Federalism and Higher Education Finance:
Rethinking the Role of the States and the Federal Government in Paying for College

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All the public attention that has been devoted to the high tuitions paid by parents at (some) private colleges and the substantial role of federal financial aid in helping students pay tuition bills may obscure the dominant role of state governments in the public finance of higher education finance. Eighty percent of all postsecondary students attend state-run colleges and universities, and the state contribution to budgets of higher education institutions ($30 billion in 198586) is over 3.5 times as great as federal spending on student aid (which amounted to $8.1 billion in 198586).

At this writing, the ability of the states to sustain this weighty commitment to the financing of higher education is coming under serious pressure. The Chancellor of the Massachusetts public higher education system has resigned in protest over the Governor's proposed budget cuts (Boston Globe, February 12, 1991, p. 1). Thirty-eight states are facing budget deficits, while the burdens placed on state governments to pay for needed improvements in elementary and secondary education, growing public health needs, decaying infra-structure and growing dependent populations continue to rise.

These pressures are likely to bring state-level spending for higher education under the kind of close scrutiny that federal higher education spending has received in the last decade. It is important that assessment of higher education spending at these two levels of government not proceed on separate tracks. We need to take a hard look at the higher education financing system as a whole, to try to ensure that limited governmental resources at all levels are used as effectively as possible. To advance that discussion, we put forward here a concrete proposal for a basic reform in governments' role in that system. Our proposal would increase the role of "ability-to-pay" financing of educational costs, by expanding the role of income-tested federal student aid. At the same time, it would reduce the size of the "across-the-board" subsidies states provide to public colleges and universities, as states react to greater federal aid availability by raising public sector tuitions. This proposal represents, in our view, a desirable goal for long run structural reform of the financing of undergraduate education. Moreover, the proposal helps clarify the issues that are at stake in considering less sweeping reforms in the existing financing system.

A proposal for structural reform in financing undergraduate education

In proposing to improve the way higher education is financed ‘in the United States, it is important first to emphasize that current arrangements accomplish quite a lot. Access to at least some form of higher education is widespread for people from a variety of social backgrounds and economic circumstances. In some of its aspects, the existing financing system responds well to differences in family circumstances, providing aid to those who are least able to pay, and helping students to spread the cost of college over time. Finally, the diverse financing mechanisms and sources of control in U. S. higher education support a wide variety of types of postsecondary alternatives and help to safeguard the independence and vitality of academic institutions.

Yet the system has real limitations as well. Because most state government dollars go to across-the-board tuition subsidies at public institutions, a great many public dollars go to pay for the education of students from affluent families who could well afford to pay more. Meanwhile, although the combination of low public tuition and federal aid does open up some kind of postsecondary opportunity for most low income students, the range and quality of those alternatives is often quite limited, and varies substantially from state to state. Finally, the federal aid system presents itself to families as a complicated maze of options and regulations which can prove daunting and discouraging to those who need it most.

We suggest that reform efforts can usefully be organized around the following goals:

- target the overall pattern of subsidies in the system (not only federal subsidies) more effectively on lower income students;

- increase the emphasis on providing high quality educational alternatives to lower income students and expand their range of choice;
- reduce inequities that result from differences across states in educational opportunities for less advantaged students; and
- simplify the federal aid system, and make its contribution to overall educational policy goals more comprehensible.

Our proposal is, in a word, to federalize the financing of higher education for lower income students. In doing this, the proposal would also simplify the federal effort by concentrating all federal student aid subsidies in a single grant program. Unsubsidized credit would be made available to all students through a federally guaranteed program. The availability of larger federal subsidies for lower-income students would permit states to cut back on the subsidies they provide to public colleges and universities without jeopardizing the educational opportunities of disadvantaged students. The combination of state cutbacks and federal expansion could allow us to deliver as much or more higher education as it does now and distribute its costs more fairly, without increasing total public spending on higher education.

It may appear that support for low income students is already "federalized", since for many students a combination of Pell grants and Stafford loans comes close to covering the direct costs of attendance they face at a public in-state institution. Notice, however, that "costs" here are costs to students, Much of the operating cost of public institutions is borne by states, so that in effect the financing of low income students relies, as we noted above, on a combination of state and federal support. Since state support is mostly reflected in tuitions that are substantially below cost for all students, the effect of this system is that subsidizing low income students produces substantial subsidies for all students.

