



## The Committee for Economic Development

# A New Partnership:

Reshaping the Federal and State Commitment to Need-Based Aid

Written by William R. Doyle

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COMMITTEE FOR ECONOMIC DEVELOPMENT

2000 L Street, N.W., Suite 700, Washington, D.C., 20036

202.296.5860

[www.CED.org](http://www.CED.org)

## On behalf of the Committee for Economic Development (CED),

we are pleased to present these research findings regarding ways to reform student financial aid. In 2012, CED released *Boosting Postsecondary Education Performance* -- calling on business to become active advocates at the state level for broad-access institutions that are so vital to the nation's economic future.

In this spirit, CED is pleased to present this latest analysis of possible ways to strengthen student financial aid entitled *A New Partnership: Reshaping the Federal and State Commitment to Need-Based Financial Aid*. While this is not an official policy statement on behalf of CED's Policy and Impact Committee, this paper does include Trustee feedback from some of the members of our Postsecondary Education Subcommittee. We believe this paper is an important contribution to the larger debate regarding student financial aid.

### The five principles of reform outlined in the paper include:

- The purpose of federal financial aid is to ensure that individuals who can benefit from college and would not otherwise attend are able to enroll.
- Efforts to reform financial aid must limit the unsustainable increase in college prices.
- Financial aid at all levels—institutional, state and federal— should be focused on those students who would not go to college without additional funding. This is the most efficient use of scarce resources.
- The federal financial system should ensure access to higher education, not reward academic success nor attempt to steer students into certain sectors of the labor market.
- Simplification of the process for application for aid and the process of repaying loans should be encouraged for the purposes of increased access and more efficient use of resources.

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Michael J. Petro  
Executive Vice-President  
Committee for Economic Development



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# Introduction

In the 2012 report, *Boosting Postsecondary Education Performance*, the Committee for Economic Development (CED) states that the system of higher education in the United States has fallen behind the rest of the world in its production of postsecondary degrees and certificates.<sup>29</sup> To remedy this problem, CED recommends that broad-access institutions—which are responsible for most student enrollment—must achieve more using already available resources. The report suggests that only an overall increase in efficiency in the system of higher education will result in increased educational attainment in the population.

This policy proposal follows from the work done in *Boosting Postsecondary Education Performance* by identifying inefficiencies and poorly used resources in our current financial aid system.\* I first draw on a very large research base to show that the most efficient way to spend financial aid money—particularly grant-based aid—is to use it to ensure that those who would not otherwise attend college make the choice to enroll. This means that grant aid should be need-based, as low-income students are the most responsive to changes in the price of college. The financial aid system must be viewed as a whole, not as separate federal, state and institutional systems. Viewed this way, it becomes clear that the actors in this system are working at cross purposes, and that much of the money that goes into this system is not spent in the most efficient way.

In a more efficient system of financial aid, the federal government, state governments and institutions would work together to increase college access. The proposal in this paper, which is centered on replacing current federal non-loan programs with a joint federal-state matching grant program, is designed to make sure that all actors in the system are working on the same problem—increasing college enrollment among those who might not otherwise go. Expending resources on students who might not otherwise attend college reduces the inefficient use of financial aid money that characterizes the current system. Second, this proposal also includes changes in how students apply for financial aid and how they repay loans, all of which are designed to reduce unnecessary duplication at the governmental level and make the system more effective and easier to use from the perspective of prospective students.

If implemented, this system would complement the changes suggested by the Committee for Economic Development in *Boosting Postsecondary Education Performance* by ensuring that larger numbers of students who are poorly served by the current system could afford to attend and succeed in broad-access institutions.

## Current State of Financial Aid System

The federal government's current financial aid system is based on a set of assumptions that no longer hold. Federal policymakers once could assume that they were working in concert with institutions and the states to ensure student access to and success in higher education. This is no longer a valid assumption. In the past, institutions could expect that support in the form of direct state funding or federal financial aid would increase as fast as their prices, guaranteeing a steadily rising source of revenue. Again, this is no longer a valid assumption. Finally some states and institutions recently seem to have assumed that student access could be primarily the responsibility of the federal government, leaving them free to pursue other goals, such as rewarding academic merit or competing to attract students who will increase institutional prestige. It can no longer be assumed that the federal government alone can provide for student access.

## College Prices

The primary issue with the current financial aid system is the price of college. Efforts to address the financial aid system will not in the end be effective unless they simultaneously address the college price spiral. One need not think that the current system of financial aid has caused the price expansion in order to think that the current system provides no incentives for institutional decision-makers to contain college prices.

College prices have increased faster than prices in any other sector of our society, including prices for medical care.<sup>5</sup> As many other analysts have pointed out, one must be careful to distinguish between college costs and prices. The cost of college is the total amount of money required for the institution to provide a student's college education. The price of college is how much a student must pay, with the net price being the price of tuition less any financial aid. In the vast majority of not-for-profit institutions, costs are more than prices—student attendance is subsidized.<sup>31</sup>

Why are college prices going up? Public college prices have increased over the last decade in large part because state appropriations have gone down and institutional leaders have turned to students and families to cover the overall cost of providing a higher education, with state leaders allowing this to happen. At both private and public colleges overall costs have increased steadily over the last thirty years, which has also contributed to increases in prices. There is an ongoing debate as to whether increases in college costs (and therefore college prices) are inevitable, and not susceptible to attempts to become more efficient.<sup>1</sup> This is an important debate, but from the

perspective of federal financial aid, somewhat beside the point. The most important fact for the purposes of redesigning the federal financial aid system is that federal aid cannot keep up with the current price spiral. Prices must be brought under control in order to keep college affordable for students and their families.

## An Overview of the Federal Financial Aid System

Below I provide an overview of the federal financial aid system, including grant funding, tax credits and student loans.

### ► Federal Grant Aid

The federal government provided \$35.2 billion in grant funding in 2011-12, of which the Pell grant program accounted for \$34.5 billion. The remaining funding is spent on legacy programs that funnel federal funds through institutions for various goals.<sup>6</sup>

### There are four key questions for the Pell Grant program:

1. Does the Pell Grant improve access to higher education?
2. Does the Pell Grant impact student success in higher education?
3. Does the Pell Grant reduce gaps in access to postsecondary education?
4. Can the Pell Grant keep pace with rising college prices?

