

Federal Financial Aid Policy and College Behavior

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Executive Summary

For more than fifty years federal higher education policy has primarily focused on helping low- and moderate-income families afford college. But despite a substantial public investment in student aid, the cost of college has steadily increased. This has led some to wonder:

Do federal grants and loans help students afford college, or do they simply encourage colleges and universities to raise tuition?

This seemingly simple question has spawned a long, and often heated, debate. In a 1987 New York Times op-ed, titled “Our Greedy Colleges,” then-Secretary of Education William Bennett’s claimed, “If anything, increases in financial aid in recent years have enabled colleges and universities blithely to raise their tuitions, confident that Federal loan subsidies would cushion the increase.”

This so-called “Bennett Hypothesis” is often explained as simple economics. Federal aid is a subsidy. Subsidies raise demand. Subsidies push up price. This claim continues to exert a powerful effect on the national conversation about financial aid policy. This simplistic approach is misleading at best – evidence to support this claim is not even remotely conclusive. The right way to understand the claims and counterclaims about the Bennett Hypothesis is by laying out an accurate framework of how tuition is set at colleges and universities.

Bennett’s claim is that federal aid enables institutions to push up tuition. By extension, this means that students also do not receive the full benefit of the grants and loans the government provides.

However, the attention focused on this point largely misses a much broader question about how changes in aid policy affect students who receive grant and loan assistance from the government. Thus, there are actually two important questions in this debate:

1. Is the full value of an increase in aid likely to be realized by aid recipients?
2. Will increases in aid have the unintended effect of raising list price tuition?

These two questions actually are very distinct. Students may not receive 100 percent of the intended benefit of government financial aid even if there is absolutely no link between their aid and their college's tuition-setting behavior. The first question is about how much, if any, of the federal aid institutions can direct to other purposes. If colleges and universities do not pass all of the aid directly to their students, then they are "taxing" the federal aid. The second question is about how much, if any, of that "taxation" happens through tuition increases.

To answer these questions, this paper builds a simple framework of college tuition-setting behavior. The first step is to show how some institutions can redirect a portion of a federal subsidy without changing their list price tuition. They can do this because the aid system allows institutions to decide their own aid allocations after they know a student's federal support package. Colleges and universities that give need-based grants can allow federal grant aid to displace some portion of their own internal funding.

This tuition-setting framework allows us to explore Bennett's contention that increased aid enables tuition hikes. This examination shows that for the vast majority of colleges, changes in the supply of federal aid provide no incentive at all to change list price tuition. For these institutions, list price is determined by the willingness to pay of families who are largely unaffected by changes in federal aid policy. By contrast, the possibility of a link between list price tuition and federal aid policy is more likely to be found at colleges and universities that give very little institutional aid, which is mainly the case in the for-profit sector and at nonprofit institutions that serve very few upper-income families.

Finally, the paper evaluates the existing evidence on both questions, and finds some important conclusions. The amount of federal aid colleges and universities redirect varies by the type of institution. The "tax rate" is higher at those for-profit institutions whose tuition appears to be related to aid availability, and at selective private institutions that give out large need-based grants. It is lower (often zero) at state universities. Perhaps surprisingly, the higher education system as a whole redirects a rather small fraction of federal aid. Nearly all of the aid reaches its intended target. Finally, and perhaps most important to answering our initial question, the evidence for an unintended aid-tuition link at the nation's nonprofit universities is very weak.