We propose, in effect, a new division of labor between the states and the federal government in providing and paying for higher education. Maximum federal grants to undergraduate students should be set at a level that approximates the costs of providing a year's education at a typical public two year institution, including residence costs, less a student contribution. Currently, we estimate those costs at around $7,800 and we would ask for a student contribution, for students from the lowest income families, of about $2,000. Awards to individual students would be limited in two ways: first, no award could exceed the net costs of attendance facing the student at that institution (after taking account of other student aid and the $2,000 student contribution); and second, the award offered to a student would decline with increases in the student's family income. A reasonable schedule might have awards falling with income at a rate that would have a typical family with one child in college reach a zero award level at an annual income of about $45,000 -- which is roughly the median U. S. income for families with head aged 45-64 (the group most likely to have children in college).

Such a change in federal policy would provide states with a powerful incentive to raise their tuitions to cover a much more substantial percentage of their costs. States which did not do so would be foregoing substantial federal revenues, owing to the rule that awards cannot exceed student cost of attendance. To the extent that states did respond by raising tuition, our proposal would involve a shift in the fiscal responsibility for paying for the education of low income students, from the states to the federal government.

Our proposed policy change would also federalize the costs of education for low income students attending private colleges and universities. Since most such students in non-profit institutions are already receiving substantial institution-based aid, in order to be able to afford attendance, this increased federal aid would in effect substitute for institutional contributions. Is such a transfer to private institutions justified? Two considerations argue in favor of it. First, a disproportionately large share of low income students are enrolled in public institutions. Thus, most of the revenues that private institutions would receive from this program would be from increases in the numbers of low income students they enrolled -- and these payments should not be seen as transfers. Second, and more fundamentally, there is no reason to think that the education that low income students receive at private institutions is less valuable than that provided at public institutions; therefore, for those who need subsidies, it is just as productive for society to support their education in private as in public institutions.

This new program is in effect a dramatic expansion of the Pell program. We would suggest, in the interests of simplifying the federal effort, that this new program should simply replace the existing campus-based programs for direct lending, supplementary educational opportunity grants, and work-study.

Accompanying this substantial increase in federal grant support of higher education would also be a reform in the federal loan programs. Federal loans should continue to carry a guarantee, but should receive no other subsidy. Anticipated default costs should be built into a fee to be charged at the time loans were initiated. Further discussion of our proposed lending reform appears below.

Such a dramatic increase in the role of federal grants in financing higher education would add to the urgency of defining the target populations for federal student aid more clearly -- an issue which is already of considerable concern. We return to this topic after considering the merits of our proposal for the population of traditional students at traditional institutions, with which it is principally concerned.

Why does it make sense to transfer fiscal responsibility for the education of lower income students from the states to the federal government? At base, we would argue that the concerns for fairness, equal opportunity and human capital development that underpin federal student aid policy are fundamentally national concerns whose costs should be borne by the federal government. More specifically, we believe the changes we propose would set up desirable incentives regarding the performance of all segments of the higher education system.

Many economists over the years have complained that the low tuition policies pursued by most states have some significant disadvantages.[1] Subsidies tend to be poorly targeted on needy individuals, institutions are insulated from competitive pressures in the provision of educational services to undergraduates, and private institutions are disadvantaged in competing with their public counterparts, The argument about competitive pressures is probably most telling at institutions which serve a predominantly low income clientele. Low income students typically have little choice about where to enroll under existing arrangements, particularly because they may be financially compelled to live at home. This analysis has led to a familiar argument that states should reduce operating subsidies to public institutions, thus causing tuitions to rise, and should use the resulting savings to provide more need based aid to their citizens regardless of where they choose to enroll.

