Shifting Federal Aid for Higher Education to the States

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Introduction

There are currently several critical problems that exist within our system of higher education subsidies. One of the most important is the problem of transparency, where the government offers generous amounts of aid for students wanting to attend college, but the system is so complex and confusing to navigate that many do not know how much aid will ultimately be available until after they have already decided to go to college, applied to the schools they want to attend, and gotten accepted.

The federal government in particular does a particularly poor job of this since their two largest forms of aid come from Pell Grants and tax credits. Pell Grants are administered by the financial aid system which requires students to successfully navigate a series of difficult bureaucratic hurdles and informational delays, and studies have shown that Pell Grants are completely ineffective at encouraging more young students to attend college. The federal tax credits are administered by the IRS through the tax code, and also present students with a bewildering complexity of difficult forms while denying full benefits to many low income families who do not owe any income tax, in addition to delaying the benefit from arriving until long after the tuition bill is due.

States, however, provide the bulk of their aid through direct institutional subsidies that lower the sticker price for public colleges and universities. This type of aid has been shown by research to be effective at increasing enrollment, in part because reducing the sticker price makes the subsidies transparent to students deciding whether to go to college, and in part because it means there is no additional bureaucratic hurdle required to get the subsidies. States, however, have had a difficult time fully funding their subsidies for higher education recently due the budget problems created by the financial crisis.

This creates a fascinating situation where the federal government then has a lot of money that they spend ineffectively, while state governments have a lot of ways to spend money effectively, but do not have as many resources as they would like. The solution then is to divert the resources spent by the federal government and send it to the states. This could be done by reducing funding for federal higher education subsidies and then using the money to create a whole new program that allows states to spend the money however they want on higher education. When looking at this potential solution, there are five key insights that are important to consider.

<u>First Insight: Even if federal tax credits and Pell Grants might be completely ineffective, existing research cannot yet guarantee which type of program will be the best replacement.</u>

If funds were to be transferred from ineffective programs into more effective programs, the safest bet would be to put the money towards more generous institutional subsidies, which consistently show moderate increases in enrollment when tuition at public colleges decline. Merit aid programs on the other hand can sometimes do better but sometimes do worse in terms of enrollment than the safe option of institutional aid. If the merit aid program is designed well, then you might be able to get a large impact on enrollment at relatively little cost, but if the program is designed poorly, than you might get no effect at all, and then direct subsidies for institutions might be the better option. At the same time, if other alternatives were possible besides the specific forms of need based aid (Pell Grants) and universal aid (tax credits) that are current being implemented by the federal government, perhaps need based aid or universal aid could be turned into more effective programs. Add in the problem that few studies have shown significant increases in degree attainment for any type of subsidy and then it becomes impossible to point decisively to one specific program that would be guaranteed to do better than all the others.

<u>Second Insight: For each type of subsidy, the federal government is at distinct disadvantage in being able to implement successful programs when compared to state governments.</u>

If you look at each of the four types of higher education subsidies (institutional, need based, universal, and merit based), all of them can be run more effectively at the state level than the federal level. In the case of institutional aid, there are thousands of individual colleges in the US, far too many for the federal government to be able to carefully consider how much aid each one should receive. That means the administration of institutional subsidies at the federal level would likely be left to some sort of aid formula, which would inevitably be able to use only a small number of factors when deciding the amount of aid to provide to each college. In contrast, states already decide how much aid to provide to all the colleges in the state based on a wide variety of factors, so that devolving the decision on new additional aid to the states would require no new decision making infrastructure. In all likelihood, going through the legislative process at the state level would be more effective and more considered than any type of general formula the federal government could construct, making state level administration the preferred option.

In the case of need based aid, the federal government has already constructed a vast financial aid bureaucracy that has made the system incomprehensible and difficult to navigate. The system the US has created at the national level has generally been shown to be completely ineffective at increasing enrollment, so that if the states had the option of creating their own program, they could easily craft a better system for their own state. States could simplify the application process, distribute the aid in a way that better fits their states specific needs, or even make the awards more transparent by offering free tuition to students with incomes below a certain level. Since the bar is set so low by the federal government, it only seems obvious that states might be able to do a better job and are unlikely to do worse.

In the case of universal aid, the federal government did not do a good job designing their aid program either. Administering the aid through the tax system creates a number of disadvantages. In order to get the aid, each student or family needs to navigate all the complexities of the tax code. In addition, by making the amount of aid dependent on how much you pay in taxes creates a great transparency problem, where students from low income families have an especially difficult time determining how much money they will get in advance. Finally, because the aid is received only after the tax return is filed and the refund is received, this creates liquidity problems because the tuition bill arrives many months before the student actually receives any money through the tax system. If states were to administer a system of universal aid themselves, they could do it through the high schools or colleges directly (perhaps with no application process required at all), and would be unlikely to ever use the tax system. As a result, they would likely avoid many of the pitfalls the federal government has had to deal with that may have greatly limited the effectiveness of their program.

