

# Fulfilling the Commitment:

# Recommendations for Reforming Federal Student Aid

The Report from the Rethinking Student Aid Study Group



The Spencer Foundation



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## **Table of Contents**

Introduction	:	2
Why Does Federal Student Aid Need Reform?		3
How Does the United States Compare?		
Are the Problems Really Financial?		4
The Rethinking Student Aid Project		6
A Framework for Reform		7
Improving the Federal Student Aid System: Recommended Actions		9
Simplification	!	9
Applying for Federal Student Aid		9
A Simpler FAFSA Is Not Enough	1	0
Making Pell Grants More Predictable	1	1
Estimated Costs and Distribution of Proposed Pell Grant Modifications	1	5
Tax Credits and Deductions		
Budgetary Impact of Proposed Changes in Education Tax Benefits	1'	7
Protecting Students Against Unmanageable Loan Burdens		
Income-Based Repayment	1	8
Loan Limits	1	9
Loan Subsidies	1	9
Budgetary Impact of Proposed Student Loan Reforms	2	0
Savings Plans for Low- and Moderate-Income Parents	2	0
Estimates of the Cost of a Savings Program for Low-Income Families	2	2
Incentives for States and Institutions	2	3
Encouraging Simple Programs of State Support		
for Low- and Moderate-Income Students	2	3
Generating Institutional Support for Student Success	2	4
Conclusion	2'	7
Appendix: Cost Estimates	2	8
Estimated Cost and Distribution of Proposed		
Pell Grant Modification.		-
Validity of AGI as a Basis for Ability to Pay	2	9
Estimated Budgetary Impact of Revision of Education Tax Benefits $\ldots$ .	3	0
The Cost of Improving the Student Loan Program	3	2
The Cost of Federal Savings Accounts for	~	~
Low- and Moderate-Income Families.	3	კ
Estimated Cost of Campus-Based Incentive Grants to Support Student Success	3	3

#### Introduction

In this report, the Rethinking Student Aid study group, brought together by the College Board with the support of Lumina Foundation for Education, the Spencer Foundation, and the Andrew W. Mellon Foundation to develop ideas for improving the federal student aid system, presents its recommendations. We hope these proposals will generate a new and open conversation about federal approaches to increasing postsecondary education opportunities.<sup>1</sup> In the report that follows, we discuss the motivation for our efforts, the goals and principles on which we believe student aid policy should rest, and the details of our proposals for making federal student aid more effective. Our long-term interest is in modifying federal policies in ways that are consistent with the vision articulated in this report. Our immediate goal is to engage the higher education policy community in a frank

and creative dialogue about how best to help students who face financial barriers to access and success in postsecondary education. Our report represents the best judgment of the study group members, whose names and affiliations are listed on the inside cover; neither the College Board nor any of the supporting organizations is responsible for the content of the report.

The policy experts, academic researchers, and higher education professionals in the group spent two years studying We believe the policies in this report would expand educational opportunities and would increase both the equity and the efficiency of the federal investment in higher education.

and discussing the current system and ways to make it more effective for students. We believe the policies described in this report would expand educational opportunities and increase both the equity and the efficiency of the federal investment in higher education.

The federal government distributed over \$86 billion in grants, loans, work aid, and tax benefits to students during the 2006-07 academic year.<sup>2</sup> These subsidies helped many students participate and succeed in educational experiences that would otherwise have been inaccessible to them. We applaud these successes, but are convinced that more can and must be done.

In the pages that follow, we propose a set of reforms that, taken together, offer a coherent, purposeful, and feasible agenda for improving in substantial ways the effectiveness of our aid system, enriching the lives of our citizens, and ensuring more productive use of taxpayer funds. We lay out strategies for simplifying dramatically the provision of all forms of undergraduate student aid; for improving the targeting, visibility, and clarity of federal grants, and for ensuring that those who borrow to pay for their college education will not be burdened with unmanageable debt. We also propose a new program designed to make the dream of accumulating savings for their children's college education a reality for millions of our nation's disadvantaged citizens. Another federal program would challenge state governments as well as individual colleges and universities to improve their performance through incentive grants that reward strong achievements in supporting low-income students through successful college experiences. The policy details described here are the result of careful thought and discussion among the members of the study group. However, there is considerable room for policymakers and others to further develop the blueprint of a federal financial aid system that would realize the vision of effective public policy we advocate.

Student aid is only one part of the system of financing higher education in the United States, and federal student aid—the focus of this report—is only one part of the student aid system. The Rethinking Student Aid project did not address the larger question of state financing of public higher

<sup>1.</sup> Distinctions are sometimes drawn among terms like "higher education," "postsecondary education," and "college." In this report, we use these terms interchangeably unless otherwise noted.

<sup>2.</sup> The College Board, Trends in Student Aid 2007 (New York: The College Board, 2007).

education. Despite the clear importance of this issue, and its interaction with financial aid, proposals for reform of state finance are beyond the scope of our inquiry. We concentrated on the role of the federal government in subsidizing students because federal policy sets the national agenda, touches all students, and has the potential to influence the student aid funding practices of states, institutions, and others. We focused only on undergraduate students because the issues facing graduate students are quite different and deserve separate consideration.

## Why Does Federal Student Aid Need Reform?

The significant increases in the proportion of Americans attending college that have occurred over the past 40 years would almost certainly have been impossible without the federal student aid programs designed and implemented in the 1960s and 1970s. However, the programs' results have fallen short of what their founders had hoped and short of what the American people can rightly expect from their investment. Increases in enrollment rates have occurred among all racial and ethnic groups and at all levels of the income distribution, but the participation gaps between affluent students and those from less privileged backgrounds have persisted.

High school graduates from middle- and upper-income families have consistently been much more likely than those from the lower 40 percent of the income distribution to enroll in college immediately after high school. In 2005, 77 percent of graduates from the top 40 percent of the income distribution and just 54 percent of those from the bottom 40 percent enrolled in college.<sup>3</sup> While the gaps across income groups are generally somewhat smaller in recent years than they were two decades ago, there has not been a consistent narrowing of these gaps, and the progress toward closing them has been quite minimal. Moreover, gaps in educational attainment are even larger than the enrollment figures reveal because lower-income students who are able to overcome the barriers to going to college are significantly less likely to complete degrees than are their more affluent peers. The failure of student aid policies to sufficiently improve persistence and completion must be addressed.

It is difficult to reconcile our common democratic belief that a person's social fate should not be determined by parental circumstances with the reality that individuals from disadvantaged backgrounds are so much less likely to enroll in and complete college than are their more privileged peers. The problem appears more acute after recognizing that significant gaps persist even after accounting for differences in high school academic achievement.<sup>4</sup>

The situation today is deeply at odds with Americans' understanding of themselves as citizens of a nation committed to equal opportunity. More than three decades ago, Senator Claiborne Pell, speaking in support of the legislation that became the Education Amendments of 1972, said, "It establishes by law the right to a postsecondary education for all of our Nation's citizens...no longer will higher education be the province of some of us—it will be a birthright of all."<sup>5</sup> This vision has long been shared by Republicans and Democrats alike, with Richard Nixon asserting, in signing the Education Amendments of 1972, that that legislation, which created the Pell Grant program, did not go far enough: "We look forward in the near future to having a set of Federal student assistance

<sup>3.</sup> Sandy Baum and Jennifer Ma, Education Pays 2007. (New York: The College Board, 2007).

<sup>4.</sup> See Table 1.

<sup>5.</sup> Congressional Record, Vol. 117 Part 22, U.S. Government Printing Office. Washington, DC, 29339-43.

programs devoted to the goal of equalizing opportunities for all." 6

The problem of financial barriers to access and success in higher education is not only an equity concern. Our nation's continuing failure to provide access to higher education for all who are able and interested will retard the dynamism and growth of the American economy. In their careful research, economists Claudia Goldin and Lawrence F. Katz confirm the economic imperative of increasing the proportion of college graduates in the U.S. labor force. They summarize the evidence in their exhaustive new study of American education, The Race between Education and Technology. "Standard measures of rates of return to education...are exceptionally high today. They have increased substantially since 1980 and are currently at historically high levels. ... More education is beneficial not only for the current generation. Increased educational attainment of parents is also of enormous value for the health and educational outcomes of their children."7 A better-educated labor force increases the standard of living for all workers and reduces the cost to the public of income support programs. We also know that more educated people enjoy better physical health and are more likely to be well-informed participants in public life. Increasingly, educational success through and beyond high school is a necessary grounding for people's capacity to lead an economically secure life, to provide for their children, and to assume full membership in an ever more complex multicultural society.8

## How Does the United States Compare?

Comparison of U.S. educational outcomes with those of other industrialized countries and even of some emerging nations raises deep concerns about international competitiveness. With an early lead in universal primary education, and having opened widespread access to secondary education earlier than most countries, the United States was for many years essentially unrivaled in the educational attainment of its people. Today's situation is quite different, with countries as different from one another as Russia, Japan, and Ireland exceeding the United States in the share of young people completing a postsecondary credential. Even more sobering is the reality that the U.S. completion rate among those who begin postsecondary programs of three years or longer is 54 percent, lower than any other Organisation for Economic Co-operation and Development (OECD) country except Mexico, and in contrast to 91 percent in Japan and 70 percent in the OECD as a whole.<sup>9</sup>

## Are the Problems Really Financial?

Finances are not the only differences among students from different economic backgrounds. Differences in academic preparation as well as expectations and aspirations also clearly have an impact on postsecondary education patterns. There are differences of opinion about the extent to which significant financial barriers to enrollment exist. According to a 2002 report from the Advisory Committee on Student Financial Assistance, financial barriers prevent nearly half of all college-qualified low- and moderate-income high school graduates from enrolling in four-year colleges.<sup>10</sup> In

8. See Sandy Baum and Jennifer Ma, *Education Pays 2007* (New York: The College Board, 2007) for details on the individual and social benefits of higher education.