Our proposal accepts this reasoning, and suggests that the best route to getting a more attractive overall system of subsidies nationally is to have the federal government step

1 For a classic statement, see W. Lee Hansen and Burton Weisbrod, "A New Approach to Higher Education Finance," in M. D. Orvig, ed., Financinq Hiqher Education: New Alternatives for the Federal Government (Iowa City: American College Testing Program, 1971). See also Charles Karelis and Richard Sabot, "Financing Higher Education: A Proposal for Reform," Liberal Education, January/February 1987. Fred Fischer has recently argued that federal student aid programs should be redesigned to give states incentives to raise tuition and return the increase to students in the form of increased student aid. See Frederick J. Fischer, "State Financing of Higher Education: A New Look at an Old Problem," Change, January/February, 1990.

forward and assume the burden of student aid for low income students. What about the alternative of inducing the states to reform their own funding programs, reducing operating subsidies and expanding income-tested student aid? This might be accomplished by instituting federal grant programs that made the receipt of funds contingent on states reforming their higher education financing programs in the prescribed way. This would certainly be worth doing, and might well be a plausible alternative to our proposal. However, two considerations lead us to prefer the approach we have sketched. First, we believe that financing the education of low income students is fundamentally a national responsibility, and the clearest and most straightforward way for the federal government to discharge that responsibility is to fund it directly. Second, the indirect route of providing incentives to states would very likely lead to uneven responses across states, with the possible result of exacerbating the already considerable inequalities in opportunity facing students who happen to reside in different states.

If our proposal to expand federal need-based aid were enacted, how would states be likely to respond? It seems to us likely that most states would raise their tuitions substantially, in order to capture these federal revenues. There is evidence that at least some states deliberately raised tuition rates when the Pell program was initiated for precisely this reason.[2]

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[2] The argument that federal student aid support would tend to induce states to move away from their low tuition policies was deployed by both supporters and critics of federal student aid at the time the BEOG program was being debated in Congress in the early 1970's. In fact, ceiling levels in the BEOG program have been low enough that these incentive effects have been relatively unimportant, There is some evidence that the decision of public institutions in New York State to abandon their zero tuition policy was influenced by these incentives. In 1972, the Keppel Task Force recommended the introduction of tuition at City University of New York, arguing that "New York State students and institutions will fail to some degree to qualify for federal funds under the new statutes unless the public institutions charge higher tuition than they do at present....[We] consider it extremely important that the State take maximum advantage of federal funding in order to reduce the burden on state taxpayers." Task Force on Financing Higher Education, "Higher Education in New York State. A Report to Governor Nelson A. Rockefeller from the Task Force on Financing Higher Education," 1972, p. 5 and 15.

Moreover, empirical research we have undertaken concerning institutional responses to changes in federal funding suggests that states would be disposed to respond positively to these incentives: according to our estimates, a one dollar increase in federal financial aid leads to a tuition increase at public four-year institutions of approximately 50 cents. If states raised tuition by enough to capture the increased federal spending fully, increased revenues to the states would in fact substantially exceed added federal spending on student aid for students at public institutions – since higher tuitions would be paid by a great many students at public institutions who would not receive federal aid. This rearrangement of federal and state fiscal responsibilities might work best as part of some larger package of changes in federal and state fiscal relationships - as federal responsibility for paying for higher education expanded, states might assume increased responsibilities in other areas. Some possibilities are discussed in the section on budgetary implications below. If the overall rearrangement of federal and state finances left the states with more revenue, it is likely that some part of the revenue "windfall" to states from increased tuition would be returned to higher education spending.

In particular, the states might well devote some resources to helping more affluent students who are not eligible for federal student aid cope with new higher tuitions. If, for example, states developed or expanded need-based aid programs for state residents, the new higher tuitions at state institutions would imply that even middle or upper-middle income students might qualify for aid, as is true now at many private institutions. (Note that even if states raise tuition by the full amount of the recommended increase in federal aid, this would be no means eliminate the operating subsidies at public institutions which reduce attendance costs for non-aided students.) Providing need-based aid to middle and upper-middle income students would, it is true, in part undo the favorable redistributive consequences of expanding federal income tested aid and raising tuition, However, this arrangement would have some important advantages over the present one. First, states would need to be explicit about whom they were electing to subsidize, and why, thus encouraging more enlightening public discussion of this issue. Second, it seems unlikely that any explicit program of subsidized tuition would reach as far up the income distribution as the present implicit low tuition subsidies do. Finally, if indeed states provided these subsidies through portable student aid, they would make the competition for students between public and private institutions, and between in-state and out-of-state institutions, more even handed.