On the question of improved access to higher education, there is surprisingly little direct evidence of the effectiveness of the Pell grant program in improving entry into college. This has mostly to do with the problem of creating an “after the fact” evaluation of a program that involves tens of billions of federal dollars and millions of students, and has already had a profound effect on the structure of postsecondary education.<sup>23</sup> The best evidence that is available comes from programs similar to the Pell grant that provide funding, but have characteristics that allow for better evaluation—so called “natural experiments.” Studies from the natural experiment literature show that reducing the price of higher education for students increases access.<sup>15;17</sup> Studies also show that low-income students are more responsive to financial aid than their middle-income or high-income peers. Based on this evidence it is safe to conclude that the Pell grant program,



targeted to low-income students, increases enrollment in higher education.

Student success is a separate issue. To date there are no high-quality studies demonstrating that need-based aid increases or decreases student persistence or success, *once the student is enrolled in college*. I do not know of any evidence that demonstrates that particular program designs for need-based aid improve the probability of an individual student attaining their educational objectives. However, common sense would dictate that students who cannot afford the price of higher education cannot continue to enroll, and that access is a necessary precursor to success.

The next issue for the Pell grant program is whether it has successfully reduced gaps in enrollment. The available descriptive evidence suggests it has not. Data from the Educational Longitudinal Study of 2002, the most recent longitudinal study tracking high school students into college, shows that 54% of low-income students enrolled in higher education, compared with 91% of high-income students. One simple way of controlling for student ability is to compare students at different levels of test scores. If we compare low-income students with high test scores to high-income students with high test scores, it turns out that 97% of high-income students with high test scores go to college, and that 77% of low-income students with high test scores are able to go to college, indicating that after controlling for ability, large gaps in enrollment rates by income remain.<sup>†</sup> The Pell grant program has increased enrollment for low-income students during a period of broadly increasing enrollment among all income groups. This means that we are not seeing gaps in enrollment close between income groups.

The last issue is whether the Pell grant can keep pace with college prices. The evidence here is unambiguously negative. Despite two presidential administrations that both funded the Pell grant at unprecedented levels, the proportion of college tuition and required fees covered by the Pell grant has gone down.<sup>6</sup> The federal government finds itself in the position of paying even more for the Pell grant program while getting less in terms of reduced cost of attendance for enrolled students.

## ➤ Student Loans

While federal grant aid has been directed primarily at low-income students, middle-income and wealthier students have had access to student loans to help defray the costs of college. There are three major federal loan programs for undergraduates, which together totaled about \$70 billion in 2011-12: the Stafford subsidized loan program, for students with documented need which provides for no interest accumulation while students are enrolled and totals \$28.7 billion in annual loan volume in 2011; the Stafford unsubsidized loan program, which



does not include an interest subsidy while students are enrolled and totals \$30.2 billion in annual loan volume; and the Parental Loans for Undergraduate Students program, which totals \$11.1 billion in annual loan volume. The federal loan program is much larger than all state-provided programs and private loans, which amounted to \$6.8 billion in annual loan volume in the same year.<sup>6</sup>

Federal student loan volume and the average amount borrowed per student have both grown rapidly, with students at all income levels now borrowing at nearly unprecedented amounts. With the sluggish recovery from the great recession and the ongoing tight labor market, many borrowers have been unable to repay their loans on time, leading to an increase in default rates.<sup>11</sup>

Evaluating the federal student loan program's effectiveness in increasing access to higher education is difficult for precisely the same reasons as it is difficult to evaluate the Pell grant program. However, given the rapid increase in loans that occurred at the same time as college tuition has been increasing, it stands to reason that families have been financing the increasing price of college through the federal loan system.

There are two hypothetical—but serious—concerns regarding federal loan programs. The first objection to student loan programs concerns students' behavior in the face of easy availability of loans. This hypothesis suggests that students borrow “too much” to finance lifestyle choices at subsidized interest costs during education, as opposed to necessary educational or living costs. This is an example of moral hazard. Little direct evidence of moral hazard exists. While there are occasional accounts in the media of students borrowing \$50,000 or even \$100,000, the average graduate with a bachelor's degree leaves college with about \$24,000 in debt, while one third of graduates leave with no debt at all<sup>4</sup>. Only two percent of graduates in recent years have reported debt levels over \$50,000. Recent studies suggest in fact that many students—most likely concerned about heavy debt burdens—may in fact be borrowing less than would be optimal.<sup>25</sup>

The second concern about student loans is that increasing student aid of all varieties, but particularly student loans, has enabled the college price spiral in higher education. This is analogous to the easy availability of mortgage lending allegedly leading to the bubble in the real estate market. Direct evidence to support this hypothesis has been difficult to produce, but evaluations using natural experiments in other settings do suggest that colleges are sensitive to the amount of aid available to students when setting prices for services.<sup>27:7</sup>

## ➤ Other Federal Initiatives

Federal work-study programs constitute about \$1 billion in financial aid. The federal government distributes this funding to institutions, which then pay students for work done on campus— this funding can be used to pay for college attendance.<sup>6</sup> Evidence on the effectiveness of work-study programs is mixed. While students who are employed on campus do appear to be more likely to persist and graduate, there are no results that suggest that work-study positions are more effective than other forms of on-campus work.<sup>22</sup>

The federal government provides approximately \$16.4 billion in tax credits for postsecondary attendance for families with undergraduates.<sup>6</sup> As part of the American Recovery and Reinvestment Act (ARRA), tax credits were expanded, with more families and students eligible for larger tax credits. These changes are due to end as of December, 2012. The credit is available to single filers making up to \$80,000 and joint filers making up to \$160,000. These changes have made tax credits the third largest source of non-loan funding for students and families, smaller than institutional aid and Pell grant aid but larger than all state student financial aid and vastly larger than programs such as work-study. To date there have been few evaluations of tax credits. Early results show little impact in the form of increased student enrollment.<sup>30</sup>

Tax credits go primarily to families of middle-income students— students who would go to college with or without the credit. In addition, the timing of these programs (students and families receive tax credits in the form of refunds in the year after college tuition is paid) means that they are not of any assistance to families who are unable to pay tuition bills when they are due. Tax credits can therefore be considered primarily a form of middle-income tax relief as opposed to student financial aid.

