly \$12,000 per year at a public four-year university and \$6,000 per year at a community college—not counting the earnings foregone by students in college. The challenge over the next decade will be to find a way to pay for college that does not discourage family earnings or savings, that encourages students to make the most of the value of the resources at their disposal, and that allows students from all family backgrounds to make worthwhile investments in college. The Administration's proposal will offer some short-term relief to families concerned about rising tuition bills. However, if the plan is enacted, we will be left with an even more complicated morass of financial aid programs, which will continue to leave families baffled about the amount of aid available and which will potentially distort family savings and investment decisions. The final section of the paper provides some ideas for how to tackle these longer term issues with more far-reaching structural reform.

A SIMMERING CRISIS IN HIGHER EDUCATION

As reported by newspapers around the country, college tuition has risen sharply over the past decade and a half. Between 1980 and 1995, the average tuition (including required fees) at public and private four-year colleges grew by 91 and 83 percent, respectively, even after taking account of overall changes in consumer prices.² Increases of such

magnitude usually provoke a response. Therefore, it was only a matter of time before the U.S. House of Representatives held hearings on "cost escalation" in higher education, which it did in the summer of 1996. In a confrontation repeated in state legislatures around the country, uncomfortable college presidents were forced to extol the intangible social benefits of higher education, while student representatives complained about rising debt burdens. What lies behind the recent tuition increases?

There have been four basic economic and demographic forces pushing us into the current crisis. First, the labor market value of a college education has increased dramatically. In 1979, the average male college graduate earned 49 percent more annually than the average high school graduate. By 1993, that differential had nearly doubled, to 89 percent. Not surprisingly, families and students have been responding: the proportion of college-age youths enrolled in college grew by one-third between 1980 and 1995, from 26 to 34 percent.³ Over the same time period, the number of associate, bachelor's, and doctoral degrees awarded grew by 28, 25, and 29 percent, respectively.

Second, in the face of rising public college enrollments, state governments have been unable to continue paying the same proportion of the cost for each student enrolling in higher education. At public colleges and universities, tuition increases have far outstripped underlying increases in costs per student. Between 1980 and 1995, real public tuition levels rose by 91 and 72 percent, respectively, at public four-year and two-year institutions—even though the educational costs per student (including faculty salaries, library costs, student support services, etc.) rose by just 20

percent.⁴ In other words, the price that students pay has been rising much more quickly than the actual costs per student at public colleges and universities. States, which have traditionally paid a large share of the costs with direct subsidies to institutions, have been compelled by other demands on their budgets to cut their subsidies per student and to raise the share of costs paid by students and their families. It is this decline in the share of costs covered by state subsidies, as opposed to a sharp increase in costs themselves, that accounts for a majority of the increase in tuition at public institutions.

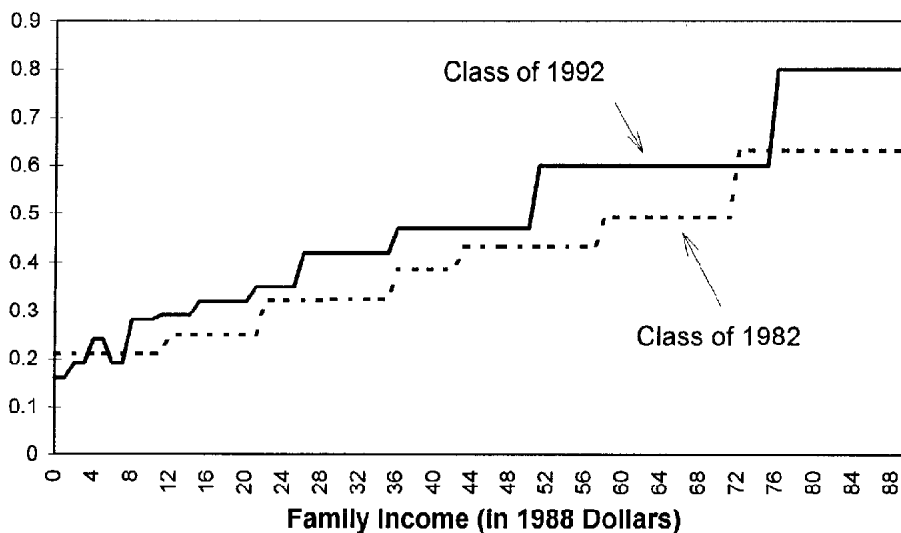
The story has been different at private colleges. First, while “sticker prices” increased by 83 percent between 1980 and 1995, the price paid by the average student rose by only half that rate, after taking into account offsetting increases in institutional grant aid. With the decline in federal need-based grant aid discussed below, private universities have increasingly used the tuition paid by some students to keep costs down for other students. On the other hand, cost increases, rather than declines in public subsidies, were larger at private four-year universities than at public universities. Costs per student rose by approximately the same amount as net tuition paid per student—over 40 percent. Despite a careful analysis by Clotfelter (1996), the sources of this increase in costs at private institutions is not very well understood. Rising costs are a problem at private institutions. But, to keep the issue of cost escalation in higher education in perspective, such institutions enroll only 25 percent of all four-year college students.