9. Organisation for Economic Co-operation and Development, *Education at a Glance: OECD Indicators* 2006 (OECD Publishing, Paris, 2006), Table A3.2, p. 59.

10. *Empty Promises: The Myth of College Access*, Advisory Committee on Student Financial Assistance, 2002.

<sup>6.</sup> The American Presidency Project, Nixon 69. Special Message to the Congress on Higher Education, February 22, 1971.

<sup>7.</sup> Claudia Goldin and Lawrence F. Katz, *The Race between Education and Technology: The Evolution of U.S. Educational Wage Differentials, 1890 to 2005* (Cambridge, MA: Belknap Press of Harvard University Press, 2008), 336–37.

contrast, some analysts argue that measurable financial barriers interfere with college attainment for only a small minority of students.<sup>11</sup>

If the barriers are not financial, improvements in the financial aid system are not likely to solve the problem. A focus on improvements in academic preparation is required to narrow the gaps. These two

issues are not, however, entirely separable. Students who do not expect to be able to afford higher education are unlikely to have the motivation to prepare academically. One important focus of our recommendations is to assure young students from low- and moderate-income families that financing will be available.

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Whatever the weight of nonfinancial factors, it is clear that a significant number of academically talented low-income students

fail to enroll and succeed in college. Table 1 shows how far well-prepared eighth-graders from 1988, those with math test scores in the top quarter of all students, progressed in school. Virtually the entire affluent group of high-ranked math students had at least begun college, while only three-quarters of the high-ranked but economically disadvantaged group had enrolled. For those who came from the most affluent and educated families, in the top quarter in socioeconomic status (SES), three quarters had completed a bachelor's degree by the year 2000, while less than a third of those talented students from the bottom SES quartile had earned four-year degrees.

**Table 1:** Highest Level of Educational Attainment in 2000:Highest Quartile of Eighth-Grade Math Test Scores, High School Class 1992

Socioeconomic Status	< HS Grad	HS Grad	Some College	Certificate or License	Associate	Bachelor's or Higher	% entering college	% of college entrants earning BA
Lowest 25%	11%	15%	35%	3%	8%	29%	75%	39%
Middle 50%	0%	9%	31%	6%	7%	47%	91%	51%
Highest 25%	NA	1%	19%	3%	3%	74%	99%	75%

Source: Fox, M.A., Connolly, B.A., and Snyder, T.D. (2005). Youth Indicators 2005: Trends in the Well-Being of American Youth, (NCES 2005–050). U.S. Department of Education, National Center for Education Statistics. Washington, DC: U.S. Government Printing Office.

The facts that many talented students from low-income families do not enroll in college and that degree completion rates among this group are so low suggest that there is substantial potential for the financial aid system to promote increased access and attainment. Fewer than 40 percent of the academically high scoring/low-SES students who do enroll in college earn bachelor's degrees. Almost half of the students from this group leave college with no credential at all, so the gaps in degree attainment rates by socioeconomic status for high-achieving students who begin college are larger than the gaps in enrollment rates. It is critical that a better-designed financial aid system improve college success and completion rates. Moreover, there is powerful statistical evidence that large and simple programs to subsidize college costs have a measurable impact on both initial attendance and college completion.<sup>12</sup>As the economists Claudia Goldin and Lawrence Katz put it, "More generous financial aid for low-income youth and a more transparent financial aid system have the potential to expand college-going and completion.<sup>213</sup>

<sup>11.</sup> Stephen V. Cameron and James J. Heckman, "The Dynamics of Educational Attainment for Black, Hispanic, and White Males," *The Journal of Political Economy* 109(3) (June 2001): 455–99.

<sup>12.</sup> See the evidence cited in Sandy Baum, Michael McPherson, and Patricia Steele, eds., *The Effectiveness of Student Aid: What the Research Tells Us.* (New York: The College Board, 2008).

<sup>13.</sup> Claudia Goldin and Lawrence F. Katz, *The Race between Education and Technology: The Evolution of U.S. Educational Wage Differentials, 1890 to 2005* (Cambridge, MA: Belknap Press of Harvard University Press, 2008), 350.

The challenge of expanding America's college-educated population is made all the greater by the rapid demographic shift the nation is undergoing. According to projections from the Western Interstate Commission for Higher Education (WICHE), students of color, who in 2004-05 constituted just over a third of all students graduating from high school, will by 2020-21 add up to just under half of new high school graduates in the United States. Because students from ethnic minorities are generally more likely to need financial help in getting through college and have historically been less likely to attend and complete college than white, non-Hispanic students, a fair and efficient student aid system will become even more critical in the years ahead.

Improvements in the system of postsecondary finance alone cannot surmount all the challenges. Nonetheless, in a society with an educational system beset as ours is by severe and persistent economic inequalities, the system of student financial aid is a significant point of leverage, and one that, we believe, can influence preparation in the precollege years as well as success in college.

#### **The Rethinking Student Aid Project**

In 2006, Sandy Baum, senior policy analyst at the College Board and professor of economics at Skidmore College, and Michael McPherson, president of the Spencer Foundation, initiated the Rethinking Student Aid project under the auspices of the College Board. They convened a group of outstanding public policy experts, academic researchers with deep and diverse knowledge of higher education and its financing system, and experienced higher education professionals. The group was purposely selected to avoid representation of particular interests and constituencies. The goal was clearly stated as the design of effective public policy, rather than the protection of any particular aspects of the status quo. In addition to generous financial, logistical, and structural support from the College Board, the group obtained support from the Andrew W. Mellon Foundation, Lumina Foundation for Education, and the Spencer Foundation.

The members of the Rethinking Student Aid study group, listed on the inside cover of this report, met over a period of two years. They agreed to narrow their focus to analysis of the federal student aid system and articulated goals and principles on which to base their work. The study group commissioned research from other experts in order to compile an accessible summary of existing knowledge on what determines the effectiveness of student aid policies. This research is available in the College Board/Lumina Foundation for Education publication, *The Effectiveness of Student Aid: What the Research Tells Us.* The group also met with individuals with experience in related areas of public policy reform and with individuals with varying perspectives on student financial aid. The study group chairs, along with project coordinator Kathleen Little, met with many individuals and groups around the country to discuss their ideas about the strengths and weaknesses of existing student aid policies and programs. The proposals outlined in this report were heavily influenced by ideas expressed by participants in those conversations.

Another important element of the process of developing the recommendations put forth in this report was obtaining reliable estimates of the budgetary impact of our proposals. With support from the Spencer Foundation, the Rethinking Student Aid project contracted with the Urban-Brookings Tax Policy Center to model the policy changes and estimate any increases or decreases in costs associated with these changes. Brief summaries of some of these findings are included in the text, and the detailed analyses can be found in the Appendix to this report.

We believe that the policies outlined in this report have the potential to transform the U.S. government's role in supporting access and success in higher education for its citizens. While significant progress in this endeavor also requires major improvements in the elementary and secondary education opportunities available to young people from lower socioeconomic backgrounds, it is urgent that we diminish the bureaucratic hurdles, the information barriers, and the financial

restrictions facing young people and adults aspiring to improve their prospects through postsecondary education.

The Rethinking Student Aid study group would be delighted to see its proposals turned into legislation in the near future. But our immediate goal is to lay the foundation for an innovative and constructive national conversation about improvements in the federal financial aid system. We intend to spend the coming months facilitating and participating in conversations with other knowledgeable and interested individuals and groups who can

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further develop our ideas and promote them on the national agenda.

## A Framework for Reform

Our goal is to design a federal financial aid system that increases enrollment and success rates for low- and moderate-income students. The existing federal financial aid system is complex. The

application process is difficult and the grant, loan, work, and tax benefit policies are poorly integrated and have inconsistent rules and regulations. Too many of the dollars spent fail to increase educational opportunity measurably, and not enough dollars are directed at meaningful increases in educational attainment. Policy reform must address these issues.

A central problem of the existing federal aid system is that it has developed piecemeal, with new programs being devised not with an eye to the effectiveness and coherence of the system

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as a whole, but to meet immediate political demands. Although many aspects of the system work very well and are certainly worthy of being perpetuated, it is critical that we step back, articulate the fundamental principles underlying an effective student aid system, and measure both existing programs and any proposals for change against those principles.