## An Overview of State Student Financial Aid

State student financial comprises about 9 percent of all non-loan student financial aid<sup>6</sup>. State student financial aid programs were established at different times for different reasons, but most states adopted a system of financial aid broadly similar to the federal methodology in the 1970s and 1980s after the creation of federal incentives to do so in the form of the State Student Incentive Grant program.<sup>‡</sup> In addition, many states had established small non-need-based grant programs such as those designed to reward National Merit Scholars.

This overall picture changes dramatically in the 1990s and the early part of the 2000s as first Georgia and then 15 other states established broad non-need-based grant programs.<sup>20</sup> Many of these programs are modeled closely

on Georgia's HOPE scholarship, which promises to pay for college tuition at Georgia public institutions (or the equivalent amount at private institutions) for students who earn a 3.0 GPA in high school and maintain a similar GPA in college.<sup>12</sup>

Between 2000 and 2011, state student financial aid awarded on the basis of need has increased by 45 percent on a per-student, inflation adjusted basis, while state student financial aid awarded on a non-need basis by 350 percent.<sup>4</sup> This understates the situation somewhat, since virtually all of the new money that has been spent on financial aid at the state level has been spent on non-need based aid.

Evaluations of state need-based programs suffer from many of the same difficulties as efforts to evaluate the Pell grant program, but the same evidence holds. Increased grant funding results in higher enrollments, with low-income students showing the most responsiveness to financial aid.<sup>9;21;16</sup>

Merit-based programs have been evaluated in several states using different approaches. Most evaluations of merit-based programs have found that they increase enrollments, with some of the largest effects being found in Georgia.<sup>16</sup> The increases in enrollment as a result of the implementation of merit-based programs have been largely in line with what would be expected given previous findings.

The primary concern about merit-based financial aid is that these programs provide aid for students who would have gone to college without any additional help. They therefore represent a shift away from the principles that guided most governmental financial aid for the previous four decades. This is undoubtedly the case, as the characteristics of students who receive state non-need-based aid reveal that they are among the groups most likely to attend college without additional aid.<sup>20</sup>

One of the apparent benefits of state non-need programs is their simplicity. The clarity of these programs leads to more students being aware of the criteria for awarding the aid and the amount of financial aid for which they are eligible.<sup>13</sup>

## An Overview of Institutional Student Financial Aid

The biggest source of grant funding for student financial aid is the funding given directly from institutions to students themselves. It is also the least well-understood. Private colleges and universities—and many selective public institutions—have increasingly adopted some



version of a high-tuition, high-aid approach, in which a very high sticker price is discounted for some students on the basis of a set of characteristics that the campus finds desirable, including student financial need, student academic characteristics, or some other student characteristics such as athletic talent.<sup>28</sup>

The overall picture of institutional aid suggests a “drift” on the part of most institutions away from aid awarded on the basis of need and toward aid awarded on the basis of academic characteristics. Institutions vary widely in their approach to financial aid, but some broad trends are easily visible using surveys of students. At public comprehensive institutions, little direct financial aid is given to students. This aid is rarely based on need, but does appear to be awarded on the basis of academic ability as measured by test scores. At public research universities, substantial amounts of financial aid are awarded, with the bulk of the aid being awarded on the basis of need, but large awards are still given based on criteria other than need. At private comprehensive institutions, aid is generally not sensitive to student income—low-income students at these institutions receive about the same amount or even less institutional aid than their high-income peers. For instance students with family income less than \$35,000 at private comprehensive institutions received on average about \$6,300 in institutional aid in 2007-08, while those students with family incomes over \$120,000 received about \$6,000.<sup>§</sup> Private non-doctoral institutions provide generous subsidies to students on the basis of academic criteria, with higher-scoring students receiving large subsidies. At private research universities, substantial need-based and non-need-based grants are awarded to students. This broad commitment to need-based and non-need-based aid is only possible because of the resources available at this type of institution.<sup>14</sup>

Multiple studies have confirmed that institutional aid is effective in recruiting students to individual institutions.<sup>26</sup> One concern about the current system is that institutions are engaged in a kind of “arms race” for academically qualified students. As each individual institution offers more aid for highly qualified students, competitor institutions feel compelled to do the same in order to maintain their perceived status in the institutional ranking order.<sup>32</sup> This drives an ongoing process of increasing financial aid to students who will go to college regardless of the level of aid they receive.

## Principles for Redesign

I suggest the following principles for redesigning of the federal financial aid system:

- The purpose of federal financial aid is to ensure that individuals who can benefit from college and would not otherwise attend are able to enroll.
- Efforts to reform financial aid must limit the unsustainable increase in college prices.
- Financial aid at all levels—institutional, state and federal—should be focused on those students who would not go to college without additional funding. This is the most efficient use of scarce resources.
- The federal financial aid system should ensure access to higher education, not reward academic success or attempt to steer students into certain sectors of the labor market.
- Simplification of the process for application for financial aid and the process of repaying loans should be encouraged for the purposes of increased student access and more-efficient use of resources.

## A Federalist Approach To Redesign

The primary lesson of the last forty years of federal financing of higher education has been that the federal government cannot accomplish increased access to higher education alone. The trends in prices and the diversion of resources at other points in the system have resulted in the federal government being the sole actor in the system whose only concern is enrollment rates of low-income students.

The goal for a new, federalist system of financial is to align goals across the system so that all actors are working on the same problem: increasing access to higher education for students who would not otherwise attend.

In the design of each of these options I will make the following assumptions: the overall size of the federal government's investment in *non-loan* funding for higher education will remain the same, and will grow from year to year on the basis of inflation (not higher education costs). This is basically an assumption that any proposal must be revenue-neutral. *Loan* funding will be based on current loan interest rates and the federal government's subsidy for interest rates for enrolled students.

The system should also be based on principles of known effectiveness, not speculation or possibility.

Interventions that are known to be effective, as established by experimental or quasi-experimental design, include:

- Lowering the price of higher education through grant funding.
- Providing such grant funding on the basis of need.
- Simplifying the system so that it is straightforward to apply for aid.

