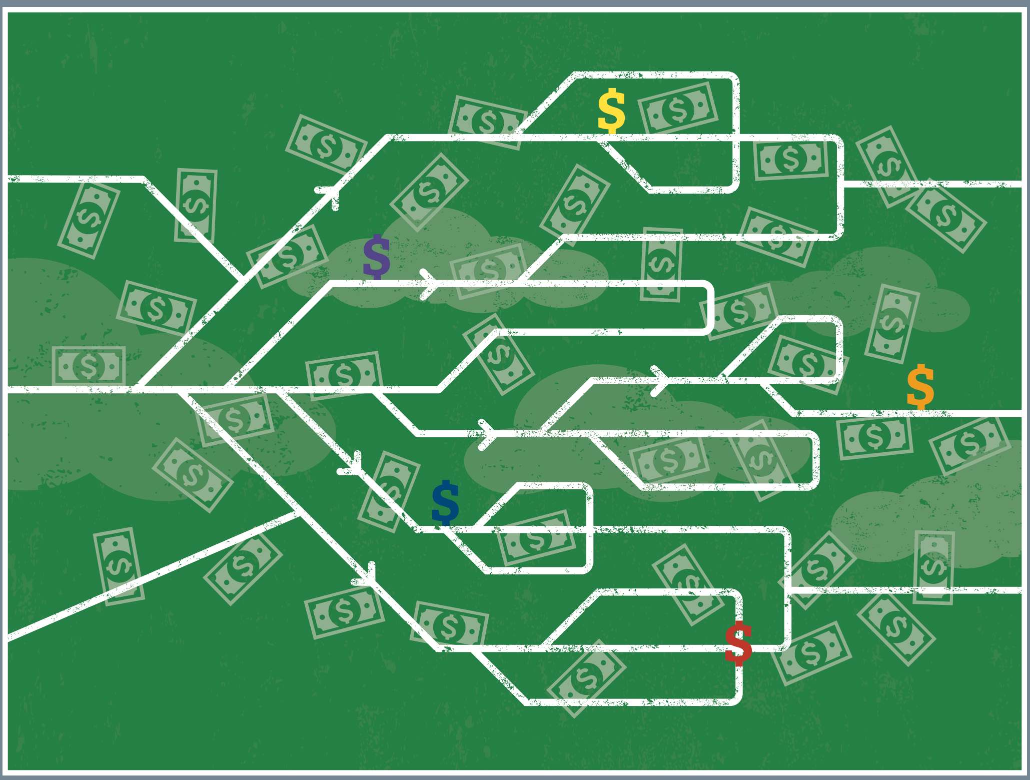
Undergraduate Financial Aid in the United States



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Section 2

Background: Fundamental Justifications for Financial Aid

PRIMARY JUSTIFICATIONS FOR PUBLIC PROVISION OF FINANCIAL AID

Public involvement in higher education finance can be justified in terms of both economic efficiency and social equity. Without intervention, higher education markets are inherently vulnerable to at least three fundamental problems that lead students to underinvest in college.[7] The first and most basic is that students face significant costs up front, while all of the benefits come in the future. For some students, family resources can solve this problem, if families have had sufficient income over time, have saved up for their children's (or their own) college attendance, and are willing to provide support. Indeed, family resources are the single largest source of funds for college, covering 38 percent of tuition, fees, room, and board charges for full-time undergraduates in 2012–2013.[8] But not all students can count upon family resources to fully fund their studies. Because this financial constraint is most binding for families with low incomes and/or limited wealth, it can lead not only to underinvestment in college but to unequal access to college by family income and race.

Private lenders may be willing to lend to parents with established sources of income and assets (among home-owning families with college-age children, nearly a quarter hold home equity loans, which are often used to help pay for college).[9] But private lenders are unlikely to lend to students, on their own, as much as they need to pay for college, because students typically have no assets with which to secure such loans, and a bank cannot repossess someone's education as they could a car or a house. Thus, some students who would benefit greatly from college—enough to eventually pay for all the costs of their edu-

7. Nicholas Barr, "Higher Education Funding," *Oxford Review of Economic Policy* 20 (2) (2004): 264–283.

8. Kathleen Payea, Sandy Baum, and Charles Kurose, *How Students and Families Pay for College*, College Board Advocacy and Policy Center Analysis Brief (New York: The College Board, March 2013).

