It has been more than 25 years since the last major structural reform of the American system for financing higher education, when the Basic Educational Opportunity Grant program effectively created a federally funded voucher program for higher education. Thomas Kane, associate professor of public policy at Harvard University, argues that it is time to rethink the structure of higher education finance from its basic foundations. He describes a financial aid system at least as misunderstood as the health care finance system was 20 years ago. He recommends several areas where research can help provide clear thinking and good policy making.
The Need to Re-evaluate Higher Education Financing

It is time for the higher education community to reconsider the nation’s financial aid system, for a number of reasons. First, public anxiety over rising college costs has generated receptiveness among voters to proposals for change, however ill-considered they may be. To play a role in this discussion, institutional leaders must be prepared to offer meaningful proposals for reform; otherwise, expedient solutions are likely to continue to dominate the public discussion.

Further, experts predict the number of college-age youth will grow by nearly a quarter over the next 20 years. This demographic trend, coupled with the increasingly clear payoff in terms of eventual career earnings for college graduates, means that more high school graduates are choosing to continue their education. If college enrollment rates remain high, or continue their increase, public budgets for higher education are likely to be stretched thin. In such an environment, colleges and universities need to direct limited financial aid dollars where they will be most effective.

Evidence on How Well the Financial Aid System is Working

How well is the financial aid system serving the goals of maintaining broad access to higher education and allowing worthwhile educational investments? The evidence is not encouraging. It is well known that there are very large gaps in college attendance by family income. For the class of 1992, 90 percent of the students from the top income quartile attended some type of postsecondary institution within 20 months of their high school graduation, compared to 60 percent of those from the lowest income quartile. The gaps by income were particularly large in four-year college entrance, with 66 percent of the highest-income youth attending a four-year college at some point, while just 28 percent of the lowest-income youth did so.

Longitudinal data indicate that these gaps have been widening over time. Although college entry rates are growing for all groups, the increases are larger for middle and higher income families. Equally disturbing is that even after controlling for test scores, high school grades, and elementary schools attended, much of the difference in college entry by family income remains. Figure 1 reports differences in college attendance by family income and students’ scores on a standardized test of basic math skills administered during the 12th grade.

![Figure 1](http://example.com/fig1.png)

The data show that of the top scoring students, 84 percent of the high-income students went on to a four-year college within 20 months of graduation, but just 68 percent of the low-income students did so, for a gap of 16 percent. Thus, nearly three decades after establishment of the Pell Grant program, large differences in college attendance remain, even among similarly academically prepared youth.

Over the years, experts have written a great deal about the impact of various types of tuition and financial aid policies on college attendance. The research shows strong
evidence of student and parent responsiveness to tuition costs: generally, a $1,000 difference in tuition is associated with a six percentage point difference in college attendance. On the other hand, there is little proof of the impact of the Pell Grant program. Research has found little evidence of a disproportionate rise in college enrollment or undergraduate degree completion by low-income youth since the 1970s, when the program was established.

While students and their parents are extremely sensitive to tuition policies, they are relatively much less responsive to the rise in the labor market payoffs to college. It appears that people are either hypersensitive to tuition, or are making a conservative estimate of the value of a college degree.

Finally, research shows that student perceptions regarding their college prospects are remarkably inaccurate, even as late as their senior year in high school, and that few parents do anything to prepare for their children’s college tuition bills. If one accepts that one of the functions of the financial aid system is to send clear signals to parents about what to expect and how much to set aside for college, then the system is not functioning as it should.

**Salient Components of the Financial Aid System**

Several important trade-offs underlie the design of the American financial aid system. The primary trade-off is reflected in the “low-tuition low-aid” versus “high-tuition high-aid” question. The appropriate mix of across-the-board subsidies and means-tested subsidies is one of the oldest debates in American higher education. At this point, it is worth considering whether we have the mix right, given the lack of strong evidence of the impact of Pell Grants on enrollment of low-income youth—a means-tested approach to financial aid—as well as the increasing reliance of middle-income families on the across-the-board subsidies at public institutions.

Other trade-offs include student-based eligibility for aid distributed by campus-based packaging. To the extent that some students and parents may have difficulty filling out the required financial aid applications or are deterred by sticker prices or miss an important deadline, they may forego an option they would have chosen had they had better, earlier information about the amount of aid for which they qualify.

Finally, while the minimum half-time enrollment requirement and the minimum length of course time required for qualifying programs are important for preventing abuse of financial aid programs, the advent of distance learning technology places these “time-based” criteria into question. Given the potential for fraud, it would be foolish to drop such requirements. However, we must consider creative alternatives such as minimum or percentage payments by students enrolled in nontraditional programs.

**A Research Agenda**

Many parallels have been drawn recently between American higher education and the American health care system. Some of these comparisons are appropriate, but others are not. However, when it comes to understanding the effect of tuition schedules and financial aid programs on the decisions Americans are making about whether to attend college, where to attend, and how much to save beforehand, we know no more than those in the health insurance field knew in 1974. That was before the federal government helped
fund some randomized-control experiments to evaluate the impact of different types of health insurance plans on expenditures and health outcomes. The main difference is that we have yet to admit our ignorance and fund the type of careful research that would allow us to fill that gap in our understanding.

Future research on the impact of tuition and financial aid on the demand for higher education should focus on three important questions. First, how does the method of delivery of public subsidies—across-the-board subsidies, in-school interest subsidies on student loans, or Pell Grants—influence their effectiveness for different groups of students? For example, according to congressional cost accounting, a dollar in Pell Grants costs roughly six times as much as an additional dollar in eligibility for the Stafford Loan program. Does a dollar in grants have six times the impact of a dollar in loans? A second area deserving of more research is the impact of different incentive programs for encouraging parents to prepare financially for their children’s college educations. Much work has been done on the impact of various types of savings incentives and IRAs on families’ savings behavior. We can learn from the literature and design experiments for evaluating the impact of different types of incentive schemes for parents saving for college. Finally, pricing structures for financial aid for online courses deserve greater attention, as the old approach for controlling eligibility does not fit new distance learning models.

**Conclusion**

Over the last 25 years, the policy debates over financial aid have focused so exclusively on the narrow, incremental questions dictated by the internal logic of our existing system that we run the risk of missing the bigger questions: Why is it that there was no apparent impact of the Pell Grant program on college enrollment rates of low-income youth? What is the “bang-for-the-buck” achieved with different types of public subsidies? We will not make progress in closing the gaps in college enrollment by family income unless we have some of the answers to these important questions.

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