I propose that the federal Pell grant and other campus-based programs be consolidated into a single program focused exclusively on portable aid for low-income students. This aid would be provided as a lump sum each year to states, with provisions requiring that: the aid be awarded to students on the basis of need; the aid be portable across institutional and state lines; states “match” the federal investment with one dollar of state aid for every four dollars of federal aid; and the state’s public institutions do not raise tuition more than the rate of increase in median family income in the state.

In addition, I propose the following:

- Elimination of **federal tax** credits.
- A “Race to the Top” for **state-based financial aid** programs.
- A **campus-based** incentive program that encourages competition for enrolling the most low-income students.
- Determination of **grant aid eligibility** through the current tax system.
- Making income-based repayment the default option for students who use the federal **loan** program.

Below, I detail the steps to creating a redesigned system of federal financial aid.

## Create a Joint Federal-State Need-Based Grant Aid Program

A combined Federal-State need-based grant program at the state level would have the following elements:

1. *Mandated per young person funding through a jointly financed federal/state need-based aid program.*

The amount of federal grant funding directed to each state would be determined by the number of low-income young people in the state, not the number of high school graduates or the number of college students. A suggested federal/state division based on the ratio of state aid to Pell grant aid would suggest that states be required to spend \$1 for every \$4 of federal aid (20 percent of the total size of the program).

1. *Eligibility for the grant aid in every state would be established via a simplified federal methodology.*

As described below, students and families are required to go through an unnecessary application process to learn their eligibility for financial aid. Based on a simplified process, all young people in every state would know their expected family contribution, and this information would be easily available to state policymakers.

1. *Grant funding would be required to be portable across institutional and state lines.*

Student mobility for the purposes of higher education is a net positive for the country, and should not be inhibited by the design of a federal financial aid program. This program would allow students to take federal/state aid with them across state lines. The institution a student attends would receive the aid from both the federal/state program under this plan. In some states, many students attend colleges from out of state. Institutions in these states will receive federal and state funding from students attending. In other states, more students leave to go to college. Leaders in these states can take advantage of the proposed system by funding students directly instead of supporting a larger system of higher education. In either case, student movement for the purpose of attending college should be encouraged.

1. *Public college tuition increases would be limited to the rate of increase in median family income.*

One of the key principles for redesign is that any financial aid program must slow down rises in college prices. This proposal would require that public institutions' in-state tuition—the price point for 80 percent of students—not increase faster than families' ability to pay, as measured by the increase in median family income in the state. State leaders could moderate tuition increases in a number of ways, including increased state appropriations and/or changes in the structure of state systems, depending on their state policy environment and the goals of policymakers.

This proposed redesign will force many changes at the state level. First, all states will be committed to a certain level of need-based financial aid, depending on the amount of federal matching funds for which the state is eligible. States with a higher proportion of low-income young people will be eligible for more funding. States will have to provide a 20% match to the federal funding.

This implies a shift in financial aid priorities for many states. States could accomplish this matching by redirecting funding from current financial aid programs, redirecting funding from direct appropriations to higher education, or spending additional dollars on financial aid. Nothing in this proposal suggests that states cannot continue to pursue their own goals, such as rewarding merit, in their financial aid programs. The policy proposal only requires that states must first meet the federal matching requirements in order to receive federal financial aid.

This proposal would also require that those states without an existing financial aid program develop the capacity to provide matching aid. Such efforts have been undertaken successfully in the past, and those states that do not have such capacity now could develop it in order to be eligible for federal matching funds.

Next, this proposal also assumes that states can work with colleges and universities to rein in college prices. In the vast majority of states, colleges fall under the regulatory authority of the legislature and a system can be developed to regulate tuition increases. In a few states, including Michigan and California, some public institutions of higher education have constitutional autonomy. In these states, a compact between the state government and institutions of higher education would need to be developed in order to limit tuition increases. Such compacts have been agreed to in the past, and could be negotiated in order to receive federal matching funds.

In every state, the constraint on college prices would force state leaders and institutional leaders to agree to a path forward for overall college costs. Since tuition increases would be limited, state policymakers and institutional leaders would need to come to a solution that involved increased appropriations for higher education, increased efficiency on the part of institutions, or some combination of both. The only solution that would be taken off of the table would be to continue financing increasing college costs through higher prices for students and their families.

The end result of these changes would be a large expansion in the amount of need-based aid available to low-income young people in all states. While the amount of the increase would vary from state to state, the increase would be most substantial in those states with large concentrations of young people that currently do not have large financial aid programs and have low college attendance rates. This change would accomplish the goals laid out in the principles for redesign, as funding at both the federal and state level would now be focused on low-income young people, many of whom are not now attending college.

It is important to note that the allocation rules for this program will be a critical feature of its design. These rules



must be simple and straightforward and not subject to manipulation. I suggest the number of low-income young people as measured by the Census Bureau in the American Community Survey as the basis for allocation of federal dollars in the matching program. This provides funding for those students who need it most, without first waiting to see whether those individuals enroll in college.

The primary possible threat to the successful implementation of this proposal is states' refusal to participate in the matching program. Such a refusal would mean that students in states that refused to participate would not receive federal matching funds. Past experience with diverse programs such as federal highway funding, Medicaid, and elementary and secondary education suggests that while many states would likely push back against the federal government's requirements, no state would refuse to participate. Such a refusal would entail substantial hardships not only for low-income students and their families, but also for many institutions of higher education in the state that depend in large part on federal financial grant aid dollars. A state's leaders who refused to participate would be reducing access to higher education in their state and consigning many institutions to reduced funding.

A possible "second order" impact of this policy would be that states would redirect funding from other important goals in order to meet federal requirements for student financial aid. Analysts have suggested that this has happened in other situations—for instance, some have suggested that Medicaid mandates have resulted in reduced funding for higher education.<sup>24</sup> However, this risk exists independent of the existence of this program. State policymakers face a set of tradeoffs with each budget year, and higher education funding will always compete with other budget priorities.

I propose two additional "add-on" components to this system, as additional incentives for state and campus leaders to focus their financial aid policies on students who can benefit the most from additional funding.

## **Eliminate Federal Tax Credits for Higher Education**

The current tax credit program is aimed at many of the wrong people and is both backward looking and mostly non-refundable.<sup>18</sup> The system should be eliminated, with the savings used to fund the initiatives described below. This would provide an additional \$18.2 billion to be used for other programs.