Third, the federal government, with budgetary concerns of its own, has not

filled the ever-increasing financial need created by rising public tuition. The Pell Grant program is the primary federal grant program for low-income undergraduates. Eligibility for a Pell Grant award is calculated by subtracting a complex function of a family's income and assets (the “expected family contribution”) from the maximum Pell Grant. The real value of the maximum Pell Grant award—a useful gauge of the aid available for the lowest income students—fell by 35 percent between 1979–80 and 1995–6. Yet, total Pell Grant spending actually increased by nearly ten percent over the same period. The explanation: changes in the benefit reduction formula, increased enrollments in college, and rising tuition levels have all raised the cost of guaranteeing a given level of aid.

Fourth, low-income students, who are particularly price sensitive, seem to have fallen behind as enrollment rates have increased overall. Figure 1 compares the proportion of students entering a four-year college within two years of high school graduation by family income level, for the high school classes of 1982 and 1992.⁵ Clearly, the proportion of high school students entering college has increased. But the increases have been particularly large among those from families with incomes above \$50,000. Entry rates were stagnant for those with incomes below \$12,000. Given the increasing importance of a college education, this widening gap in college enrollment rates between youths in high- and low-income families has disturbing implications for future intergenerational mobility. Moreover, there is some evidence that the gap between high- and low-income youths increased more in states with the most rapid public tuition increases.⁶

Over the same time period, the earnings of high school graduates fell. This had

FIGURE 1. Proportion Entering a Four-Year College by Family Income

two effects. First, because foregone earnings were a large share of the costs borne by families, the opportunity costs of attending college fell, offsetting somewhat the rise in tuition expenses. Second, to the extent that families faced borrowing constraints (because borrowing under the student loan programs was limited, those programs were only a partial solution), college students relied upon low-skilled jobs in order to finance college investments. If low-income students were more likely to be constrained in their borrowing, this may explain the slower rise in enrollment rates by low-income youths over this period. (For more on college borrowing constraints, see Kane (1996).)

Finally, the pressure to spend more on higher education is likely to get worse. The size of the college-age population—which has declined by 15 percent since 1980, partially relieving the cost pressures from rising college enrollment rates—is projected to rise by one-fifth

over the next 15 years.⁷ The renewed expansion of the college-age population is expected to be even more rapid in California, where the population of 15 to 24 year olds is projected to rise by twice the national rate.⁸

Simply put: Although labor market trends seem to justify sending more youths to college, a college education is a very expensive undertaking—costing approximately \$12,000 a year at the average public four-year institution, not counting room and board costs and the value of the student's time out of the labor market. As existing federal and state subsidies for higher education are being stretched thin, families are paying a larger share of the costs. If college enrollment rates remain high—and it seems prudent to expect so, given conditions in the labor market—we will be forced to make some tough decisions in the coming years about how our subsidies to higher education are targeted.

THE CURRENT APPROACH TO FINANCING HIGHER EDUCATION

State, local, and federal governments primarily employ two types of subsidies to help families pay for higher education. First, and by far the largest, are the direct appropriations from state and local governments to public postsecondary institutions. In 1993–4, the state and local governments appropriated \$45 billion in subsidies to public institutions of higher education, the vast majority of which were used to keep tuition charges low for in-state students, rather than providing “means-tested” grants.⁹

Sparking a lively debate more than two decades ago, Hansen and Weisbrod (1969) argued that such broad-based subsidies to public institutions were “regressive,” because middle- and higher income families were most likely to attend the elite four-year institutions which received a large share of such subsidies.¹⁰ (See the relationship between college going and income in Figure 1.) Critics, most notably Pechman (1970), responded that the net progressivity (or regressivity) of subsidies depended not only on the income distribution of public college students, but also on the marginal source of revenue used to pay for public higher education. Pechman argued that, if state income taxes were the marginal source of revenue, then, on net, public subsidies to higher education may still be equitably distributed, because, as taxpayers, higher income families pay a disproportionate share of public subsidies for higher education. An obvious difficulty is that it may be difficult to identify the marginal source of revenue for higher education.