A major impact of our program, then, will be to target more governmental assistance on relatively low-income students and (to the extent that states allow public tuitions to rise) to reduce the assistance now going to relatively affluent students. This redistribution of higher education subsidies advances the goal of improving access to postsecondary education generally as well as broadening the range of higher education alternatives for lower-income students. A substantial body of statistical evidence shows that lower-income students are sensitive to net-price levels in deciding both whether and where to attend college. Moreover, the evidence also suggests that middle- and upper-income students are not discouraged from enrolling in college by increases in net price.

How would private institutions be affected by the reform we propose? It is first important to clarify one feature of the expanded federal aid program we propose. Awards in this program would be proportioned to family income (or some broader measure of financial capacity), not to "need" as conventionally defined in higher education. The usual "needs analysis" on which institutions rely in distributing their own scholarship money has a family's need for assistance rising dollar for dollar with the tuition of the institution attended. To adopt this principle for a program with the very high maximum award levels we propose would have two very significant drawbacks. First, for students at relatively costly private institutions, such an arrangement would move the distribution of federal grant aid quite far up the income distribution. Depending on exactly how benefit reduction rates were set, it would not be implausible for families with incomes in excess of $75,000 with multiple siblings in college to receive significant amounts of government grant aid. This does not seem a justifiable use of scarce federal grant resources. Moreover, private institutions already commit considerable resources to financial assistance of middle-income and upper-middle-income students, and could continue to do so under our plan.

"Needs" testing rather than income testing is unattractive for this federal program not only because it would mistarget funds, but also because it could provide a substantial incentive for private institutions to raise prices. It is important to stress that, despite occasional claims to the contrary in recent years, there is no credible evidence that existing student aid programs have a measurable tuition-raising effect at private institutions. However, a generously funded needs-tested program with a high award ceiling would allow an institution to "capture" federal funds by raising its tuition. An income-tested program would avoid these incentives to raise price for all but a handful of private institutions. Most private institutions currently charge more than the maximum we are proposing, and these institutions would not be able to capture additional federal aid by raising prices. The relative handful of institutions currently charging less than $7,800 (including residence costs) would have an incentive to raise prices under our proposed policy, but this is not obviously a bad thing, since spending levels at these institutions are currently quite low, and higher tuition and spending might well bring commensurate quality improvements.

Our proposed policy would be likely to induce changes in the way private institutions allocate their own aid funds. Institutions whose costs were roughly comparable to those of public institutions would find most financial need met for lower income students. Under current arrangements, such institutions generally have to supplement available federal aid significantly to make attendance possible for low income students. “Federalizing” college finance for low income students would relieve moderately priced private institutions of this burden. At the same time, since few private institutions can meet the need of low income students completely under present arrangements, some low-income students are currently discouraged from applying to these institutions by the absence of adequate aid. Our expanded federal aid program would extend the range of choice for these students.

High cost private institutions would face a somewhat different set of incentives. Because the proposed grant program would not be tuition-sensitive (above the ceiling set by the maximum award amount), high cost institutions would not receive any more federal student aid to finance the education of a student with a given economic background than would less costly institutions. More expensive institutions would find, under this regime (as under present policy) that (holding income constant) their students have greater “unmet need” than students at cheaper institutions. It would make sense, then, for these institutions to continue to operate need-based student aid programs “on top of” the foundation support provided by the federal grant program we have described.

<u>Dealing with non-traditional students and institutions</u>. Under existing eligibility criteria, it is likely that a large fraction of awards under the expanded federal program we describe would not go to the traditional “college-age” students attending degree-granting institutions full time. Instead, a good deal of the aid would go (as it does now) to independent adult students, part-time students, and students in non-degree vocational programs at community colleges and proprietary trade schools (there is considerable overlap among these groups).

It is not clear that this would be a good result from the standpoint either of equity or efficiency. Considering the distributive dimension first, there is reason for doubt about how effective existing needs analysis systems are in identifying needy adults, compared to their effectiveness in measuring ability to pay of the families of dependent students. On the social efficiency side, there is reason for doubt concerning the level of social returns to at least some postsecondary vocational programs as well as to some of the many activities pursued by adults as continuing education. At a minimum, it is not clear that all these activities are equally worthy of federal subsidy.