# Create a “Race to the Top” for Financial Aid at the State Level, and Campus-Based Competitive Funding for Innovative Financial Aid Designs

The essence of the “Race to the Top” program at the K-12 level was to take existing known best practices for K-12 and to reward those states who aggressively moved toward implementing those practices at the state and district level. The concept behind a Race to the Top for federal financial aid policy would be the same; use what is known to work, and reward states for doing more of it.

Under a “Race to the Top” program for financial aid, states would be given a checklist, and states that scored highest on this checklist would be given a substantial increase in their federal lump-sum payment. Some possible items for such a checklist include:

1. Create a work-study program that ties student experiences to local labor markets.
2. Establish a state-based matching program for private institutions that provides additional need-based aid for students at private institutions that meet state-based criteria for awarding need-based financial aid.
3. Establish a program so that every young person in the state has full information regarding their eligibility for aid and the amount of college tuition that would be covered by aid at local institutions.
4. Create state-level programs that reward institutions for using financial aid to increase college success, not just access to college.

States that were able to come up with a proposal that met all of the criteria would be eligible for additional funding that would be made available through the elimination of federal tax credits for higher education. State eligibility for funding would decline as their compliance with various “scored” parts of the proposal declined.

As with the previous proposal, this proposal assumes some level of postsecondary governance structures at the state level. Every state would need to have an entity tasked with crafting postsecondary policy for the state as a whole in order to compete for this grant. Many policy analysts believe that such entities are not just desirable but

necessary, particularly in times of fiscal difficulty. The development of such entities in states where one does not exist would be a desirable side effect of this proposal.

As noted above, campus leaders in the current system have substantial incentives both to increase tuition and to structure their financial aid to attract more highly-qualified students. A portion of the savings from the elimination of the tax credits should be applied to a campus incentives program that will provide federal incentive funds for need-based grant aid on campuses. Different from the current Supplemental Educational Opportunity Grants, this program will provide supplemental unrestricted funding to campuses that demonstrate a substantial commitment to need-based aid, with funding limited and provided on a competitive basis. Funding awarded as part of this program could also be used to provide support for promising programs that increase student success through creative deployment of financial aid. Funding awards would be made from year to year and would not be guaranteed.

Both the campus incentives programs and the financial aid “Race to the Top” are designed to utilize the power of competition to spur innovation. The CED has emphasized the positive role of competition in other reports, and there is no reason that federal financial aid policy need be different. Institutions of higher education have shown tremendous competitive spirit in seeking out federal research dollars or in moving up in institutional rankings. The goal of both the state- and the institution- based incentive programs is to ensure that institutions and states are competing for the goal that matters most—ensuring access and success to higher education for students who would not otherwise attend.

## **Simplify and Automate the Financial Aid Application Process Through the Tax System**

Compelling evidence from the research base suggest that simply having the Free Application for Federal Student Aid (FAFSA) filled out for individuals increases their enrollment in college, even though such an action does not involve anything more than using tax returns and a few additional questions to establish eligibility for financial aid.<sup>3</sup>

The current FAFSA system operated by the Department of Education should be eliminated entirely, and determination of eligibility for aid (calculated now as Expected Family Contribution, or EFC) should become the responsibility of the IRS through the filing of tax returns. Individuals who may enroll in higher education or who may have dependents enrolling in higher education in the near future should be asked to check a box

on all tax returns. Eligibility for financial aid would then be calculated by the IRS and communicated to relevant parties, including states and institutions and students and families themselves. Individuals or families with dependents who decide to enroll at a later date can establish their eligibility through a simple, one item application to the IRS at any time.<sup>19 ¶</sup>

This proposal would considerably simplify the federal financial aid system and let students and families know what their eligibility for financial aid would be without any additional work beyond filing their taxes. As mentioned, this simplification could dramatically increase student enrollment in higher education.<sup>2</sup>

## **Make Income-Based Repayment the Default Option for Students Who Use Federal Loans**

The current federal loan system is built on an infrastructure designed for a bank-based lending approach. In the original federal loan programs, banks loaned students money, while the federal government subsidized interest rates for some students and guaranteed loans for the banks. If a student defaulted, then banks could ensure that they were paid in full by the federal government. Banks needed loans to be repaid on a regular schedule and on time, so that each loan provided a steady and predictable stream of revenue to the bank.

In a government-run direct loan program, there is no need to ensure a constant, steady stream of revenue. While government loans should be repaid eventually, the concept of default is no longer necessary. If a student cannot make payments on a loan for a given period of time, a bank must go through a default and collection process in order again to ensure that some revenue is collected from underperforming loans. The government, on the other hand, can simply wait to be repaid.<sup>11</sup>

Repayment of federal loans for most students should happen through a system similar to the current income-based repayment program. However, I would additionally suggest that individuals have the option of repaying loans directly through their employers. Individuals who owe money to the federal government and who are earning wages could have their wages withheld by their employer, with a percentage amount taken out of every paycheck to repay loans. This is precisely the system used in Australia, where employers are provided with a simple form outlining withholding amounts for different wages.<sup>8</sup> Such a system would eliminate the issue of default, since anyone earning wages would be repaying their loan, and anyone unable to find paid work would by definition be exempt. Unless the current system forces many people to work who would otherwise choose to be

unemployed through the threat of collection actions, this proposal would be budget-neutral over the long term.<sup>9</sup>

One possible issue with the income-based repayment program is the concept of a risk pool. Students who expect to earn high incomes would opt out of income-based repayment, leaving only those who are unlikely to earn high incomes. By making income-based repayment the default, it is quite likely that the risk pool will encompass both a number of high-earning and lower-earning individuals.

Several issues and tradeoffs will continue to be a part of the federal student loan program. First, students may borrow more than they strictly need. The current safeguards against over borrowing in the form of borrowing limits could be strengthened and sharpened, but in the end there is little more to do about this problem, since it is difficult to determine with any precision what the exact right amount of borrowing is for any individual. However, the federal government could improve its informational procedures by creating the equivalent of a “Schumer Box” for student loans. Every semester, a student could receive a statement detailing his or her total loan amount, projected loan amount based on current borrowing levels and degree goals, projected monthly repayment, and total projected repayment amount, including interest.