The second largest form of public subsidy to higher education is means-

tested grant and loan programs to help families pay for college. The largest of these is the federal Pell Grant program, currently distributing approximately \$6 billion per year in grants to low-income youths and adults. Most states also have their own grant programs to supplement the Pell Grants, although total spending on state need-based grant programs is roughly one-half that of the Pell Grant spending. In addition, the federal government spends several billion dollars per year to pay the interest on loans for students in school and to pay off defaulted loans. (For a summary of financial aid spending see The College Board (1996).)

With the exception of the defaulted loans, most of this aid is distributed according to a “backward-looking” assessment of a student’s ability to pay. For dependent undergraduates (defined as those who are not married, who are under age 24, who have no military experience, and who have no dependents), eligibility for aid is based not only upon their own income and assets, but also upon parental family income and financial assets. Such backward-looking means testing implicitly taxes income and savings, by providing less aid to those with higher incomes and assets. Because only a single year of income (the prior tax year) is considered and because the implicit marginal levy on savings (a maximum of 5.6 percent) is repeated each year that one has a child in school, these marginal tax rates can become quite large.¹¹ Edlin (1993) and Feldstein (1995) estimate that the marginal tax on savings can reach nearly 50 percent for those with children in college over a span of eight years.¹²

Though substantial, the implicit tax rates may not be as high as these estimates imply. First, as Case and McPherson (1986) point out, the marginal tax rate

for financial aid is zero for those whose incomes are already too high to qualify for financial aid. Three-quarters of four-year college students attend public four-year universities with an average tuition of approximately \$3,000. Relatively few of those with incomes in the top income bracket or with financial assets larger than the asset protection allowances would qualify for any aid at these low-cost institutions. Second, the tax rates calculated by Edlin and by Feldstein assumed that any difference between the cost of attendance and the expected family contribution was being met. Yet, as Dick and Edlin (1997) report, the average college does not meet students' full financial needs. Rather than a 50 percent tax on savings, Dick and Edlin estimated a marginal asset levy of 8 to 26 percent and marginal income taxes of 2 to 16 percent for those attending the average-priced college. As tuition levels rise, an increasing number of families find themselves with incomes and assets low enough to face such implicit tax rates.

SOME OF THE DISTORTIONS CREATED BY THE FINANCIAL AID FORMULA

Beyond simply studying tax rates, the most enlightening way to find the loopholes in the financial aid formula is to read one of the many financial planning guides for parents planning to send their children to college. Some of the more glaring distortions in our financial aid system, described below, are highlighted in those manuals.

First, as one financial aid manual advises, "Having two kids in school at the same time is like a two-for-one sale." Under the federal financial aid formula, a family with two members in college is expected to contribute only half as much per member as a family of equal resources with one person

currently attending. This is not simply a family size adjustment. Larger families are given larger income protection allowances to account for differences in "financial need." Rather, the effect of such a rule is to distribute aid on the basis of the timing of college attendance. Families with children closer in age or in which a secondary worker has returned to school part-time are eligible for considerably more aid than other families of equal size.

Second, a parent's and an applicant's income in the most recently completed calendar year is the only income that matters in determining eligibility for financial aid. Therefore, families have a strong incentive to shift income into the years before and after college. Job bonuses and capital gains are likely candidates for shifting. In addition, because aid is based upon "adjusted gross income," above-the-line deductions to income (such as the proposed tax deduction discussed below or business-related expenses for self-employed workers) produce higher eligibility. The tax rates on students' income are even higher than the tax rates on parents. Although the first \$1,750 in income per year is protected from consideration in the formula, for every dollar above that limit, a student's financial aid is reduced by \$0.50. If the student puts any savings from this income in his or her bank account, that income faces an additional \$0.35 levy due to the tax on student assets.