In the case of merit based aid, even if the federal government did design a highly effective program, it is unclear that one program would be appropriate for each individual state. By one important measure in particular, the percent of 18 year olds who start attending a 4 year college within a year after graduating from high school, there is substantial variation among the states. This percentage can range from 10% in Wyoming to 38% in Florida with a range of values in between. A state with a low percentage on this measure would design a merit based scholarship program very differently from a state with a high percentage. The low percentage state would want to make sure to provide generous aid that provided strong incentives for their best students to attend a 4 year college, whereas a state with a high percentage would want to have rigorous renewal requirements to motivate those going already going to a 4 year college right after high school to graduate with a bachelor's degree. A medium percentage state might need an entirely different strategy, where they would want to develop a broad based program that is not offset by other forms of financial aid to get more average and low income students to attend a 4 year college. If each state were allowed to design their own merit based system of scholarships, they could customize it to their own individual needs, whereas the federal government would have difficulty crafting a merit based program that would work in all states.

Third Insight: Because the federal government is ill suited to administer higher education subsidies at the national level, it probably makes sense to reduce the money spent on tax credits and Pell Grants at the federal level and shift those funds to the states for them to spend more effectively.

Since federal aid is largely ineffective, states are likely to be able to do a better job at designing and administering their own programs. State level higher education subsidies can play a unique role in providing an avenue for policy experimentation, which is especially important since it is currently unclear which type of subsidy might ultimately work the best. Since states are likely to learn over time what works well and what does not, it might make sense to distribute the money in phases. Perhaps the first phase could shift half the money spent on tax credits and Pell Grants to individually designed state programs, and then once researchers have had the 8-10 years necessary to learn which strategies improve bachelor's degree attainment the most, the second half of the federal money could be shifted to the states for them to spend. One of the trickiest parts about this problem is figuring out how to shift funds away from the ineffective subsidies as quickly as possible, while still making sure the new programs are extremely effective. Given our limited state of knowledge about which programs work and which do not, this means there needs to be a process for experimentation and learning built in so that the policies improve significantly over time.

The other main problem with shifting money from the federal government to the states is ensuring that the states do not reduce their own level of support for higher education in response to the new resources from the federal government. Perhaps a specific set of rules encoded in legislation could be designed that ensures states do not decrease their spending, however, the easiest way to do this would be to set the level of federal transfers equal to a certain percentage of state spending. If for example, the federal government had approximately $25 billion a year they wanted to send to states, and states already spent approximately $50 billion a year on higher education, then the federal government could simply provide a 50% match for every dollar the state government already spends. If states responded to the new federal money by reducing their own level of support, then this would be unprofitable since it would decrease the amount coming from the federal government as well. Some states might complain they get too little from the federal government since they themselves spend so little on higher education, however this problem could be solved by simply having the low spending states increase their support for higher education, and encouraging low spending states to spend more would be an important advantage to this strategy.

Fourth Insight: States do have a lot of promising options to use federal funds effectively for all different types of subsidy.

In the case of institutional subsidies, states could adopt a plan to provide free tuition at all community colleges. This would be a highly transparent form of aid (everybody understands free after all), and has been shown to increase enrollment at community colleges in Tennessee once they tried this approach, though it also might cause some students who would have gone to a 4 year college to attend a 2 year college with higher drop out rates. Alternatively, a state could try and provide enough aid so that every student would get free tuition at all public colleges and universities. Unfortunately, this would require additional money since shifting funds from tax credits and Pell Grants would not be quite enough, and would also create a couple of problems. One, if colleges were forced to depend entirely on funds from state government, this might pose few problems over the short run, but in all probability the growth in state aid would not keep up with the spending needs of colleges, and colleges would no longer be able to fill the gap by raising tuition. Two, if institutional aid made public colleges entirely free, this would further distort the decisions students face when deciding between a public and private college, and might induce more students to go to public college in order to get the subsidy, when they would have done better by going to a private one. A compromise measure might use the funds from tax credits and Pell Grants to dramatically reduce the tuition at public colleges (but not make them free), while also using some of the funds to provide a subsidy for students who go to private colleges. This might have a significant positive impact on enrollment by dramatically reducing the sticker price of college, but avoid the chronic long term underfunding problem, while also reducing the impact of the public private distortion created by the new institutional subsidies.

In the case of need based subsidies, states have a variety of options to try and improve upon the federal program. First, they could try and increase the transparency of the need based subsidies by adapting a Canadian program that provides college subsidies early on in a child's life and has the government increase that aid each year as students grow up based on the income reported by their parents on their tax return. Each student would know early on exactly how much they have available to spend on college well before they actually have to decide to go, and could be administratively simpler if the higher education subsidies were incorporated into the tax system in a streamlined way. In addition, states could increase transparency by offering free tuition to every student below a certain income cutoff (which could rise as more resources become available), or encourage more students to go to a 4 year college by providing a different maximum grant for 2 year and 4 year colleges.