## Impact of Proposed Policy Changes

These policy changes, if implemented, would increase the number of individuals attending higher education. In particular, students from traditionally underrepresented low-income groups would attend at higher rates than they do now. Below, I detail the specific changes anticipated for students, states and institutions.

### ► Impact on Students and Families

The programs described above would have differential impact on students and their families depending on their level of family income. For low-income students the changes would be most dramatic. First, aid eligibility and information about grants and loans available to students would be available automatically upon filing a tax return. Students and families now face a two-step process, where families first complete their taxes, then complete the FAFSA, then learn their eligibility for aid. Many students and families do not do this until relatively late in the year—March or April—leaving them less time to plan for paying for college. With a new one-step process, they will learn about their eligibility quickly and have more time to plan and anticipate college costs.



Second, low-income students would pay less for college. For example, a low-income student in Mississippi currently receives an average need-based grant of about \$4,400 from the state and federal grant programs combined. Under the terms of the new federal-state partnership, this student would receive \$8,000. At a projected increase in enrollment of 2.5% for every \$1,000 decrease in the cost of college, this would imply a 9 percent increase in the number of low-income young people enrolling in higher education in the state.\*\*

Middle-income students and their families would also see their college costs go down, as public institutions would be pushed to moderate tuition increases. Limiting the cost spiral would be a boon to these families, allowing them to plan for paying for college and to anticipate price increases over time. As opposed to tax credits, which come too late to help with actually paying tuition bills, lower tuition increases would mean less out-of-pocket money at the time of enrollment for middle-income families. Ease of application for financial aid would also help these families, as their exact expected contribution could be known earlier and without extra steps.

Both low-income and middle-income students could benefit from state- and campus-level initiatives funded by the incentive-based programs described above. As states and campuses innovate to utilize financial aid more effectively, the lessons learned would spread to other states and institutions, increasing our knowledge and use of effective interventions to increase student success through financial aid.

States that chose to provide non-need-based grant aid could continue to do so, after meeting the federal match for need-based aid.

All students would benefit from making income-based repayment a default option, as students could make career choices knowing that they do not face the imminent prospect of default if their income in a given time period is not sufficient to meet the monthly minimum loan repayment.

Eligibility for federal student loans would be the same as it is today.

## ➤ Impact on States

In all states, spending on need-based financial aid would either stay the same or increase under the terms of this proposal. States that currently spend a large amount on need-based financial aid would be mostly unaffected by this plan. States that spend a large amount on non-need based-aid would either need to redirect some funding to need-based aid or increase overall spending on financial aid in order to meet the federal matching requirements.

States that spend little to nothing on student aid of any kind would be the most affected by this proposal—they would be forced to begin spending more on need-based aid than they have in the past. Overall, the impact would be to ensure that states are meaningful partners in governmental efforts to increase low-income attendance.

States with a low level of governance capacity to implement the terms of this proposal would also need to build such capacity—a step that most analysts of state policy would recommend in any case. In addition, state policymakers would need to work with public colleges and universities to establish how to fund higher education without imposing large year-on-year increases in tuition on students and families.

## ➤ **Impact on Colleges and Universities**

As state spending on higher education has declined, public colleges and universities have turned to students and their families to cover their overall costs. Students and families have in effect become the funders of last resort for public colleges. Most students and families have turned to borrowing to cover these increased prices. This trend cannot continue. The terms of this plan would ensure that it would not, as it would require that public colleges and universities in the states limit price increases to the rate of increase in family income.

This would force a conversation that is long overdue. State leaders and institution leaders would need to come to some form of durable agreement about how much state appropriations will change, how much students and families can pay, and how institutions will become more efficient. As the CED has noted before, efficiency among broad-access public institutions is key to ensuring continued access to higher education.

For private colleges and universities, increases in financial aid would entail that more low-income students can attend higher education. In addition, access to funds through competitive programs would push private colleges and universities to use their own financial aid to increase college access and success—goals they have no incentives to accomplish now.

## Tying the Principles and the Actions Together

### ➤ **Principle:**

The purpose of federal financial aid is to ensure that individuals who can benefit from higher education and would not otherwise attend college are able to attend postsecondary education.

### ➤ **Actions:**

Use the federal matching program to induce additional state funding for need-based grant aid and to allocate resources more equitably across state lines.

### ➤ **Intended Outcome:**

Increased access to higher education for currently underrepresented students.

### ➤ **Principle:**

Efforts to reform financial aid must attempt to rein in rising college prices.

### ➤ **Actions:**

Mandate that states that wish to receive federal matching funding must not increase tuition at public institutions faster than median family income in the state.

### ➤ **Intended Outcomes:**

Increased access to higher education for students at all income levels; increased efficiency at broad-access institutions.

### ➤ **Principle:**

Financial aid at all levels—institutional, state and federal—should be focused on those students who would not go to college without additional funding. This is the most efficient use of scarce resources.

### ➤ **Actions:**

Create incentives for states to fund need-based aid through the federal matching program; provide additional incentives to states and institutions through “Race to the Top” and campus-based competitive programs.

### ➤ **Intended Outcomes:**

Increased innovation and solutions specific to state contexts.



➤ **Principle:**

The federal financial system should be utilized to ensure access to higher education, not to reward past behavior or to steer students into certain sectors of the labor market.

➤ **Actions:**

Eliminate federal tax credits; provide incentives for states and campuses to fund need-based aid through federal matching program and competitive programs.

➤ **Intended Outcomes:**

Savings from elimination of tax credits can be used to provide “venture capital” for innovative practices at the campus level; increased access and success tied to effective local practice.

➤ **Principle:**

Simplification of the process for application for aid and the process of repaying loans should be encouraged for the purposes of increased access and more efficient use of resources.

➤ **Actions:**

Eliminate the FAFSA and determine eligibility through the tax system; communicate information to students and families, states and institutions directly. Create a simple loan repayment program that would work through the current tax withholding system.

➤ **Intended Outcomes:**

Increased access as more students understand financial aid options; more participation in higher education as the threat of loan default becomes less onerous; higher repayment rates of federal loans.