Third, in 1993, housing equity was excluded from the federal formula for calculating financial aid, thereby boosting the number of families qualifying for Pell Grants and subsidized Stafford Loans. Families with college-age children now have a strong incentive to move their equity into housing. For instance, a family with substantial

financial assets could simply prepay their mortgage and, when their children emerged from college, refinance their home. The change in law lowered the tax rate on savings, but by doing so without any offsetting measures of a family's ability to pay, the change reduced the progressivity of the federal formula. Many private colleges have chosen to continue using home equity in the provision of institutional financial aid. But this has created another distortion: home equity loans are preferable to other forms of debt, such as car loans and credit card balances, for financing consumption.

Finally, the financial aid formulas were not originally designed with "non-traditional" students in mind. The same rules designed to evaluate "need" for the traditional college student—with some summer income and substantial parental resources—do not work very well in determining ability to pay for independent students. First, a student taking less than six credits of coursework does not qualify for any federal financial aid, grant, or loan. This is one reason why state and local governments have been under pressure to keep tuition low at community college and four-year comprehensive universities, because the institutional subsidy is the only aid that adult students attending less than half-time can receive. Second, income in the previously completed calendar year is not likely to be a good indicator of individual students' ability to pay, particularly those who are entering their second year of study. The tax rates on students' income are much higher than on parents. Those who plan to make a switch in careers will not be eligible for much aid during their first year in college, because 50 percent of an individual's income and 35 percent of the student's assets are considered

available for college. But, after having been enrolled in school, they can expect to receive considerable aid during their second year in college.

THE ADMINISTRATION'S PROPOSAL

The President has proposed two major changes to the way we finance higher education: an increase in Pell Grant spending of roughly \$9 billion over the next five years and a new tax credit and tax deduction for college expenses, estimated to cost approximately \$36 billion over the same period.¹³

The proposed increase in Pell spending is the result of two roughly equally costly changes in the student aid programs. First, the maximum Pell Grant would be raised to \$3,000 from \$2,700 for the 1997–8 school year. A \$3,000 maximum grant would still be below the 1979–80 level of \$3,500 (after inflating by the Consumer Price Index), but it represents a very substantial rise from the level of \$2,400 in the first year of the Clinton Administration. Second, the "income protection allowance" for single, independent students would be raised from \$3,000 to \$9,150—allowing older, independent students to earn more before having their income taxed away by the student financial aid formulas.

The proposed tax credit would be a 100 percent credit on the first \$1,500 in tuition expenses per person for a first year. Family members would qualify for a second year by maintaining a "B average" (defined as having a GPA of 2.75 or greater on a four-point scale). The value of any Pell Grants received would be subtracted from the value of a credit. Eligibility would be phased out for families with adjustable gross income (AGI) between \$80,000 and \$100,000 for single and between

\$50,000 and \$70,000 for head-of-household returns. The credit would be nonrefundable and family members would have to be enrolled at least "half-time" in a degree program at an institution qualifying for the student financial aid programs administered by the Department of Education.

The proposed deduction would allow families to deduct up to \$10,000 in tuition expenses, for those enrolled at least half-time in a degree program. As proposed, the deduction would be an "above-the-line" deduction, available to those not itemizing. The deduction would be subject to the same income phaseouts as the credit. Unlike the credit, there would be no limit on the number of years a family could file for the education deduction, and there would be no grade requirements.

Eligible families would have the choice between taking the \$1,500 credit or the \$10,000 deduction. For a family member in college for the first or second year, those in the 15 percent tax bracket will generally prefer the credit if they qualify. However, regardless of their grades, those in the 28 percent tax bracket paying more than \$5,357 for tuition should choose the deduction, because the deduction will be worth more (i.e., $0.28 * \$5,357 = \$1,500$).

Table 1 portrays the combined value of the Pell Grant increase and the tax changes for four groups of students: "dependent" and "single, independent" students attending the public and private four-year institutions, with average tuition and required fees of \$2,860 and \$12,432, respectively.¹⁴ As reported in Table 1, single independent