A final concern is that proprietary vocational schools are the set of institutions most likely to increase their total claim on national resources if federal aid became more generous. We expect that public institutions would raise tuition, but that this would largely take the form of a transfer from federal to state governments, since state appropriations to these institutions would be likely to fall as tuitions rose. Most private non-profit institutions already have student charges that exceed the maximum federal aid level we propose to set. However, it appears that a large fraction of proprietary institutions have levels of student charges and of expenditures per student that roughly equal the sum of the current Pell grant and Stafford loan maxima – roughly $5,000 per student. These institutions would have strong incentives to raise their charges to capture added federal support. Whether such added revenues would translate into expenditures on higher quality programs is doubtful. To the extent that competitive pressures from well informed consumers are effective, there would be pressures in this direction. However, to the extent that proprietary institutions could capture the added revenues as profit, it would plainly be in their interest to do so.

All these concerns, about equity, efficiency, and levels of resource use, exist in the present system, but are rendered less visible by the fact that the mechanisms for providing educational subsidies to needy students are more indirect and complex than they would be under our proposal. Indeed, from some points of view, making these social choices about what kinds of educational activities to subsidize, and for whom, more explicit might be seen as a virtue of our proposal.

The point we want to stress is this: if the proposal we are advancing here is a good one with regard to the education of “traditional” college age students at academic institutions, the existence of other groups of students and other kinds of institutions which receive support should not be treated as an insurmountable obstacle to implementing it. If the goals of adult and vocational education are well served by grants to individual students, and if the social judgment is that these activities and populations should be equally well supported as traditional students and institutions, then so be it. But it is necessary to recognize that this is indeed a costly proposition, which policy makers should acknowledge in decisions about funding. If, on the other hand, other delivery mechanisms seem preferable, or if, on balance, society is inclined to support these activities less generously than traditional student aid, then the necessary programmatic distinctions have to be made.

It is worth emphasizing that our proposed program might have the effect of making more traditional academic programs attractive to some of the students who now enroll in vocational programs. More substantial grant-based funding would widen the range of academic alternatives disadvantaged students could consider. Raising the purchasing power available to these students would also increase the incentive for institutions to be responsive to their particular needs and capacities. Undoubtedly, however, a substantial number of potential students will continue to believe that their best course is to pursue vocational training, and this may well be the right course for most such students.

Our tentative recommendation is that, under our structural reform, federal support for non-degree oriented programs and short-term vocational training should be administered and funded separately from academic postsecondary education. The voucher mechanism implicit in student aid funding, coupled with minimal regulatory oversight, does not appear to have worked well in this area. The alternative of funding vocational efforts through contracts with providers may well have merit as an alternative. Institutions offering vocational training would contract with the federal government, or perhaps with state government agencies relying on federal funds, to supply training to individuals whose eligibility would be decided jointly by the funding agency and the provider. Students would not pay tuition; rather, educational costs would be covered by the contract. Living costs might be subsidized directly by the government. These arrangements appear to have potential advantages over the existing system in permitting the government to impose performance standards, in allowing the supply of training in various fields to be tailored to regional labor market conditions, and in regulating the costs of the training provided.[3]

Placing these programs under separate authority would, in itself, introduce a significant change in the treatment of adult and independent students, since a large fraction of them are enrolled in vocational and other non-degree programs. Indeed, an advantage of such a reorganization is that it might encourage more effective techniques for determining adult eligibility for such programs. If people were admitted to federally supported programs on the basis of such criteria as technology-related job loss, long term economic

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3Why wouldn't this be a suitable mechanism for all federal educational support? If it is good enough for vocational training, why shouldn't it be applied to academic postsecondary education as well? Our reply has several aspects. First, traditional concerns with academic freedom are much more salient in academic than vocational contexts, and these argue for a funding mechanism which is more neutral with regard to program content and method than a contract approach would be. Second, because academic education is typically more nearly "general" human capital than the "job-specific" human capital provided in short-term vocational programs, there is less need to worry about the suitability of training to short term labor market conditions. Finally, both state-run and non-profit suppliers have built in regulatory mechanisms in the form of governing boards which help to supervise the use of voucher funds. These mechanisms are absent in profit-seeking institutions, which provide a large share of short-term vocational training.

disadvantage, or the like, this might provide a better measure of economic need than the independent student needs analysis standards, which appear less reliable than the comparable standards for dependent students.