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# Technical Appendix: Impact of Proposed Changes

In this section I simulate the impact of this policy on states and individual students. The primary policy, as proposed, would be to take the existing federal Pell grant program and other smaller grant programs and combine them into a single matching grant to be provided to the states. States would be obligated to match this grant with one dollar of state aid for every four dollars of state aid—the state contribution would be equal to 25% of the federal contribution, or one fifth of the overall grant program’s size. The money would be provided to states based on the number of low-income young people in the state.

**Figure 1: Pell Amount Per Poor Young Person in the State, 2010**

Figure 1 shows the current Pell grant amount per low-income young person in each state <sup>††</sup>. The figure also shows the amount of federal only aid that would be given to each state, on a per low-income young person basis. As figure 1 shows, one of the immediate effects of this proposal would be a redistribution of aid away from states where a relatively large number of students receive Pell grant toward states with high numbers of low income young people who are not currently taking advantage of the program. Under this program, the federal government would provide about \$6,000 per low-income young person in every state.

Figure 1

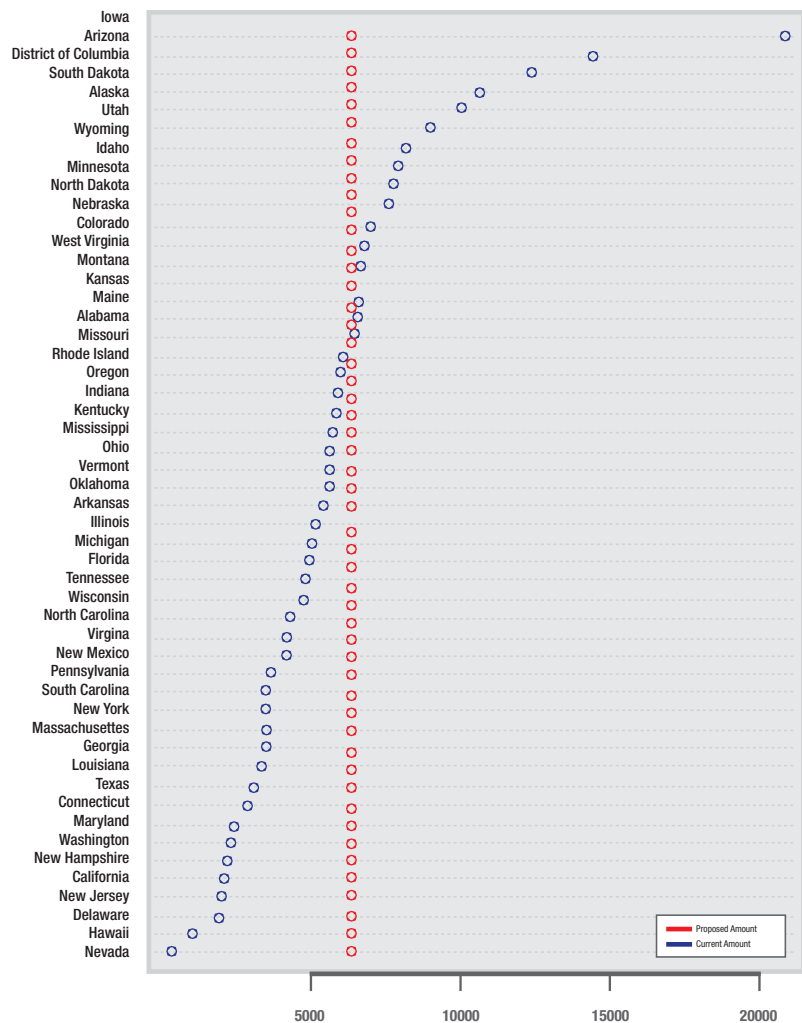


Figure 2

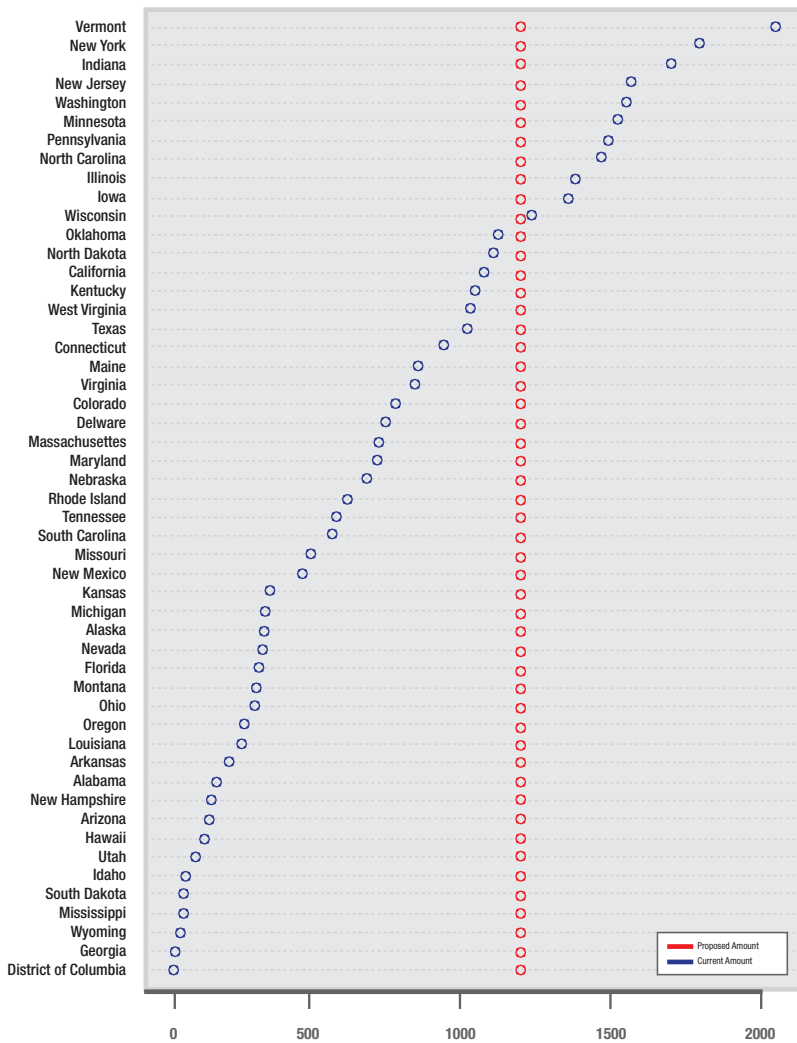


Figure 2: State Need-Based Aid Per Young Per Young Person in the State, 2010

Figure 2 shows the amount that states are currently spending on need-based financial aid per young person. Each blue dot represents the amount that the state currently spends. The red dots indicate the amount that each state would be *required* to spend per young person. Under the maintained assumptions, this would total \$1200 per low-income young person in every state.