TABLE 1
IMPACT OF THE ADMINISTRATION'S PROPOSAL BY FAMILY INCOME AND TYPE OF COLLEGE ATTENDED

Unadjusted Family Income	Additional Pell Grant	Tax Credit	Tax Deduction	Total Benefit	
				First 2 Years of College	Later Years of College
<i>Dependent Student at a Four-Year Public University</i>					
\$0-20,000	300	0	0	300	300
\$30-50,000	0	1,500	429	1,500	429
\$60-80,000	0	1,500	801	1,500	801
\$117,000+	0	0	0	0	0
<i>Single Independent Student at a Four-Year Public University</i>					
\$10,000	3,000	0	0	3,000	3,000
\$15,000	1,450	50	0	1,500	1,450
\$20-30,000	0	1,500	429	1,500	429
\$40-50,000	0	1,500	801	1,500	801
\$77,000+	0	0	0	0	0
<i>Dependent Student at a Four-Year Private University</i>					
\$0-20,000	300	0	0	300	300
\$30-50,000	0	1,500	1,500	1,500	1,500
\$60-80,000	0	1,500	2,800	2,800	2,800
\$117,000+	0	0	0	0	0
<i>Single Independent Student at a Four-Year Private University</i>					
\$10,000	3,000	0	0	3,000	3,000
\$15,000	1,450	50	0	1,500	1,450
\$20-30,000	0	1,500	1,500	1,500	429
\$40-50,000	0	1,500	2,800	1,500	801
\$77,000+	0	0	0	0	0

students would enjoy a large increase in Pell Grant eligibility. Under current law, these students lose \$0.50 in Pell Grants for every dollar of earnings above \$3,000. In other words, with the current maximum of \$2,700, an independent student with just over \$8,000 in income does not qualify for any Pell Grant. The proposal would allow these students to protect more of their income, but would keep the marginal tax rate the same. The second largest beneficiaries would be dependent students in the 28 percent tax bracket attending expensive private universities. Table 1 should be interpreted in combination with Figure 1. Because members of higher income families are more likely to go to college in the first place (and more likely to attend expensive private schools when they do), they are more likely to benefit from the proposal.

ADMINISTRATIVE CONSIDERATIONS

As with any new tax expenditure, the proposed credit and deduction create several novel problems for the Internal Revenue Service (IRS). Probably most important, the IRS would face a difficult task preventing families from using the tax credit for the purchase of leisure-related coursework. To cite an extreme example, a local university could charge middle and higher income adults up to \$1,500 for a series of whale-watching tours, offer these new “students” credit toward a marine biology degree, and the federal government could end up subsidizing the whole affair. Without monitoring course content directly, the IRS will be hard pressed to prevent such abuse by relying on “degree-seeking” status and half-time enrollment alone. This is an inevitable result of providing a 100 percent tax credit. With \$1,500 of pure subsidy at stake, families and institutions are likely to use some

ingenuity in finding ways to qualify for the credit.

Second, tax years generally do not overlap with academic years. As a result, because most academic programs start in the fall, students applying for the first year of their tax credit will have paid only one semester of tuition. The B-average requirement would typically apply to their first semester in college. The second year of eligibility for the tax credit will most often apply to the spring of their first academic year and the fall of their second academic year.

Third, the B-average requirement for those seeking a second year of tax credits will be very difficult to police. Including various branch campuses, there are more than 3,700 two-year and four-year colleges in the United States. Many have unique grade accounting schemes that do not meet the standard four-point grading scale. As a result, verifying student grades is likely to be a challenge.

Of the three administrative concerns described above, the B-average requirement may be no more troublesome than policing the half-time, degree-seeking requirement, but it is probably also an unnecessary administrative complication. Presumably, the purpose of the requirement is to improve students’ incentives to study in college. However, it may have precisely the opposite effect if students choose to take less challenging coursework or if colleges adjust their grading scales. Moreover, the grade requirement probably fails an equity test as well, because it disproportionately benefits higher income students. While the half-time, degree-seeking enrollment requirement is imperfect and may prove difficult to enforce, it is a fundamental safeguard against abuse. The

B-average requirement will also be costly to enforce and is probably an unnecessary complication.

THE PROSPECTS FOR TUITION INFLATION

Despite the fears of some of the plan's critics (and, perhaps, the hopes of some of the plan's supporters in the higher education community), I do not believe that the proposal will lead to rampant tuition inflation. The reason: although the plan may provide welcome tax relief to families, it has little effect on the marginal cost to most families when an institution raises tuition. Except for those paying less than \$1,500 in tuition expenses, the most tax relief a family will receive when their college raises tuition will be between \$0.15 and \$0.28 on the dollar—and that would cover only those tuition increases up to \$10,000. Moreover, the only people receiving this tax relief will be first- and second-year students from families in the 28 percent tax bracket paying between \$5,357 and \$10,000 and students later in their careers paying between \$1,500 and \$10,000. Most others—first- and second-year students paying less than \$5,357, first and second-year students in the 15 percent tax bracket (who will be using the credit rather than the deduction), students with incomes too high to qualify for tax relief, and those paying more than \$10,000 in tuition—will all be paying 100 percent of any tuition increase. Facing prospects of declining enrollments or the political resistance of angry parents, colleges may properly hesitate to raise tuition.