At the same time, a number of adult and independent students will remain interested in pursuing academic postsecondaty alternatives, and their numbers may increase if federal grant support for such programs becomes more generous. We believe that educational opportunity is quite important for disadvantaged adults, and that access to federal support through the expanded grant program should be provided. A needs analysis system for adult and independent students should, however, aim to meet three criteria that the existing system meets only imperfectly.

1. The subsidy system should seek to avoid creating substantial incentives for students to move voluntarily from dependent to independent status.
2. The system should expect a larger contribution from independent students than from the parents of dependent students in comparable financial circumstances, since the student is the principal beneficiary of the education.
3. Because a person's short term economic status is reduced by returning to school, the system should attempt to base its assessment of the student's ability to pay on information extending over several years prior to the resumption of schooling.

The nuances of designing a system that meets these criteria, especially since it must deal with married as well as single people, parents as well as childless adults, are quite complicated, and we will not pause for a detailed discussion here.

Reforming federal loan finance. As we have indicated, our proposal would preserve guarantees for federal student loans, but eliminate interest subsidies. The basic reasoning here is that a subsidized loan can usefully be thought of as a package of a grant and a smaller unsubsidized loan. Packaging the two together makes it hard to target both subsidies and credit access at the right groups, and confuses both policy makers and borrowers about just what is going on. Our proposal is to give grants to those who need subsidies, loans to those who need credit, and some of each to those who need both.

Unsubsidized loans could be provided either through a guarantee mechanism for privately generated loans, as in the present GSL system, or through a direct lending system, presumably operated through schools, which would rely on federally provided capital. In terms of the fundamental economics of the matter, there is little to choose between these arrangements. We would urge that payments to banks to compensate their costs in offering these loans -- if any are needed in an unsubsidized system -- should be set through an auction mechanism. We would further urge that a healthy direct lending mechanism would be worth developing in parallel with the guarantee system, partly as a potential source of institutional innovation, and partly as an alternative source of credit should banks for one reason or another withdraw from the program or fail to provide credit to certain groups of students.

A possible reason for concern about offering unsubsidized loans is that they would generate unreasonably large repayment burdens for students. This worry, however, neglects the point that we are proposing to divert the resources that currently subsidize loans into direct grant subsidies instead. Suppose, for example, that a particular student would qualify for a grant equal in value to the subsidy she would otherwise have received for a loan and that her costs of attending college are not otherwise affected. Then her borrowing requirement is reduced by the grant just enough that the repayment burden for her loan is exactly what it would have been before. Obviously, if this equality held for everyone, there would be little point to changing the loan subsidies into grants. The advantage of making the separation, however, is precisely that it is possible to make a direct policy judgment about the best way to target all the grant funds, and then meet the credit needs that remain as a separate matter.

Estimated budaetatv and enrollment implications. Both the budgetary and enrollment consequences of implementing our proposed plan would depend critically on the responses both of students and of institutions to changed student financing incentives.

If public institutions do not raise prices at all in response to increases in federal grant ceilings, the bulk of added federal grant awards would go to students in private higher education. Since most students are enrolled in public institutions, the cost of the expanded grant program would be relatively modest - totalling, by our estimate, approximately $2.9 billion, of which about $2.1 billion would go to students at private institutions and about $.8 billion to public institution students.[4]

Alternatively, suppose that public institutions raise their prices enough to fully qualify their students for increased federal aid. In that event, students at public institutions who current receive grants would find their grants increased substantially, to help offset the higher tuitions, and a number of students who do not now qualify for grants at public institutions would do so. We estimate that the added costs at public institutions would total some $12.2 billion per year. In addition, the costs of added grants at private institutions would, as before, total $2.1 billion.