We believe that the following principles should undergird the federal financial aid system:

- 1. The system should have as its main purpose helping those who are unlikely to meet their educational goals without financial help.
- 2. Federal grant aid, in combination with a reasonable amount of work and loans, should be adequate to make completion of a four-year degree financially possible for all qualified students.
- 3. Federal aid should be provided as clearly, transparently, and simply as possible. Communication with families and students about college opportunity should be early, proactive, encouraging, sustained, and accurate.
- 4. Federal aid eligibility should be predictable. Individuals and families in given economic circumstances should be able to anticipate confidently the resources that will be available to meet their needs.
- 5. Programs should be oriented first and foremost to helping students. Concerns about the impact of policy changes on particular institutions such as colleges, banks, or government agencies should take second place.

- 6. Aid policies should be designed to help students not only to begin postsecondary education but also to succeed after they arrive.
- 7. Taxpayer funds should be used as efficiently as possible in advancing the principles set out above.

The Rethinking Student Aid study group sought to develop proposals for reform that would be consistent with the best available research on program effectiveness.<sup>14</sup> We designed these proposals to be comprehensive in their attention to the various components of the federal student aid system and alert to the interactions among those components. Although our focus is on federal student aid, we believe we have been sensitive to the federal government's role as one element in a complex system that includes other major actors, including state governments and individual colleges and universities. In addition, we considered the estimated costs of alternative approaches in the design of our final proposals.

We believe that the financial aid system can and should do more than it now does to make college success available to all who can benefit from it, and to assure that society's investment in higher education goes as far as possible toward improving educational opportunities. We believe that the financial aid system can and should do more than it now does to make college success available to all who can benefit from it, and to assure that society's investment in higher education goes as far as possible toward improving educational opportunities. While student aid cannot be expected to completely eliminate the gaps in college enrollment and completion across socioeconomic groups, it should significantly narrow those gaps. Under the best circumstances, student aid would support college participation patterns that differ only according to precollege achievement levels, not according to financial circumstances. The reforms we advocate aim to increase the proportion of low- and moderate-income students who earn postsecondary credentials.

The proposals are not designed to be short-term fixes, but rather to provide a vision of how a reformed federal student aid system might move the nation's educational agenda forward, in cooperation with states and institutions. In our thinking, we chose not to be bound by short-term political constraints, but we were nonetheless interested in striking a balance between equitable, effective public policy and the potential for broad public support. Thus, while our proposals are designed with the primary goal of reducing income-related gaps in attendance and persistence, they also reflect other realities, including the college financing burden on all but the wealthiest families and rising student indebtedness at all income levels. Implementing the policy changes we recommend requires that these challenges be addressed as well.

Not surprisingly, some of the specific ideas we put forth emerged from difficult conversations and represent significant compromise among members of the group. We grappled constantly with the trade-off between simplicity and transparency on the one hand and precision in allocation of aid on the other hand. Individuals in the group placed different weights on the relative contributions that could be made by reforms in different elements of the aid system. However, we are all convinced that if our proposal for a new approach to federal student aid is implemented, students who face financial barriers to postsecondary education will be winners, and as a result, our economy and American society will be strengthened.

14. The papers commissioned as part of the Rethinking Student Aid project, with the support of Lumina Foundation for Education, are available online at www.collegeboard.com/rethinkingstudentaid. *The Effectiveness of Student Aid: What the Research Tells Us* is also available in print from the College Board.

## Simplification

Calls for simplifying the student aid system have become widespread. The importance of making federal programs more easily understood and more accessible to students is basic to the design of the Rethinking Student Aid recommendations. An easier, more straightforward application system is one aspect of the required simplification, but consolidating and streamlining individual programs is also critical. The number of separate programs providing subsidies to students through grants, loans of various types, tax credits and deductions, and other approaches—each with different eligibility criteria, different coverage of expenses, and different forms of support—has increased dramatically in recent years. A simpler system will remove barriers to receiving federal aid and make the system more transparent, facilitating the provision of early eligibility information to students and families.

The papers in the Rethinking Student Aid research volume conclude that simplifying the federal student aid system is a prerequisite to increasing its effectiveness. This theme appears repeatedly, whether the evidence examined relates to particular forms of student aid, such as grants or loans, or to specific goals, such as promoting persistence or providing opportunities for older students.<sup>15</sup>

## **Applying for Federal Student Aid**

Most discussions of student aid simplification focus on the Free Application for Federal Student Aid (FAFSA). The American Council on Education estimates that 1.8 million U.S. college students who were likely eligible for federal Pell Grants did not apply for aid in 2003-04. The Council's report attributes this phenomenon largely to a combination of complexity and lack of information.<sup>16</sup> The Spellings Commission, in its 2006 report, *A Test of Leadership: Charting the Future of U.S. Higher Education*, recommended "replacing the FAFSA with a much shorter and simpler application." The report went on to suggest that the simplest IRS tax form collects most of the key pieces of data necessary to determine federal aid eligibility.<sup>17</sup> The Institute for College Access and Success in its 2007 report, *Going to the Source: A Practical Way to Simplify the FAFSA*, provided a detailed discussion of the potential for using data from the IRS to pre-fill the FAFSA.<sup>18</sup> An ongoing project involving H&R Block and financial aid researchers has already provided evidence of the effectiveness of using tax data to complete the FAFSA.<sup>19</sup>

Economists Susan Dynarski and Judith Scott-Clayton have analyzed the impact of reducing the number of questions on the FAFSA and find that relying on less detailed information to calculate

<sup>15.</sup> Sandy Baum, Michael McPherson, and Patricia Steele, eds., *The Effectiveness of Student Aid: What the Research Tells Us* (New York: The College Board, 2008).

<sup>16.</sup> American Council on Education, "Missed Opportunities Revisited: New Information on Students Who Do Not Apply for Financial Aid," Issue Brief, February 2006, http://www.acenet.edu/AM/Template.cfm?Section =InfoCenter&CONTENTID=14244&TEMPLATE=/CM/ContentDisplay.cfm.

<sup>17.</sup> Commission on the Future of Higher Education, A Test of Leadership: Charting the Future of U.S. Higher Education, 2006.

<sup>18.</sup> Lauren Asher, *Going to the Source: A Practical Way to Simplify the FAFSA*, The Institute for College Access and Success, 2007, http://www.ticas.org/pub\_view.php?idx=232.

<sup>19.</sup> Eric Bettinger, Bridget Long, and Philip Oreopoulos, "Increasing College Enrollment Among Low- and Moderate-Income Families: An Intervention to Improve Information and Access to Financial Aid" (The H&R Block FAFSA Project, Interim Report, July 2008).

eligibility for Pell Grants would have minimal impact on the distribution of federal grants. They focus on problems related to the timing of the federal aid application and the complexity of the system and make the case that the students most negatively affected are from low-income backgrounds. They recommend an eligibility system that would rely on much more limited data and would be more transparent than the current Federal Methodology.<sup>20</sup>

Congress has begun to respond to calls for simplification. The reauthorization of the Higher Education Act in 2008 calls for a simple version of the FAFSA for students and families with few financial resources. Additional provisions specify an earlier application processing calendar and the pre-population of the FAFSA using IRS data. While these simplification provisions are well intended, more fundamental changes are required to permit families to predict accurately their eligibility for federal student aid in advance of colleges' award notifications.

## A Simpler FAFSA Is Not Enough

The Rethinking Student Aid study group recommends a more significant change in the application process than most of these proposals suggest. *Congress should eliminate the FAFSA and retrieve the financial data required for Pell Grant allocation from the Internal Revenue Service (IRS)*. Parents

Eliminate the FAFSA and retrieve from the IRS the financial data required to establish Pell Grant eligibility. and students who wish to apply for federal financial aid would provide simple demographic information on a new form that includes an authorization for the IRS to release tax information to the Department of Education. The study group further recommends that only Adjusted Gross Income and family size (number of exemptions) be used to determine a student's eligibility for Pell Grants, as described later in this report.

Families receiving means-tested public benefits, such as Temporary Assistance for Needy Families (TANF), would be eligible for maximum Pell Grants without use of IRS data. Non-tax filers would fill out simple tax forms (or an alternative simple form) to apply for student aid, rather than the longer, more complicated application form that is currently required. As detailed in the following sections of this report, Pell Grants would be the only federal student aid for which eligibility would be based on this financial information.

We recognize that some states and institutions may require more detailed income information to determine eligibility for their own funds. Many currently rely on the federal computation of an expected family contribution (EFC) as the basis for allocating their student aid. To address this need, the release statement would authorize the IRS to provide more detailed financial information to the Department of Education, which the Department would make available to the states and institutions designated by the student on the new form. *In addition to providing data from the tax form, the Rethinking Student Aid study group proposes that the Department of Education calculate an index of financial capacity for use by states and institutions designated by the student to allow states and institutions to allocate need-based aid as they deem appropriate.* This approach would relieve aid applicants of the burden of supplying more detailed financial information from their own records, but would provide the information needed by states and institutions in a simple, transparent way. It would also relieve financial aid offices of the burden of verifying the data provided on the FAFSA.<sup>21</sup>

<sup>20.</sup> Susan Dynarski and Judith Scott-Clayton, "College Grants on a Postcard: A Proposal for Simple and Predictable Federal Student Aid" (Hamilton Project Discussion Paper 2007-01; KSG Faculty Research Working Paper Series RWP07-014, March 2007).

<sup>21.</sup> Aid applicants whose financial circumstances make them exempt from filing federal income taxes could be automatically considered eligible for maximum financial aid, or could be asked to report their annual income on a very simple form.