The greatest risk of tuition inflation will be among the schools currently charging less than \$1,500. However, even at these schools (predominantly public, two-year institutions), the tuition inflation may be muted. First, because

the credit is not refundable, low-income students with negligible income tax liability would not be protected from the cost of a tuition hike. Second, though many of the students at public two-year institutions are receiving federal Pell Grants, such grants do not rise with tuition paid.

The primary impact of the proposal will be an income effect, rather than a price effect—as if the federal government were sending families a tax refund unrelated to how much more they spend on college. Families will spend some of this tax savings on higher education, but are likely to spend most of it on other consumption—such as a summer vacation or new furniture. Colleges may capture a portion of the benefit, if families choose to consume more education with their tax windfall, particularly those colleges with considerable market power. Ironically, the more successful the program is in its stated objective of stimulating enrollment, the larger too will be the effect on tuition inflation. But, because these enrollment impacts are likely to be small, relatively little of the tax relief is likely to make it into faculty salaries, dormitories, and libraries.

Depending upon how institutional financial aid is treated, however, the proposal could have a larger effect on how colleges distribute financial aid. Under the current proposal, for those without a Pell Grant award, the amount of the credit for an eligible student will be the lesser of \$1,500 and actual tuition and fees minus all nonfederal grants. For those with Pell Grants, the credit will equal the above minus the value of any Pell Grant received. In other words, any Pell Grant award is to be subtracted dollar for dollar from the credit. Nonfederal grant aid (including state grants and institutional aid) will be

subtracted dollar for dollar for those students paying tuition expenses less than \$1,500. If institutional grant aid is subtracted from the credit and the deduction, colleges will have a strong incentive to cut their own institutional aid, because such aid would be taxed at 100 percent for those students with out-of-pocket expenses less than \$1,500.

Whereas many colleges may be hesitant to raise student charges on the margin, they will have a strong incentive to re-label other student charges as "tuition" in order to allow families to claim the credit or deduction. Under current law, there is no incentive for colleges to shift room and board expenses into tuition charges, because they are treated equivalently in the student aid formulas. However, those colleges with current tuition charges below \$10,000 (primarily public institutions) will have a strong incentive to begin to charge on-campus students "tuition" for access to dormitory study halls, etc. Given that a fifth of the six million students at public four-year colleges live on campus and pay room and board charges averaging roughly \$4,000, there is a possible additional tax expenditure of \$1.3 billion if these institutions shift room and board charges into student tuition (assuming that families are at the 28 percent tax bracket). Although the Treasury department is likely to succeed in developing regulations preventing some of this shifting, the relabeling of room and board charges could boost the cost of the proposal by up to 18 percent.

EQUITY

Many have criticized the plan for providing large subsidies to middle- and higher income families attending expensive private institutions and

smaller amounts to the lowest income families receiving Pell Grants. However, a full consideration of the distributional implications of the current proposal is complicated by the President's and Congress' commitment to proposing a budget that will be "balanced" in 2002. Given this consensus, it may be wrong to assume that frugality on the tuition tax credit and tax deduction proposals will mean a greater contribution toward reducing the national debt or greater prospects for increased student aid in the future. In fact, if the President and Congress are serious about the 2002 target, then a smaller education tax credit or tax deduction is likely to mean either a larger capital gains tax increase or smaller Medicare cuts. Although they may rightly criticize the plan on grounds of economic inefficiency, many of those criticizing the plan on grounds of equity may find these alternatives even less appealing.¹⁵

A MORE FAR-SIGHTED APPROACH TO REFORM

The Administration's proposal would provide tax relief for families struggling to pay tuition bills. It would also provide some additional assistance for low-income youths attempting to pay for college and, particularly, for older, low-income, single students going back to school. Just like the large across-the-board subsidies provided by state governments to students attending public colleges, the Administration proposes using public revenues to keep families' out-of-pocket expenses down while students are enrolled in school.