Thus the increase in the cost of the Pell program, on the assumption that public institutions raise tuition to fully capture additional federal funding, would total $14.3 billion. If public institutions do not raise tuition, Pell costs would rise by about $2.9 billion. These two

4Data supporting the cost estimates in this and the following paragraphs are presented in McPherson and Schapiro, Keeping College Affordable (forthcoming, Brookings Institution), Chapter 9.

cases bracket the extremes; our guess is that the most likely outcome would be an increase in the cost of the federal Pell program in the range of $10 billion.

There are, however, important offsets to these added costs. First, the cost of other federal programs would be reduced under our proposal. The three "campus-based" programs would be eliminated, resulting in a saving of about $1.2 billion. Elimination of interest subsidies in the Stafford program would also bring substantial saving. New accounting rules agreed to as part of last fall's budget accord will force Congress for the first time to recognize when it authorizes a new loan that between 30 and 50 percent of the cost of that loan will be borne by the federal government, with more than half of that being subsidized interest cost. Thus with no change in loan volume, eliminating the interest subsidy portion of federal cost would save the government between $1.4 billion and $2.3 billion per year.

Even more important would be the saving on state budgets resulting from the increases in public tuitions we expect our policy to induce. In 1987-88, the average cost of attendance (tuition plus room and board) at public institutions was $3,960. If these rose to average $7,800, the resulting revenue increase would be about $23.2 billion. Even if the tuition increase was only half that large, the revenue increase would be $11.6 billion. Thus, unless states rebate part of the increased tuition through expanding their own student aid programs or through increasing spending per student, the net effect of our proposed policy - if it succeeded in inducing states to raise tuitions substantially - would be a reduction in total government spending on undergraduate education. If states did not raise tuition, the increase in federal spending on Pell would be much less, and would in fact be largely offset by savings on loan subsidies and "campus-based" programs.

Our proposal, then, would involve a substantial increase in federal budgetary commitments compensated by reductions in state spending. *In* recent years, much of the fiscal movement has been in the opposite direction, with federal budgetary constraints leading to increasing fiscal burdens on state governments. Over much of the 1980's, state budgets appeared to be in substantially better shape than the federal budget, and this was one important source of this shift in fiscal responsibilities. However, although the federal budget continues to be in substantial deficit, there are growing signs that the ability of state governments to increase their budgets is reaching its limits. Thus, proposals like ours, which would move some responsibilities away from state budgets toward the federal budget, may be more plausible in the 1990's than they would have seemed in the recent past. Moreover, some of the most pressing needs facing the nation fall into areas that are more clearly state and local responsibilities than is the financing of higher education. As we noted at the outset, states are increasingly hard pressed to respond to needs for investment in public infrastructure, in health care, and in elementary and secondary education, among other areas. As proposals to address these and other areas of need continue to come forward which would further strain state budgets, the idea of including some fiscal movements in the other direction in a policy "package" may have appeal. Further pressure in this direction might arise from state-level "tax resistance" referenda and from national-level proposals, such as restricting the federal deductibility of state tax payments, which make it more difficult for states to raise taxes.

The kind of structural reform we have outlined could only be accomplished over a substantial period of time. Although the proposal would not raise the national public costs of higher education - and conceivably could lower them - it would call for a major redistribution of financing responsibilities among levels of government, which would probably need to be worked out as part of a larger package of fiscal reorganization.

Moreover, the proposal would conflict with the real or perceived interests of some major political elements in the national college finance effort: banks will not want to lose student loan subsidies; public colleges will not uniformly welcome incentives to raise prices (even if they are compensated for some students by higher aid); private colleges will be concerned about the lack of tuition sensitivity in our proposed grant program; and proprietary vocational schools and vocational programs at community colleges will be unsettled by the thought of having their support diverted to other funding channels.

We believe that our proposal would actually have significant benefits for some of the groups who might focus on these costs. Private colleges, for example, might benefit significantly from higher public tuition; those public colleges and universities who succeed in serving students well will benefit from funding mechanisms that are more sensitive to student choice; some proprietary institutions and community colleges might find a contract funding mechanism quite effective for their purposes. More important than its appeal to various interest groups, we believe the revision in funding we propose would advance the interests of students and of the nation in a more competitive and equitable higher education system.