The government must ensure that limited Pell Grant dollars are awarded as equitably as possible to students with the greatest need. Using IRS data would help the government achieve that goal. *The Rethinking Student Aid study group proposes to use an average of the most recent three years of income information, adjusted for inflation, to provide a more reliable picture of the student's or parents' financial circumstances.* This approach will diminish changes in eligibility resulting from unstable income levels and minimize the possibility of shifting income to "game the system." Using three years of income is not practical when students and parents supply financial information on the FAFSA, but the IRS can easily supply the data.

Congress recognizes in the 2008 reauthorization legislation that families should be able to estimate their eligibility for federal student aid at an early point in time, and the Department of Education has implemented the FAFSA 4caster tool on its Web site to help potential students estimate their aid eligibility. However, the tool requires detailed financial information, and assumes that parents who need the information the most will go to the Web to find it. A more proactive solution would use the federal tax system to facilitate early notification to families of the federal aid for which

they are likely to be eligible. *The Rethinking Student Aid study* group recommends that tax filers with dependent children between the ages of 5 and 19 be informed every year of the Pell Grant for which their children would be eligible under the applicable program eligibility rules. This information should be accompanied by facts about the prices of two- and four-year public institutions within the tax filer's state of residence, as well as available state grant programs. Additional information should encourage academic preparation and college savings, and provide information on borrowing opportunities, as well

Notify tax filers and recipients of meanstested federal income support programs who have dependents between ages 5 and 19 of their children's probable Pell Grant eligibility under prevailing program rules.

as tax credits for which the filer would qualify. These early communications could be accomplished by adding a simple check-off box to the IRS forms, giving the IRS permission to release income information to the Department of Education, which would communicate directly with the family. Similar communications could be disseminated through each state's office of public benefits to recipients.

Sending all parents information on college affordability long before their children are old enough for college will provide encouragement to low- and moderate-income families that college is affordable and provide more affluent parents with realistic information to encourage precollege planning. Our proposed annual communication will also raise college awareness and encourage academic preparation for children from families where neither parent has attended college.

## **Making Pell Grants More Predictable**

The Pell Grant program is the foundation of the federal student aid system. In 2006-07, the federal government distributed about \$13 billion in Pell funds to 5.2 million low- and moderate-income students. Almost 60 percent of these recipients were independent students, whose parents are not required to support their college education. Among the dependent students, almost all came from families with annual incomes below \$50,000 per year. Pell Grants account for about two-thirds of federal grant aid to students. Aid to veterans and military grants make up another 27 percent of these subsidies.<sup>22</sup>

While researchers have not been able to document the expected benefit of the Pell Grant program, there is strong evidence that simple, well-understood grant aid can have a significant impact on the college enrollment rates of low-income students. As David Mundel concluded in his paper on the

22. The College Board, Trends in Student Aid 2007 (New York: The College Board, 2007).

effectiveness of grant aid written for the Rethinking Student Aid project, "large, predictable, and easy to understand grant programs (like the Social Security, GI Bill, Georgia Hope, and DC Tuition Assistance Grant programs) have had observable and substantial effects on college enrollment rates and patterns. The Pell program and many other grant programs have few of these efficacy-increasing operational characteristics...With respect to complexity—the Pell program was complex when first implemented and if anything, became increasingly complex over time."<sup>23</sup>

The Rethinking Student Aid study group recommends that the eligibility criteria for Pell Grants be dramatically simplified to rely only on Adjusted Gross Income (AGI) and family size. This simple calculation will allow the creation of a look-up table to which students and families can refer far in advance of their application for student aid. This system will inevitably award Pell Grants to some tax

Compute Pell Grant eligibility using only AGI and family size. filers with complicated financial situations whose low Adjusted Gross Income masks other financial resources. However, as detailed in Appendix Table A3, this phenomenon is extremely rare on returns reporting low positive AGI. It is more common among those with negative AGI, but only about 1 percent of

filers fall into this category. The complexity for all applicants resulting from provisions designed to deny Pell Grants to such a small number of people would violate the fundamental nature of the proposed reform.

Instead of being informed of their expected family contribution (EFC) as is currently the practice, the formula will yield a Pell award amount. For a maximum Pell Grant of \$5,000, the look-up table for a family of four might be as follows:

% of poverty	Income	Pell Award
	\$0	\$5,000
150%	\$31,800	\$5,000
160%	\$33,920	\$4,500
170%	\$36,040	\$4,000
180%	\$38,160	\$3,500
190%	\$40,280	\$3,000
200%	\$42,400	\$2,500
210%	\$44,520	\$2,000
220%	\$46,640	\$1,500
230%	\$48,760	\$1,000
240%	\$50,880	\$500
250%	\$53,000	\$0

 Table 2: Possible Pell Grant Look-Up Table for Dependent Students,

 \$5,000 Maximum Grant

The formula underlying this table provides the maximum Pell Grant to any dependent student whose family income is at or below 150 percent of the poverty level for the relevant family size. The grant amount declines by 24 cents for each dollar increase in income, reaching \$0 at 250 percent of

23. David Mundel, "What Do We Know About the Impact of Grants to College Students?" in *The Effectiveness of Student Aid: What the Research Tells Us*, edited by Sandy Baum, Michael McPherson, and Patricia Steele (New York: The College Board, 2008).

the poverty line. Because the poverty line is indexed for inflation, the Pell Grant amounts accruing to students at different income levels will automatically rise as prices in the economy rise.

In comparison to the current Pell Grant program, which reached 5.2 million students in 2006-07 and is anticipated to cover an estimated 5.5 million students in 2008-09 with a maximum grant of \$4,731, this formula would make about 5.2 million students eligible for Pell Grants in 2008-09. The aid now going to students with incomes higher than 250 percent of the poverty level would be redirected to lower-income students. Total federal expenditures would be \$16.2 billion, compared to \$16.0 billion under current law (and \$12.9 billion in 2006-07 when the maximum grant was \$4,050).<sup>24</sup>

In order to cover the same proportion of the average cost of attendance at a public four-year college as it did 30 years ago, the maximum Pell Grant would have to be about \$10,000. A more generous Pell program would extend over a broader range of incomes. Table 3 illustrates a formula that would cover an additional one million students per year at a total cost of approximately \$34.5 billion. The program's cost would, of course, be higher if the more generous Pell Grants were successful in inducing more low-income students to attend college.

% of poverty	Income	Pell Award
	\$0	\$10,000
150%	\$31,800	\$10,000
160%	\$33,920	\$9,333
170%	\$36,040	\$8,667
180%	\$38,160	\$8,000
190%	\$40,280	\$7,333
200%	\$42,400	\$6,667
210%	\$44,520	\$6,000
220%	\$46,640	\$5,333
230%	\$48,760	\$4,667
240%	\$50,880	\$4,000
250%	\$53,000	\$3,333
260%	\$55,120	\$2,667
270%	\$57,240	\$2,000
280%	\$59,360	\$1,333
290%	\$61,480	\$667
300%	\$63,600	\$0

**Table 3:** Possible Pell Grant Look-Up Table for Dependent Students,\$10,000 Maximum Grant

A similar formula would apply to independent students, as illustrated in Table 4, which applies to single independent students. Grants would be higher for independent students with dependents.

<sup>24.</sup> These data are based on estimates from the Urban-Brookings Tax Policy Center conducted for the Rethinking Student Aid project. Lowering the income level at which the amount of the Pell Grant award begins to decline would allow the lowest-income students to receive larger grants. Maintaining the schedule in Table 2 but increasing awards to \$7,500 for those with incomes at or below 100 percent of the poverty line would have no effect on the number of recipients, but would increase the estimated 2008-09 cost of the program from \$16.2 to \$21.1 billion.

% of poverty	Income	Pell Award
	\$0	\$5,000
150%	\$15,600	\$5,000
160%	\$16,640	\$4,500
170%	\$17,680	\$4,000
180%	\$18,720	\$3,500
190%	\$19,760	\$3,000
200%	\$20,800	\$2,500
210%	\$21,840	\$2,000
220%	\$22,880	\$1,500
230%	\$23,920	\$1,000
240%	\$24,960	\$500
250%	\$26,000	\$0

**Table 4:** Possible Pell Grant Look-Up Table for Single Independent Students,\$5,000 Maximum Grant

As noted in the discussion of simplification of the application process above, reliance on IRS data will permit use of multiple years of data without increasing the burden on students and families.

Diminish the negative impact of student work on the Pell Grant eligibility for independent students. The Rethinking Student Aid study group recommends that Pell Grant eligibility be based on an (inflation-adjusted) average of three years of income. The use of three years of income is particularly important for independent students. The current Federal Methodology embodies a severe penalty on students who work. For each extra dollar of income earned while in school, students stand to lose 50 cents of Pell Grant funding.

Although the table proposed here appears to incorporate a similar marginal assessment rate, reliance on three years of data will significantly diminish this problem. A student who earns an extra dollar during the school year or over the summer will find his three-year average income increasing by only 33 cents, leading to a much smaller reduction in Pell eligibility. He could earn the extra amount for three consecutive years before the full impact on his Pell eligibility took effect. Reducing the impact of higher student earnings on Pell Grant eligibility is an important component of the proposed reform.