However, given the economic and demographic forces pushing college enrollment rates up, the real challenge over the next decade will be to design a financial aid system which does not discourage family earnings or savings,

which encourages students to make the most of the value of the resources at their disposal, and which allows students from all family backgrounds to make worthwhile investments in college. While providing short-term relief, the Administration's proposal does nothing to solve some of the structural weaknesses in our current system for financing college. Indeed, it complicates matters. The reauthorization of the Higher Education Act this year provides an opportunity to fundamentally rethink how those subsidies are to be provided in order to maintain access for all groups. In contributing to that discussion, I would add the following observations.

First, simplicity and transparency should be fundamental policy objectives. Information on federal financial aid is primarily delivered by college financial aid offices, offering financial aid "packages" to the students who apply for aid. There are a number of state and federal programs available to help families pay for college, but these families are unlikely to know just how much aid is available until they apply, are accepted, and receive a financial aid offer from the college. One strength of such a system is that the mixture of grants, loans, and work study can be narrowly tailored to meet the particular needs of each student. However, an often-overlooked weakness is that parents and students are often uncertain about the extent of aid available up until the time that they receive their package. Ironically, those whose decisions we would most hope to affect—those who would not be going to college in the absence of aid—are least likely to navigate the system easily.

The mystery surrounding the financial aid application process may explain a long-standing puzzle in research on

higher education. On one hand, most research that has compared college enrollment rates in high- and low-tuition states has found that those states that have high public tuition levels tend to have lower enrollment rates, all else equal. As hinted above, this is particularly true for low-income youths. On the other hand, there is very little evidence of any disproportionate increase in college enrollment among low-income youths between the early and late 1970s when many of our federal programs were expanded.¹⁶ (The Pell Grant program was established in 1973.) The answer to the puzzle may lie in the fact that low-income students on the fence about to enter college know about public tuition levels—which they hear about on the radio or read in newspaper headlines—but they may be less able to anticipate the availability of aid or to fulfill all the bureaucratic hurdles on the way.

The complications surrounding financial aid policy limit its effect and add to parents' anxiety. However, this confusion is largely unnecessary. For example, parents and students could be offered a clearly stated guarantee of an amount of aid (e.g., up to \$5,000) to finance each year of undergraduate study. Although the mixture of grants, loans, and work study one received could still depend upon one's own circumstances, there is no need to leave the total amount of available aid in question. Students would at least know how much they would have to finance out of their own pocket and could plan their career choices accordingly. Another approach would be to grant presumptive eligibility to those receiving other means-tested programs—Food Stamps, Aid to Families with Dependent Children, and the Earned Income Tax Credit—and inform these families of their likely benefits.

Second, income-contingent loan forgiveness provides an alternative form of means testing. Most of our current financial aid programs are provided on a backward-looking basis. For instance, eligibility for Pell Grants and subsidized federal loans is based upon a family's and youth's income and assets in the prior year. In contrast, income-contingent repayment makes a "forward-looking" evaluation of a person's means.

As a result of the 1992 reauthorization of the Higher Education Act, student borrowers were given the option of choosing an income-contingent repayment schedule. Under income-contingent repayment, students' monthly payments are a function of their own and their spouse's AGI in the previous year. Those with consistently low-incomes are to have their remaining balances forgiven at the end of 25 years in repayment. In order to avoid adverse selection, the cost of income contingency is paid by taxpayers rather than other borrowers. Those with high incomes do not subsidize lower income borrowers any more than other taxpayers; they simply pay their loans more quickly. Given the hassles of reporting one's AGI each year, most youths continue to choose one of the more conventional repayment plans. Though the repayment schedule in the current income-contingent program has been designed primarily to lengthen the duration of repayment rather than forgive many loans, the program could easily be adapted to be more generous.

As an alternative to the traditional form of means testing in student aid, forward-looking means testing has several advantages. First, it offers "insurance" to both high- and low-income families concerned about whether their children will be able to

shoulder their student debt. Parents and students may value the additional peace of mind even if they never actually have to sign up for the income-contingent repayment option. Second, forward-looking means testing does not involve the same difficulty in distinguishing dependent students—whose parents' resources are considered in the determination of need—from independent students. The distinction between dependent and independent students becomes moot if subsidies are dispersed on the basis of future incomes, rather than on a single year of income and assets. Third, the most onerous administrative burden imposed by our financial aid system—that parents and students spend long hours each year filing complicated financial aid forms—could be lightened if a larger share of available subsidies was provided on a forward-looking basis. Indeed, transferring other loan subsidies—in-school interest subsidies, preferential rates on Perkins Loans, etc.—into income-contingent loan forgiveness would relieve millions of parents of the need to file financial aid forms every year to establish their eligibility. Only those seeking institutional aid (primarily the quarter of students that attend private four-year institutions) or Pell Grant or Federal Work Study aid would have to file a financial aid application. Fourth, forward-looking means testing can greatly diminish the marginal tax rates on income and savings implicit in the financial aid formula, because subsidies would be based upon an entire career of income rather than a single year.