Figure 3: Difference Between Current State Spending and Required State Spending

The difference between current spending and required spending in the new program is shown in figure 3. As this figure shows, in many states, there would be a large required increase in spending. For instance, Georgia would be required to spend \$1,000 more per low-income young person than it does today.

The final analysis for this simulation makes some additional assumptions to compare the existing program of state and federal need-based aid to the proposed matching program. For this analysis, I assume that not every low-income young person in the state receives the new matching grant. Instead, I assume attendance rates will be the same as attendance rates among the highest-qualified low-income students currently—about 75% <sup>##</sup>. I further assume that states that currently spend more than the required minimum amount of \$1,200 will continue to fund need based programs at their current amounts, less the required funding for the matching program. States that do not meet the required minimum will spend up to the minimum.

Figure 3

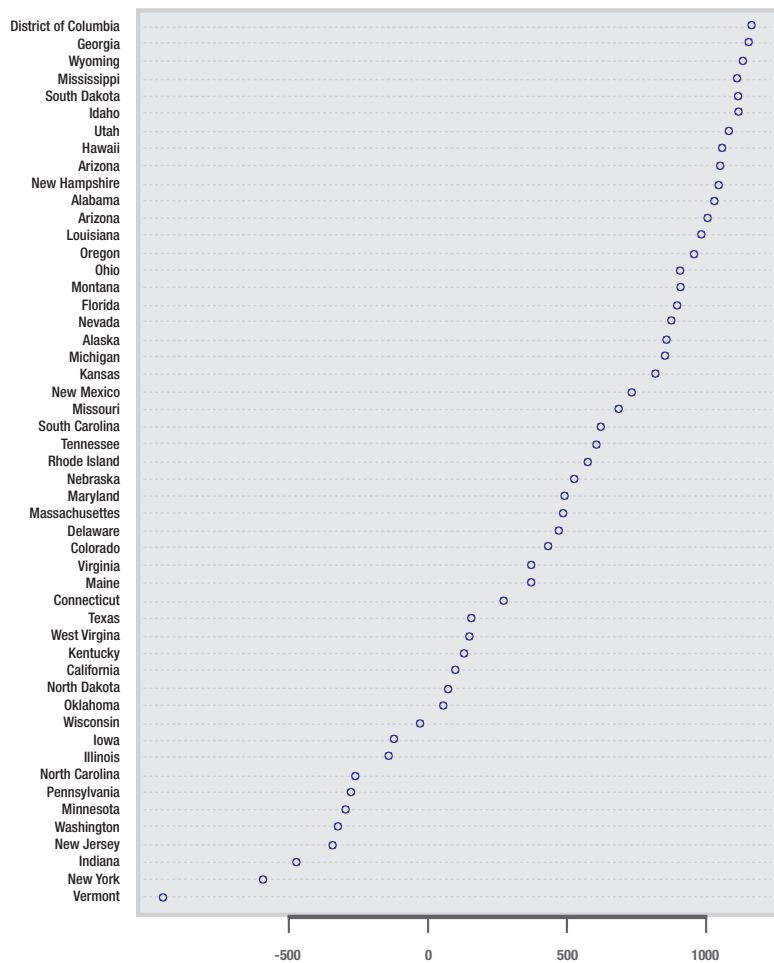


Figure 4: Comparison of Per-Recipient Funding, Current and Proposed

In figure 4 the per-recipient amounts under my proposed federal-state matching program (red dot) are compared with current state and federal spending on need based aid, using current Pell recipients as the denominator (blue dot). As figure 4 shows, this program would result in a substantial increase in per-recipient need-based financial aid across all states.

Further, the mandate that public institutions not increase tuition more than the rate of increase in median family income would mean that at most in-state institutions, the

purchasing power of this federal-state matching grant would not decline over time, meaning that college would be more affordable for young people in the state. At an average decrease in price of about \$2,500, the proposal would net an increase of 4-6% more low-income young people attending college in most states, using current best estimates of student price response.

In addition, it would be expected that the simplification of application for student aid funding would increase enrollment in higher education, with no additional spending required. A conservative estimate from the literature would indicate an increase of 1-2% in low-income attendance once this proposal is fully implemented.

The impact of the implementation of competitive programs at the state and institutional level are much harder to estimate, and would need to be evaluated on an ongoing basis.

Figure 4



Estimating the impact of reforming the student loan program on access is similarly complicated. The result of the implementation of this program in Australia did not lead to widespread enrollment increases, but the impacts of changing to an income-contingent loan program are unlikely to be observed in the short term, but instead over the long term.

## Notes:

\* This white paper concerns only aid for undergraduate students. Financial aid for graduate students, which is handled primarily through the federal loan system, is an important issue but beyond the scope of this paper.

† Author’s tabulations from the ELS of 2002. This comparison was first done with NELS data by Thomas Kane— these results are a replication of what he found in his first look at this data in the 1990s

‡ It is an open question as to whether many states might have done so in the absence of these federal incentives. Many of the largest state programs were in existence prior to the implementation of SSIG

§ Author’s tabulations from the National Postsecondary Student Aid Survey of 2008

¶ This was a key proposal of the College Board’s Rethinking Student Aid Study Group. Families would need to voluntarily enroll in such a program, as the IRS cannot reveal such information without the express permission of filers

ⓓ The current income-based repayment program has several issues, as described by DeLisle and Holt in a report from the New America Foundation<sup>10</sup>. In particular, the program needs to be redesigned in order to eliminate subsidies for high-debt, high-income students

\*\* The technical appendix for this paper details the projected impact of this plan on students and states

†† The young population is defined as 14 to 18 year olds. Using this population helps avoiding young people as low income who are in fact from high income families but are temporarily low-income because they are in college

‡‡ This is a conservative assumption—lower participation rates would result in higher per-recipient amounts



Committee for Economic Development  
2000 L Street N.W. Suite 700  
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