This simple formula for Pell eligibility will make these basic grants easy to understand and predictable for students. As Saul Schwartz argues in his paper on early commitment of financial aid in *The Effectiveness of Student Aid: What the Research Tells Us*, the simplest early commitment program is likely to be the advance knowledge of Pell Grant eligibility.<sup>25</sup>

The maximum value of the Pell Grant has increased sporadically over time. In order to provide both adequate and predictable funding, the maximum Pell Grant must increase ndex the maximum Pell Grant to the CPI.

automatically. *The Rethinking Student Aid study group recommends indexing the maximum Pell Grant to the Consumer Price Index (CPI).* Since the poverty level is also indexed to the CPI, this practice will allow the Pell eligibility amounts described in the above tables to maintain their real, inflation-adjusted levels over time.

25. Saul Schwartz, "Early Commitment of Student Financial Aid: Perhaps a Modest Improvement," in *The Effectiveness of Student Aid: What the Research Tells Us*, edited by Sandy Baum, Michael McPherson, and Patricia Steele (New York: The College Board, 2008).

Over time, the federal student grant system has also been complicated by the addition of new

programs related to Pell, but with somewhat different eligibility requirements. In 2006-07, about 7 percent of Pell Grant recipients began to receive Academic Competitiveness and SMART grants, which are based on academic criteria in addition to financial criteria.<sup>26</sup> *We propose eliminating supplementary grant programs with complex eligibility requirements and using the funds to increase the generosity of Pell Grants*. This program consolidation will reduce confusion among students, paperwork

Consolidate federal grant programs for Pell Grant recipients into a more generous Pell Grant for all low- and moderate-income students.

for colleges, and the federal bureaucracy. Moreover, this change will return the focus of the core federal grant program to increasing educational opportunities for low- and moderate-income students.

## **Estimated Costs and Distribution of Proposed Pell Grant Modifications**

Detailed cost estimates are provided in the Appendix. They indicate that using the simplified Pell formula described above and depicted in Table 2, with a maximum grant of \$5,000, would reduce the total number of recipients by about 5 percent compared to the current policy with a maximum grant of \$4,731, because the maximum income for eligibility would be capped at 150 percent of the poverty line. This approach would increase expenditures compared to the current system with a maximum of \$4,731 by only about \$0.2 billion, or roughly 1 percent of current spending. The proposed changes would have little effect on the distribution of Pell Grants either across family income groups or higher education sectors. Raising the maximum Pell to \$10,000 would of course increase expenditures dramatically relative to the cost of the program with a \$5,000 maximum, more than doubling estimated expenditures to \$34.5 billion.<sup>27</sup>

## **Tax Credits and Deductions**

The Tax Reform Act of 1997 created two new tax credits for higher education expenditures. Since 2000, there has also been a federal tax deduction allowed for tuition and fee expenses.<sup>28</sup> Taxpayers must choose among the Hope Tax Credit, the Lifetime Learning Tax Credit, and the Tuition Tax Deduction. The president's budget for fiscal year 2008 includes \$6.7 billion in foregone tax revenues for these three education tax benefits.<sup>29</sup>

As Andrew Reschovsky reports in his paper on education tax benefits in the Rethinking Student Aid research volume, *The Effectiveness of Student Aid: What the Research Tells Us*, the limited available research casts doubt on the effectiveness of these benefits.<sup>30</sup> Bridget Long's analysis found that the

<sup>26.</sup> National Association of State Student Grant and Aid Programs, 2006-07 Academic Competitive Grants and SMART Grants by State, Excel table.

<sup>27.</sup> Based on estimates from the Urban-Brookings Tax Policy Center conducted for the Rethinking Student Aid project. Lowering the income level at which the amount of the Pell Grant award begins to decline would allow the lowest-income students to receive larger grants. Maintaining the schedule in Table 2 but increasing awards to \$7,500 for those with incomes at or below 100 percent of the poverty line would have no effect on the number of recipients, but would increase the estimated 2008-09 cost of the program from \$16.2 to \$21.1 billion.

<sup>28.</sup> At the time this report is going to press, the tuition tax deduction has expired, and it is unclear whether or not Congress will reinstate it.

<sup>29.</sup> Office of Management and Budget, Budget of the United States Government, *Analytical Perspectives*, Federal Receipts and Collections (288), http://www.whitehouse.gov/omb/budget/fy2008/pdf/apers/receipts.pdf.

<sup>30.</sup> Andrew Reschovsky, "Higher Education Tax Policies," in *The Effectiveness of Student Aid: What the Research Tells Us*, edited by Sandy Baum, Michael McPherson, and Patricia Steele (New York: The College Board, 2008).

introduction of the tax credits did not increase the probability that eligible individuals would attend college.<sup>31</sup> Explanations for this problem include the reality that the tax credits and deductions provide subsidies after taxes are filed, long after most payment for college expenses has occurred. In addition, these subsidies are directed toward middle- and upper-income taxpayers who generally do not face significant financial barriers to enrolling in postsecondary education. Almost half of the benefit of the tax deduction goes to taxpayers with incomes above \$100,000. Almost 60 percent of the tax credits go to taxpayers with incomes above \$50,000, with the remaining 40 percent going to those with lower incomes.<sup>32</sup> According to the Government Accountability Office (GAO), about 20 percent of those who would be eligible for the tax benefits fail to claim them.<sup>33</sup>

Despite the apparent ineffectiveness of these tax benefits in increasing college participation, the tax credits do provide subsidies to middle-income families for whom paying for college is a challenge. As noted above, the tax credits are much better targeted on this group than is the tax deduction. *The Rethinking Student Aid study group recommends combining the existing tuition tax credits and* 

Combine the existing tax credits and tax deductions into a single tax credit with a standard allowance for nontuition expenses. *deductions into one tax credit.* In addition to improved targeting, having only one such benefit will significantly simplify the system, making it easier for potential beneficiaries to understand and predict their benefits. It is likely that, as GAO has suggested, participation<sup>34</sup> rates would increase under this scenario without compromising benefits to middle-income families.

One reason current tax provisions do not provide much benefit to lower-income taxpayers is that they are nonrefundable. Benefits are available only to the extent that the student or family has a federal income tax liability from which the credit can be subtracted. Another problem is that the credits and deduction apply only to tuition and fee payments, not to room and board, books, or other costs of attending college. Because a significant percentage of low-income students receive grant aid to help defray their costs, and the law requires this grant aid to be applied to tuition first for purposes of the tax benefits, these students are generally ineligible for the credits and deductions even if they do have tax liabilities. This is particularly true if they attend low-price public colleges. For this reason, even a refundable tax credit applicable only to tuition and fees would not be likely to bring many new students into eligibility.<sup>35</sup> We do not propose making these credits refundable because we believe that grant aid is the most effective way to subsidize low-income students and that the substantial dollars required to make the credits refundable would be better spent on Pell Grants or the other programs proposed in this report.<sup>36</sup>

The Rethinking Student Aid study group recommends that the tuition tax credit be applicable not only to tuition and fees, but to the total cost of attendance for postsecondary students. Measuring the room and board charges paid to institutions by students residing on campus is not difficult. It is more difficult to assess the relevant costs for non-residential students. The simplest approach to this problem is to determine a fixed annual cost for non-tuition expenditures and allow all full-time

 U.S. Government Accountability Office, "Multiple Higher Education Tax Incentives Create Opportunities for Taxpayers to Make Costly Mistakes" (May 2008), http://www.gao.gov/highlights/d08717thigh.pdf.
 Ibid.

35. Andrew Reschovsky, "Higher Education Tax Policies," in *The Effectiveness of Student Aid: What the Research Tells Us*, edited by Sandy Baum, Michael McPherson, and Patricia Steele (New York: The College Board, 2008).

36. Estimates of the budgetary impact of refundable tax credits can be found in Appendix, Table A4.

<sup>31.</sup> Bridget Long, "The Impact of Federal Tax Credits for Higher Education Expenses," in *College Choices: The Economics of Which College, When College, and How to Pay For It,* edited by Caroline M. Hoxby (Chicago: University of Chicago Press and the National Bureau of Economic Research, 2004).

<sup>32.</sup> The College Board, Trends in Student Aid 2007 (New York: The College Board, 2007).

students to consider this charge in calculating their tax credits. Costs would be prorated for part-time students.

## **Budgetary Impact of Proposed Changes in Education Tax Benefits**

The implications for the federal budget of consolidating the tax credits will, of course, depend on the size of the credit that is implemented. According to the cost estimates detailed in the Appendix to this report, repealing the tuition tax deduction and the Lifetime Learning Credit while extending the Hope Tax Credit to all degree or credential-seeking students would add just under \$1 billion to the program's cost. Covering non-tuition expenses would increase the budget impact from \$8.6 to \$13.9 in 2008-09. Making the credit fully refundable would more than double the cost to the government. Relying only on a credit and not a deduction will shift the subsidy down the income distribution, and allowing non-tuition expenses to be covered will strengthen this effect. The study group does not recommend increasing the overall subsidy provided to taxpayers through this policy by more than the amount required to extend the current Hope credit to students who would become eligible through coverage of non-tuition expenses.