Incremental reforms

The long-run proposal we have sketched can, we believe, help in the short run by guiding incremental steps that would advance the four major goals we outlined above. The following are among the directions we believe that reform efforts should attempt to take:

1. Support efforts for federal credit reform

The best way to get Congress to make better informed and more balanced decisions about the relative role of grant and loan programs is to account for those programs in a way that reflects their true relative cost. As we noted earlier, the budget agreement of last fall took important steps in this direction. By making Congress appropriate an amount equal to the expected present value of the stream of “special allowance” payments to banks and of future default costs when it authorizes new loans, it will not be inclined to view lending as quite cheap and grants as quite expensive.

2. Reduce subsidies in the loan programs and translate those subsidy dollars into larger grants.

As we have said, a subsidized loan of given size is equivalent to a grant plus a smaller loan. Unbundling these components is the best way of getting both subsidies and credit to the right people.

3. Develop alternatives to the support of postsecondary vocational training through the student aid programs.

If it indeed makes sense to fund short-term vocational training for postsecondary students through channels other than grants and loans to individual students, it is to be expected that the transition to these other funding mechanisms would occur gradually. Although projects funded by the Job Training Partnership Act provide a useful model for an alternative funding mechanism, it would be useful for the Office of Postsecondary Education in the Department of Education, which funds the student aid programs, to initiate some experiments with alternative ways of funding short-term vocational training for postsecondary students. If such pilot efforts are successful, both in meeting student needs and in providing a viable means of supporting effective institutions, they could lay the groundwork for more ambitious recasting of funding mechanisms at a later point.

4. Eliminate the 60% of cost provision in the Pell grant program.

The main effect of this provision is to reduce the size of Pell grants going to the neediest students at the lowest priced community colleges. At the same time, because the Pell grant can increase by only 60 cents for each dollar that the school's tuition increases, this provision reduces the incentives for these schools to raise tuitions. If, as we argue, it is desirable in the longer run for public institution tuitions to rise closer to cost-covering levels, this provision is counterproductive.

5. Focus discussion explicitly on the level and distribution of federal grants.

Early in the development of the federal Pell grant program, a good deal of attention was focused on the appropriate schedule for determining award eligibility under the program – how large the maximum grant should be; how grant size should decline with rising income, and what income level should be the maximum for grant recipients. In recent years, these debates have faded into the background, with the result that the distribution of Pell funds across income classes is largely a byproduct of the overall appropriation level Congress settles on. More explicit discussion of these key policy variables would help contribute to more intelligent decisions about how to target federal subsidies.

In line with the longer run reform proposal we have outlined, we would argue that the maximum Pell grant should be raised significantly, but that the rate at which the award level declines with increases in family resources should be made high enough that the maximum income level for a family qualifying for a grant will not increase substantially. While any student's total aid package, including Pell, should continue to be limited by the total cost of attending the institution, the formula for awarding Pell should be revised to eliminate other elements of tuition sensitivity. That is, Pell should be made an "income-tested" (or more generally a "family-resources-tested") rather than a "needs-tested" program.

6. Maintain a broad-based notion of family resources in assessing family ability to pay and eligibility for federal grants.

Both the "Pell eligibility index" and the Congressional methodology for performing needs analysis incorporate a fairly comprehensive view of family income and assets into their formulae. Keeping track both of assets and of tax-preferred sources of income, such as the income from tax-exempt bonds, is very important in assessing family ability to pay, since a family's taxable income in a particular year is sometimes a very poor measure of its underlying financial strength. Congress has repeatedly entertained attempts to revise the underlying broad-based conception of family resources in order to respond to the perceived needs of some constituent group. In the summer of 1990, for example, there was pressure on Congress to remove the value of owner-occupied housing from the list of assets counted in family wealth. Such a step would plainly introduce horizontal inequity among families who hold similar amounts of wealth in different form and vertical inequity in disregarding an asset which is held in disproportionately higher amounts by more affluent groups.

Conclusion

Although no one can be sure what the future holds, the ability of state governments in particular to continue to finance high quality education while keeping tuitions low for all students may be severely tested in the years ahead. Without significant changes in the financing system, it is the population of lower-income students whose educational opportunities would be most severely threatened by such a development. Our proposed reforms would, we believe, help considerably to reduce the vulnerability of lower-income students to these threats to their college opportunity.