Finally, federal spending should complement and not just substitute for state spending. State governments continue to provide the lion's share of subsidies to higher education. The federal government should be looking for ways to help state governments stretch their re-

sources rather than simply substitute for them, with general tax relief. One idea would be to offer states the opportunity to “buy into” the federal loan programs, reimbursing the federal government for providing more favorable interest rates or income-contingent repayment schemes to their residents. Given the mobility of the Nation’s population across state lines, the federal government is in the best position to operate an income-contingent repayment scheme efficiently. In order to buffer the effect of public tuition increases, states may be interested in helping to provide more favorable loan terms to their residents.

Conclusions

It is no coincidence that, as the labor market increasingly values educational attainment, calls to improve the educational system have become ever louder. Reformers have offered a long list of suggestions for improving the quality of elementary and secondary education—ideas such as school choice, national standards, and greater accountability at the school level.

Many of these proposals—particularly those that improve accountability and flexibility for individual schools—have merit. However, it would be an understatement to say that additional investments in the K–12 sector are not a foolproof investment. Ever since the publication of *Equality of Educational Opportunity* in 1966 (commonly known as the Coleman Report), researchers have argued over whether marginal increases in school spending have been associated with improved student performance.

There is no need to enter the fray over whether “money matters” in elementary and secondary education. That

literature is well established and inquiry is ongoing. However, in the meantime, I would suggest that we should investigate the prospects for investing along a different margin: improving not only the quality of elementary and secondary schooling, but also investing in the quantity of schooling received by youths, by better targeting existing subsidies for higher education (and investing, at the other end of the educational pipeline, in early childhood education). Although structural reforms in elementary and secondary education may yet bear fruit, there may be higher returns to investing along different margins in education.

ENDNOTES

- ¹ President Clinton, *State of the Union Address*, February 1997.
- ² U.S. Department of Education (1996, Table 309, p. 320).
- ³ U.S. Department of Education (1996, Table 182, p. 189).
- ⁴ These figures include the costs of instruction, administration, student services, libraries, and the operation and maintenance of each college’s physical plants, but they exclude expenditures on scholarships. Figures were adjusted for increases in consumer prices (U.S. Department of Education (1996, Tables 339–340, pp. 352–3)).
- ⁵ The estimates in Figure 1 are based upon the author’s tabulation of the High School and Beyond Survey of those with high school diplomas from the class of 1982 and the National Education Longitudinal Study of those graduating from high school in 1992.
- ⁶ For more on this, see Kane (1995).
- ⁷ U.S. Bureau of the Census, *Statistical Abstract of the United States*, 1995, Table 17, p. 17.
- ⁸ Callan and Finney (1993) and Campbell (1994).
- ⁹ U.S. Department of Education (1996, p. 334).
- ¹⁰ Between 1970 and 1977, the *Journal of Human Resources* was inundated by at least seven separate responses to an article by Hansen and Weisbrod in that journal.
- ¹¹ For more on implicit tax rates in financial aid formulas, see Edlin (1993), Feldstein (1995), and Dick and Edlin (1997).
- ¹² The average tax rates on savings remain low, however, given asset protection allowances of \$36,000 for married parents at age 45, ranging up to \$66,000 for parents 65 and older.

- ¹³ Although the Administration has also proposed several other initiatives related to higher education (allowing parents to make penalty-free withdrawals from IRAs to pay for college tuition, extending the exclusion of employer-provided education benefits, a new ten percent tax credit for expenditures on employee training by small employers, and Presidential scholarships for students in the top five percent of their high school class), I do not discuss those proposals here.
- ¹⁴ Single, independent students were assumed to have no dependents and no savings above the asset protection allowances. The dependent students were assumed to come from a two-parent, two-child family with only one student in college and no assets above the asset protection allowances. Moreover, I assumed that none of these students was receiving institutional grant aid.
- ¹⁵ After the year 2002, the equity calculations become more complex, because the tax credit and tax deduction are likely to still be in existence.
- ¹⁶ For more on this issue, see Kane (1994, 1995), Hansen (1983), and McPherson and Schapiro (1991).

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