## **Protecting Students Against Unmanageable Loan Burdens**

An improved federal student aid system will provide more generous grant aid to students who lack the financial resources necessary for successful participation in and completion of postsecondary education. Reliance on loans among students from low- and moderate-income families cannot continue to increase without negative consequences. However, most students will continue to depend on loans to supplement the combination of their own and their family's resources and available grant aid. It is important that the federal government provide ample access to loan funds for all students and that the terms of these loans be favorable enough to minimize both resistance to debt among promising potential students and oppressive debt burdens for former students, including those who do not successfully complete degrees or whose career paths do

not meet their expectations.

Another important component of the federal student loan program is easily accessible information for potential borrowers. Students must understand the impact of interest on the amount they will repay and the implications of alternative repayment schedules for both monthly payments and total payments over the life of the loan. With a better-designed loan program, more The distribution of subsidies to students should be based primarily on financial circumstances *after* college rather than on student and/or family resources *before* college.

students will benefit from the opportunity of borrowing to fund their investments, while successfully carrying out their repayment responsibilities.

We believe an effective student loan system should be based on the following principles:

- 1. The distribution of subsidies to students should be based primarily on financial circumstances *after* college rather than on student and/or family resources *before* college.
- 2. Students should be assured that their loan repayment obligations will not exceed a specified percentage of their incomes.
- 3. Loan limits should be high enough to prevent excessive reliance on alternative loans with less favorable terms and without the borrower protections provided by the federal government. Higher loan limits can also obviate the need for multiple federal student loan programs.

As of July 1, 2009, an improved Income-Based Repayment (IBR) plan for federal student loans will be available. The IBR plan embodies many of the basic components the Rethinking Student Aid study group considers important. Under the new IBR plan, no payments will be due if the borrower's income (combined with the borrower's spouse's income if applicable) does not exceed 150 percent of the poverty line for the relevant family size. The payment due will be no more than 15 percent of the amount by which income exceeds this threshold.<sup>37</sup> These are sound parameters that should be maintained. The detailed provisions of the IBR program must also be designed carefully to facilitate responsible and successful repayment.

Income-based repayment is critical to being able to assure students that their education debt will not be overly burdensome. However, because most borrowers do not find themselves with excessive debt/income ratios and because of the complications involved with continual verification of income, we do not recommend that all loans automatically enter IBR. *The Rethinking Student Aid study group recommends that a graduated repayment plan be the standard loan repayment pattern, unless a borrower chooses another option.* Borrowers will repay amounts that increase gradually until the debt is repaid. For the typical borrower, earnings will increase as he or she gains more experience in the labor market, so graduated repayment will lead to more consistent proportions of income being devoted to debt retirement. This structure will reduce the number of borrowers who experience financial hardship or default on their student loans.

## **Income-Based Repayment**

Design income-based repayment to ease the difficulties faced by borrowers facing long-term financial hardship. A well-developed income-based repayment (IBR) program is critical to protecting former students from undue debt burden. The Rethinking Student Aid study group recommends strengthening the new Income-Based Repayment (IBR) program and making it clearer and more easily accessible to all borrowers who would benefit from it. Information about the availability and provisions of this program must be straightforward and widely

distributed. Transferring into IBR has to be simple and quick in order to meet the needs of students whose circumstances change unexpectedly. A satisfactory IBR program must also be designed to ease the process through which borrowers who have defaulted can regain good standing and to minimize the difficulties faced by permanently disabled borrowers.

Under the current IBR program, a borrower's payments are first applied to interest due, then to any loan fees due, and finally toward the principal. The government will pay any remaining interest on subsidized loans for up to three years. This provision should be retained, covering all Stafford Loans, but a provision should be added limiting the size of the total debt that can result from accrued interest and fees to 150 percent of the original loan principal. A limit of this sort will prevent borrowers already under financial strain from seeing the amount of their debt skyrocket even as they conscientiously make the required payments. The remaining debt of borrowers in the IBR program would be forgiven after 20 years (not the current 25 years). The burden on borrowers who are unlikely to make reductions in their loan balances after an extended repayment period, as well as the burden on the government of continuing to seek these payments, makes pursuing borrowers beyond 20 years simply not worth it. The amount forgiven should not be taxable.

<sup>37.</sup> At the time of this writing, proposed federal regulations for the new Income-Based Repayment program combine the income of the borrower and the borrower's spouse, but allow each partner to repay up to 15 percent of this combined income each year. This approach violates the intent of the system and would not be maintained under our proposal.

## **Loan Limits**

Existing federal loan limits for undergraduates are not high enough to meet the borrowing needs of many students. About 5 percent of undergraduates relied on private student loans in 2003-04<sup>38</sup> and this number has certainly increased since then as the proportion of undergraduate loans coming from private lenders increased from 19 percent to 29 percent between 2003-04 and 2006-07.<sup>39</sup> In addition, many students also rely on credit cards to supplement their education loans.<sup>40</sup> Nonfederal loans generally come with higher interest rates and less generous borrower protections than federal loans. Students without strong credit ratings or cosigners are particularly vulnerable. As a result, inadequate availability of federal loans has a significant adverse impact on low- and moderate-income students.

The Rethinking Student Aid study group recommends that full-time students be eligible to borrow up to the amount of the federal poverty guideline for a single individual for each year of study. This amount was \$10,210 in 2007.<sup>41</sup> Linking the loan limit to an independent basic living standard recognizes that students incur the costs of housing, food, and other day-to-day expenses during periods of enrollment. This approach also eliminates any Full-time students should be eligible to borrow up to the amount of the federal poverty guideline for a single individual for each year of study.

potential link between federal loan limits and tuition prices. Eligibility should be in the form of a line of credit so that a student who does not borrow the full amount allowed in the first year can carry the available credit over into future years. This is important so that students will not be motivated to borrow more than necessary in the early years for fear of running out of available credit. A maximum of five full years of credit would be available for undergraduate study, with available credit prorated for part-time students, including those enrolled less than half time.

The Rethinking Student Aid study group recommends that Parent Loans for Undergraduate Students (PLUS) should continue to be widely available, and the terms should be accommodating enough to prevent parents from relying more heavily on student borrowing. Student loans should be available on favorable terms and with ample borrower protections in order to meet the needs of all students. However, policies should be designed to encourage parents who are in a position to provide support for their children to do so.

## **Loan Subsidies**

The Rethinking Student Aid study group recommends eliminating the distinction between subsidized and unsubsidized Stafford Loans. Consistent with the principle that the focus of the subsidy on student loans should be on diminishing the burden of repayment, generous repayment protection will replace the in-school subsidy. There is no evidence that eliminating inschool interest is critical to enrollment decisions. The most important consideration is how much the student will owe at the completion of studies. Estimates of this amount, including interest that may accrue, should be explicit.

**E** liminate the distinction between subsidized and unsubsidized Stafford Loans, focusing subsidies on former students who are struggling to repay their loans and eliminating necessity for a federal need-analysis system to distribute student loans.

<sup>38.</sup> National Postsecondary Student Aid Study (NPSAS) (2003-04). Calculations by authors.

<sup>39.</sup> The College Board, Trends in Student Aid 2007 (New York: The College Board, 2007).

<sup>40.</sup> Nellie Mae, Undergraduate Students and Credit Cards in 2004: An Analysis of Usage Rates and Trends (2005).

<sup>41.</sup> U.S. Department of Health and Human Services, *The 2007 HHS Poverty Guidelines*, http://aspe.hhs.gov/poverty/07poverty.shtml. Accessed August 7, 2008.

Eliminating the distinction between the two Stafford Loan programs means that a federal needanalysis system will not be necessary for the allocation of student loans. As discussed above in the section on Pell Grants, although it will be possible to calculate an index of financial capacity for use by states and institutions, Pell Grant awards will be based on a simple formula embodied in a lookup table. Requiring a more complicated need-analysis system in order to allocate in-school interest subsidies on student loans undermines simplification efforts.

The Rethinking Student Aid study group recommends that the interest rate on Stafford Loans be flexible but lower than market rates for all students. It is appropriate for the federal government to subsidize student borrowers to some extent, since the lack of collateral makes them vulnerable to high rates in the market. However, there is no reason why taxpayers should bear a particularly high share of the cost of student loans during periods of time when interest rates on mortgages and consumer debt are higher. Similarly, students should not pay higher fixed interest rates when market interest rates are low.

## **Budgetary Impact of Proposed Student Loan Reforms**

Estimates from the Department of Education indicate that eliminating the in-school interest subsidy on Stafford Loans for undergraduates and graduate students would save about \$8 billion in 2008-09, assuming loan limits increase as proposed by the Study Group. Because unsubsidized Stafford Loans carry no cost in the federal budget at this time, increasing the loan limits under this scenario would not require additional federal resources. Further details of the estimated budgetary impact of the proposals described here can be found in Appendix Table A7

## **Savings Plans for Low- and Moderate-Income Parents**

In 1996, the federal government introduced a new vehicle to encourage families to save for college. This legislation allows families to set aside funds in special 529 plans on which interest accumulates tax free. Since 2002 these funds can be spent on a family member's college expenses tax free. These 529 accounts have proved popular and have grown rapidly. In 2007, 10 million 529 accounts held average assets of over \$12,000 that could be used to pay college expenses.<sup>42</sup> An appealing feature of these plans is that they help make planning for college a reality for families when their children are young, building their confidence that their children can and will go to college, and promoting the idea that academic preparation should be in step with financial preparation.