9. Harold Stolper, "Home Equity Credit and College Access: Evidence from Texas Home Lending Laws," unpublished working paper, Columbia University, 2015, http://b.3cdn.net/nycss/e721264380141003d6_0pm6btwhk.pdf.

cation and then some—may not go because of a temporary credit crunch, and both individual and society suffer as a result.

This credit crunch provides justification for the public provision of student loans. Two other problems can motivate subsidies to reduce outright the price families pay. First is that individuals may not consider positive social spillovers when they make their college choices. But a college education may generate benefits to society above and beyond the benefits reaped by individuals, including improved infant health, reduced reliance on social welfare programs, and increased civic participation.[10] Second is the reality of imperfect information and limited rationality: students might not make decisions even in their own long-term interest because they underestimate benefits or overestimate the costs of college or, like other human beings, they procrastinate, avoid complex choices, and exhibit inertia in planning and executing their decisions.[11] Loans alone do not address these latter two problems (loans could even make information problems worse, due to their complexity).

Taken together, these underlying problems in the market for higher education can justify not only student loans but also broad-based policies to reduce the price students and families pay across the board (such as directly funding public institutions so that they can charge less than the cost of provision). Targeting financial aid to specific groups (such as need-based aid for low-income students) may enhance both equity and efficiency, if the problems outlined above are particularly acute for the targeted group or the aim of policy-makers is to reduce educational inequality. Other policy responses can be tailored to the specific problem they seek to solve. For example, performance-based aid may address informational and behavioral constraints by establishing performance expectations and providing students with needed motivation.

INSTITUTIONAL AND PRIVATE ORGANIZATIONAL JUSTIFICATIONS FOR AID

Concerns about efficiency and equity motivate private providers of financial aid as well. Some employers provide aid out of a desire to promote a skilled workforce. Colleges and foundations provide financial aid targeted to low-income, racial/ethnic minority, and other underrepresented groups out of both a sense of social purpose and a belief that diversity along multiple dimensions enhances the undergraduate learning experience for all students. Diversity objectives

10. Philip Oreopoulos and Uros Petronijevic, "Making College Worth It: A Review of the Returns to Higher Education," *The Future of Children* 23 (1) (2013): 41–65; Thomas S. Dee, "Are There Civic Returns to Education?" *Journal of Public Economics* 88 (9) (2004): 1697–1720.

11. Judith Scott-Clayton, "Information Constraints and Financial Aid Policy," in Donald Heller and Claire Callender, eds., *Student Financing of Higher Education: A Comparative Perspective* (London: Routledge, 2013); Adam M. Lavecchia, Heidi Liu, and Philip Oreopoulos, "Behavioral Economics of Education: Progress and Possibilities," Working Paper 20609 (Cambridge, Mass.: National Bureau of Economic Research, 2014).

more broadly can motivate aid targeted to students with unusual backgrounds or exceptional talents.

The goals of individual institutions and organizations, however, may also differ in important ways from the public purpose of financial aid. For example, some institutions—both public and private—may provide merit-based and athletic scholarships primarily to enhance institutional prestige. And one key goal of institutional aid is particularly distinct: colleges may use financial aid simply as a revenue-maximizing pricing strategy. Charging different prices to different students enables the institution to capture more revenue from more students than would be possible if all students paid the same price.[12] This is the same discounting strategy used by airlines and other sectors to maximize profits. Postsecondary institutions' pricing strategies can be even more sophisticated than in other industries, because colleges typically have much more detailed information on students' financial circumstances that can be used to target precisely these discounts. Students also may be more responsive to price discounts when they are called "scholarships," a labeling option that most other industries do not have.[13]

There is no reason why different providers of financial aid should necessarily have the same goals, and the motivations underlying a given aid program may be of little relevance to the students who benefit. Still, recognizing the distinct goals of public versus private aid is useful background to discussions of how these programs work and how they affect students' decisions and outcomes.

12. In economics this is referred to as price discrimination. If the institution is constrained to charge everyone the same amount, the most enthusiastic enrollees pay only as much as the least enthusiastic enrollee.

13. Christopher Avery and Caroline M. Hoxby, "Do and Should Financial Aid Packages Affect Students' College Choices?" in Caroline M. Hoxby, ed., *College Choices: The Economics of Where to Go, When to Go, and How to Pay for It* (Chicago: University of Chicago Press, 2004), 355–394.