In the case of universal aid, a program that was administered by the state could simply provide a flat graduation bonus for every student that graduated from a high school within their state. There would be no need for applications or financial aid forms, since each college would know where every student graduated from high school and could simply get the aid directly from the state. This would avoid all problems created by administering the program through the tax code, where low income students would be guaranteed the same amount, students would not have to navigate the complex tax code to receive it, each student would know exactly how much they should expect to get before they decide to go to college, and the money would arrive at exactly the same time as their tuition bill.

In the case of merit based aid, there has already been a lot of experimentation at the state level, so states would have a lot of examples to draw upon. If you were a state with a low percentage of 18 year olds going to a 4 year college right after graduation, then Florida offers the best model since they successfully went from one of the states with the lowest percentage on this measure before their merit aid program began to the state with the highest percentage now. If you are a state with a high percentage, then West Virginia offers the best model since they were able to successfully significantly increase their graduation rate for students already going to a 4 year college right after high school, most likely through their rigorous renewal requirements. If you are a state with a medium percentage, then Kentucky offers a viable model, where they provided broad based subsidies that were not offset by other forms of financial aid and saw large increases in enrollment at relatively little cost as a result, though some alterations to Kentucky's program might need to be made in order to improve the rates of bachelor's degree attainment overall.

Fifth Insight: When allowing states to administer a larger share of the higher education subsidies, the federal government should design their program to prevent states from using their aid to deter students from travelling out of state.

When states get to administer subsidies for higher education, they inevitably target these subsidies only on in state residents and usually allow them only to be used on in state colleges. Public universities famously charge much higher tuition for out of state students and state merit aid programs generally restrict the use of the aid on out of state colleges. Part of the motivation is to ensure tax money paid by in state residents only gets used on in state students, and part of the motivation is to try and encourage more students to go to an in state in college so they are more likely to stay in state after they graduate. If the money is coming from the federal government, there is no need to limit the benefits to in state students for tax fairness reasons, and allowing students to use aid at out of state colleges can prevent a mismatching of college selection where students attend a lower quality in state college in order to get the subsidy but sacrifice long term educational outcomes as a result. One study in Massachusetts showed that their merit aid program induced many high performing students to go to a cheaper lower quality in state public college when they could have gone to a higher quality out of state private college and suffered lower graduation rates as a result. Even if these deliberately designed higher education subsidies do retain more students in state, and this does increase benefits for the state administering the subsidies, at the same time this will reduce benefits for other states by the same amount or more since they lose young migrants going into their state. Ultimately, the net effect is negative overall since it simply discourages the most efficient allocation of talent across the country.

If the federal government does end up providing generous transfers to the states for them to administer new subsidies for higher education, then the federal government needs to ensure that states do not use the money to compete for more in state students in a way that hurts the students and the national economy overall. In addition to providing funds, the federal government could reduce the harmful competition between states that already goes on by attaching new requirements to the federal money if states want to get it. The federal government could say that any institutional aid funded by the federal transfers need to go to schools that charge the same tuition to in state and out of state students, and that any federal money going to need based, merit based, or universal aid can be used at any college across the country. This would be especially important for students from small states with few options for in state colleges, and also for the best students who might be able to get into some of the best colleges anywhere in the US.

Conclusion

This policy memo then provides a framework for addressing one of the major problems, the problem of transparency, that exists in our current system of higher education subsidies. By shifting aid from the federal government to be spent by the states, this allows spending to be reduced on the complex, bewildering, and ineffective programs run by the federal government, and allow states to experiment with new ways of providing subsidies while also expanding the transparent and effective subsidies that they already provide. If states do find particularly effective ways to spend the money, then perhaps the federal government could expand the aid to states beyond what they already spend on ineffective aid, and increase the overall amount of resources spent on higher education subsidies altogether. By focusing on aid that works, this makes it easier to get even more spending on higher education subsidies, and by tapping into the vast financial resources of the federal government, this can help offset the funding limitations that the state governments are forced to manage. Ultimately then, not only might this policy shift lead to greater transparency in existing subsidies, it might help solve the problem of providing too few subsidies overall as well. Hopefully, this process will inspire more students to attend and graduate from college, and allow more people to achieve their dreams in life and career for well into the future.

End Note

#1 – A summary of the literature on the effects of different subsidies can be found in Dynarski and Scott-Clayton (2013) and also in Sly (2018).

References

Dynarski, Susan, and Judith Scott-Clayton. 2013. “Financial Aid Policy: Lessons from Research.” The Future of Children, 23(1), 67–91.

Sly, James. 2018. “Calculating the Optimal Subsidy for Higher Education.” Unpublished working paper. March.