Unfortunately, very few low- and moderate-income families participate in these plans. This is partly because tax deductions are of less value to lower-income families who face lower tax rates or have no income tax liability. But the main reason few of these families fail to participate is simply that they do not have the discretionary funds required to save. To the degree that they do save, it is through building equity in their homes.<sup>43</sup> Moreover, the terms of 529 plans, which include penalties for withdrawal for non-education expenses, make them risky for many low-income families. These families are both more likely to be forced to withdraw any savings for emergency use and less confident that their children will actually go to college. This reality is unfortunate not only because it implies that these families are deprived of a subsidy available to their more affluent fellow citizens, but also because they miss out on the encouragement of early academic and financial planning for college that results from knowing that money is being put aside for their children's education.

<sup>42.</sup> The College Board, Trends in Student Aid 2007 (New York: The College Board, 2007).

<sup>43.</sup> Susan Dynarski, "Who Benefits from the Education Saving Incentives? Income, Educational Expectations, and the Value of the 529 and Coverdell," NBER Working Paper No. <u>10470</u>, May 2004, and *National Tax Journal* 57(2), (2004).

The Rethinking Student Aid study group proposes to address the limitations in the existing 529 plans by developing a parallel federal college savings program designed to assure the participation

Develop a federal college savings program parallel to existing 529 savings accounts that creates an account for every young person whose parents would qualify to receive a Pell Grant according to their most recent tax return. of families who don't have the wherewithal to undertake saving on their own. The proposed program would create a fund holding a savings account established by the federal government for every young person who, if they were enrolled in college, would qualify to receive a Pell Grant according to their parents' most recent tax return or based on their eligibility for meanstested federal income support programs. These accounts would accumulate interest tax-free and could be drawn on tax-free by the beneficiary to meet college expenses. They could not be used, even with penalties, for any other purpose.

The Rethinking Student Aid study group further proposes that every year the federal government deposit funds equal to a proportion of the Pell Grant for which the dependent child would be eligible that year. Under the new, simplified Pell allocation formula, this amount would be easily determined from income tax forms. For example, a family that would qualify for a \$5,000 Pell Grant in a given year might receive a contribution to college savings of 10 percent of that amount, or \$500 for each child of qualifying age. A family with more income that qualified for a \$3,000 Pell Grant would

receive a \$300 contribution. The account will earn interest, and the family will receive annual written notification of the amount of college savings in the student's name.

We believe that these accounts, explicitly targeted by the federal government to provide money for college for low-income children, have the potential to change significantly the way parents view their children's prospects for education. Imagine the impact on the single mother of a seven-year-old who receives a The size of the federal contribution should be proportional to the size of the Pell Grant for which a family with that income and family size and a college-age child would qualify.

letter informing her that the federal government has just put aside \$250 toward the college education of that child and that this money will earn interest until the child is ready to enroll. Today, most affluent families see a college education for their children as a natural part of the growing-up process, something like a birthright. The program we propose here can help weave the expectation of college into the fabric of growing up in America, not just for affluent families, but for all families.

Programs based on similar ideas have been implemented both in other countries and in some states. Through the Canada Learning Bond program, the Canadian government deposits funds into accounts for children from low-income families and makes additional deposits as long as the family continues to qualify.<sup>44</sup> The Kentucky Educational Excellence Scholarship, in existence since 1998, makes annual awards to high school students based on their grade point averages. The funds available at the time of college enrollment depend on how much students have accumulated over their high school years. The states of Michigan and Oklahoma are among those that provide matching funds for some of the 529 college savings of low- and middle-income families.

Depending on the amount of money going into these accounts, this savings program, once fully implemented, would establish a financial base for people to use in paying for college. That of course is exactly the role that Pell Grants are intended to play. After this savings program had operated for a sufficient number of years, almost everybody who had grown up in the United States and would qualify for a Pell Grant at the time of applying to colleges would bring a savings account with them. Thus, while in the short run the savings program we advocate constitutes a complement to the Pell

<sup>44.</sup> Human Resources and Social Development Canada, Canada Learning Bond, http://www.hrsdc.gc.ca/en/ learning/education\_savings/public/clb.shtml. Accessed August 7, 2008.

program, in the long run, if funded generously enough, it could function as a replacement for it. In other words, the Pell Grant program and a federally funded savings account program represent two alternative ways of providing funds for people whose family resources will not support college expenses. Of course changing from one system to the other requires managing a long transition period. We are not advocating such a transition as a specific policy goal; we only want to note that it provides a fresh perspective on the challenge of helping low-income people pay for college.

Over the long run, the savings account approach has two substantial advantages over a financial aid grant program. First, the Pell Grant program bases its assessment of family ability to pay on a snapshot of recent income experience. Under the savings approach, the nest egg for paying for college accumulates over time, in proportion to family ability to pay over the entire period that children are approaching college age. This longer temporal perspective is likely to be both fairer and more efficient than the snapshot approach. The accumulation of experience with a modest savings program like the one we propose would provide a useful basis for deciding whether a larger movement in this direction is desirable.

The federal savings accounts would remain available to individuals from low- and moderate-income backgrounds who postponed their undergraduate education until later in life. The second advantage is that the accumulated funds in a savings account automatically provide resources for adult and independent students. People who grow up in low-income families but don't go to college right away will still have their accounts intact and continuing to accrue interest. In other words, as this program matures, it provides a means of subsidizing adults who come from disadvantaged families more generously than other adults who have postponed their undergraduate education.

The accounts in question would be, like Social Security accounts, commitments by the federal government to pay the specified amounts when the requirements for payment are met. Notice that these accounts actually pay off (and therefore cost the government money) only for people who go to college. At current rates of attendance by low-income students, and prorating the cost of part-time enrollment, only about 55 percent of these notional accounts would be claimed within a year after high school graduation, and not all of these accounts would be fully depleted.<sup>45</sup> Additional accounts would be claimed by older returning students. While we intend that this rate of attendance will rise in response to the program, it is likely (albeit unfortunate) that only a portion of the promises represented by these accounts would ever be cashed.

A final set of issues concerns the disbursement of the proceeds. We recommend that the funds should be available to pay for both tuition and other college expenses. Students should not be allowed to spend out their savings accounts too rapidly. Students could be limited to spending a maximum of one-quarter of the total accumulation on full-time first year attendance, one-third of the remaining funds on second-year attendance, and so on. The funds could only be used for expenditures on undergraduate education, not for any further education after obtaining a bachelor's degree.

## Estimates of the Cost of a Savings Program for Low-Income Families

We estimated the cost of our savings program for several different starting ages and for two different levels of contribution for individual families. We began by studying the estimated annual cost of a program that would provide annual contributions equal to 10 percent of the Pell Grant for which the family would qualify, beginning when the child was age 12. We found that at current college participation rates for eligible families, this program would reach 12.6 million families and would cost about \$2.8 billion per year. If the program raised the college participation rate of children from

<sup>45.</sup> Sandy Baum and Jennifer Ma, Education Pays 2007 (New York: The College Board, 2007).

these families from the current 54 percent to 60 percent, the cost would rise to about \$3.1 billion annually. A program that provided 25 percent of Pell would change these numbers to \$7 billion at current participation rates and \$7.8 billion with the higher participation rate. Of course starting at an earlier age boosts these costs substantially. For example, the version of the estimates that has a cost of \$2.8 billion per year when it starts with 12-year-olds would, when fully in place, cost \$7.3 billion if funding began at the child's birth. Details of the estimates are provided in the Appendix.

## **Incentives for States and Institutions**

While our focus is on the federal role in student aid, that role includes undertaking intelligent policies that will influence other actors in the higher education system. States and institutions clearly have a responsibility for being active and constructive partners in the assurance of affordable educational opportunity. We believe that the federal government has an important role in encouraging states to use their available aid funds for students who need help as well as in encouraging institutions to focus their funds and their energies not just on enrolling disadvantaged students, but in helping them to succeed.

## Encouraging Simple Programs of State Support for Low- and Moderate-Income Students

The federal government currently provides a small amount of funding to states (\$74 million in 2006-07) through the Leveraging Educational Assistance Partnership (LEAP) Program in the form of matching grants for state need-based grants and community service work-study assistance. The principle of providing incentives for states to direct funds toward students with financial need is both important and consistent with the goals and principles of the Rethinking Student Aid proposals. When this program was initiated (as the State Student Incentive Grant or SSIG Program) in 1974, few states had need-based aid programs. In the intervening years, most states have established these programs. However, after growing for a period of years, LEAP funding has declined and is now no higher in real dollars than it was when the program was first implemented. It no longer provides adequate incentives to states.

While states continue to devote increasing amounts of money to student aid, the proportion of those dollars dedicated to meeting financial need has declined markedly since the early 1990s.

In order to achieve the goal of targeting student aid funds at those whose educational opportunities will be most improved by the assistance, the federal government should strengthen the incentives it provides to states for aid to students with limited financial resources. It is also vital that states not undermine the simplified application process for federal student aid by requiring additional financial information from students.

Current federal incentives for state need-based grant aid through the LEAP program should be strengthened.

The Rethinking Student Aid study group recommends that a reformed Leveraging Educational Assistance Partnership (LEAP) Program provide matching funds for state grant aid, with the match declining as the recipient's family income increases. The study group further proposes that states be rewarded for relying solely on the financial information available through the IRS, rather than requiring students to complete additional forms.

An important element of this program is that states need not limit their grant aid to students with financial need to qualify. However, the only dollars eligible for a match would be those awarded to students whose incomes are at or below 125 percent of the state's median—or some similar standard. States should be required to demonstrate a substantial commitment of their own funds

to aid programs that help low- and moderate-income students before qualifying for the program. Thus, states should only receive matching funds for investments that exceed a minimum threshold of spending per qualifying student.

## **Generating Institutional Support for Student Success**

Ultimately, the purpose of federal assistance programs for undergraduates is to help them improve their lives and our society through successful engagement in higher education. Whether success for a particular student means a bachelors' degree, an associate degree, or simply progress in learning some desired skills, it is clear that access alone is not enough. We want colleges and universities to focus on helping their students succeed, and we propose here to advance that agenda through a program of incentive payments to institutions whose students achieve certain benchmarks of success. As Don Hossler and co-authors make clear in their paper on the impact of student aid on persistence in *The Effectiveness of Student Aid: What the Research Tells Us*, evidence about the effectiveness of existing student aid programs in improving college success and completion is weak.<sup>46</sup> There is little in the current student aid system that is purposefully focused on supporting students toward completion. We believe that such an approach is needed.

Three federal student aid programs currently provide funds to institutions to distribute to students with financial need. In 2006-07, institutions received about \$800 million in Federal Supplemental Educational Opportunity Grant (FSEOG) funds and \$1.2 billion in Federal Work-Study funds. They also distributed about \$1.1 billion in Perkins Loans, which, like the other campus-based programs, combine federal dollars with institutional matching funds. The formula for distributing these funds to institutions depends on a combination of historical funding patterns and current circumstances, and the proportion of low-income students who benefit from them is relatively low. For example, in 2006-07, 5.2 million students received Pell Grants, while 1.3 million received FSEOG aid, 880,000 had Federal Work-Study jobs, and 514,000 were awarded Perkins Loans. In addition to the problem of inadequate funding, institutions require a federal expected family contribution (EFC) in order to allocate these funds to individual students, and admitted students do not learn of their eligibility for these funds until the spring of their senior year in high school.

The campus-based program proposed here would provide more generous funds, distribute those funds to institutions according to their success in enrolling and graduating low- and moderate-income students, and increase the options for how institutions can spend their federal dollars. The continuation of direct funding to institutions is important because of the discretion this approach allows colleges and universities in allocating these resources. *The Rethinking Student Aid study group recommends that the campus-based program proposed here provide more generous funds, distribute those funds to institutions according to their success in retaining and graduating low- and moderate-income students, and increase the options for how institutions can spend their federal dollars.* It would implement a goal expressed in the original authorizing legislation for the Pell Grant program (then known as the Basic Educational Opportunity Grant [BEOG] Program), which provided for Cost of Education Allowances—grants to institutions proportioned to the number of BEOG recipients the

institution enrolled. These allowances, while authorized, were never funded.

The distinguishing feature of the program described here is that it conditions institutions' receipt of federal subsidies on their performance in advancing students' success. We seek to reward schools

<sup>46.</sup> Don Hossler et al., "Student Aid and Its Role in Encouraging Persistence," in *The Effectiveness of Student Aid: What the Research Tells Us*, edited by Sandy Baum, Michael McPherson, and Patricia Steele (New York: The College Board, 2008).

whose disadvantaged students progress to further years of undergraduate study and who obtain degrees or certificates. The Rethinking Student Aid study group recommends a pilot program under which the federal government commits additional dollars to a program that will provide funds to institutions in proportion to the number of Pell Grant dollars received by students who progress to second-, third-, or fourthyear undergraduate status and who transfer to four-year institutions or complete bachelor's degrees, associate degrees, or

Campus-based funds will be proportional to the Pell Grants received by students with second year or higher status and those earning degrees or certificates of appropriate length.

*certificates requiring at least one year of full-time study.* Funding for each benchmark would equal a proportion of the Pell Grant for which the individual student is eligible, with higher levels of funding for students who have progressed further in their studies.

Table 5 illustrates a possible funding formula. Only experience with the program will reveal how large the subsidies would have to be to achieve their goals.

Table 5: Proposed Institutional Inc	centive Grant Formula

	Percent of Pell dollars
2nd year	10%
3rd year	15%
4th year	20%
1 yr + certificate	10%
Associate degree (or transfer to 4-year institution)	15%
Bachelor's degree	20%

Two particular points in the program design are worth noting. First, we propose not to provide any institutional rewards for enrolling Pell students in the first year. This is because we want to focus this program on retention and graduation rather than on access. Second, we propose making the incentive payments proportional to the Pell dollars students receive, rather than to the number of Pell recipients. This is because proportioning awards to Pell dollars automatically provides larger benefits to institutions that help higher-need Pell students succeed.

The Rethinking Student Aid study group recommends that for the most part institutions should have wide discretion in their use of these incentive funds so they can be used for academic support, mentoring, or other efforts in addition to need-based aid. This recommendation is based on our judgment that institutions are in the best position to decide which investments will best promote student success in their local context. Many institutions will likely find that using a portion of the funds to finance academic support and mentoring programs will be more effective than devoting all of the dollars to need-based financial aid. However, because of widespread belief in the importance

Institutions will have wide discretion over the use of federal funds to promote the success of low-income students, but a portion of the funds must be used to support on-campus work for Pell Grant recipients.

of on-campus work,<sup>47</sup> the study group further recommends that institutions be required to earmark a portion of the incentive funds they receive to support on-campus work opportunities for low- and moderate-income students.

<sup>47.</sup> Don Hossler et al., "Student Aid and Its Role in Encouraging Persistence," in *The Effectiveness of Student Aid: What the Research Tells Us,* edited by Sandy Baum, Michael McPherson, and Patricia Steele (New York: The College Board, 2008).

While there is reason to be optimistic about the potential impact of a federal program of incentive grants to institutions to increase persistence, little empirical evidence exists to confirm this logic. Moreover, the program must be carefully designed to minimize the incentive for institutions

to promote program completion without concomitant student learning. Accordingly, prior to committing to a national program, it would be advisable to undertake a demonstration project. This project would be well suited to a trial in several states or groups of institutions—an expansion in federal funding for these institutions, in exchange for which they would need to commit to undertaking rigorous analysis of program effects.

If this program of incentives for institutions to improve retention and success rates among low-income students proves successful and is sufficiently funded, it could eventually replace The incentive grant program for institutions to encourage college success among low-income students should be introduced as a demonstration program in order to ensure optimal design and implementation.

the existing campus-based programs. In the shorter run, current campus-based funding should be maintained based on existing allocations to institutions. Each institution will be guaranteed a federal block grant equal to the average campus-based allocation of the past three years in the first year of the new financial aid system. This block grant will be phased out gradually and eventually replaced by the new campus-based program of incentive grants, assuming the demonstration projects prove successful. Meanwhile, institutions can use federal indices of financial capacity calculated for state and institutional purposes to allocate their funds to individual students, but the federal government will no longer dictate this distribution of funds, since the federal aid eligibility allocation formula will be limited to Pell Grants. Institutions will have the opportunity to experiment with using these federal funds to improve student opportunities in different ways, including mentoring, academic support programs, and provision of emergency funds.

## Conclusion

Reforms of the federal student aid system are necessary if we are to meet the challenge of narrowing the gaps in postsecondary education opportunity facing less affluent Americans. Both our character as a nation that values equity, and our economic and civic strength in an increasingly challenging world environment, depend on a more effective system of subsidies for college students.

The recommendations put forth in this report hold the promise to go a long way toward meeting the goal of increasing access and success in higher education for low- and moderate-income students. These policy changes would lead to a federal financial aid system that is simpler, easier to understand, and easier to navigate than the complex set of processes and programs facing students today. They would better target taxpayer funds toward changing the options, choices, and experiences of individuals whose potential is not now fully realized.

We believe that the clarity and predictability of the system will help increase motivation for students from low- and moderate-income families to prepare for and enroll in college. As a result, we will further our national goals of increasing equity and developing the potential of America's individuals as a basis for strengthening our economy and society.

We look forward to an open and constructive conversation based on these ideas with those who share our goal of increasing educational opportunities.

#### Estimated Cost and Distribution of Proposed Pell Grant Modification

Estimates prepared by the Urban-Brookings Institute Tax Policy Center indicate that maintaining the Pell Grant maximum at its 2008-09 level of \$4,731 and implementing the proposed simplified allocation method would reduce the number of recipients from 5.5 million to 5.2 million, while the average grant per recipient would increase from \$2,902 to \$2,949. Because the upper income limit for eligibility would be set at 250 percent of the federal poverty level (FPL), students with higher incomes would be excluded. The number of dependent Pell Grant recipients from families with incomes below \$40,000 would increase by over 100,000, or 7 percent, and average grants for this group would rise, while a similar number of dependent recipients from higher-income families would lose eligibility, reducing the number of recipients from families with incomes above \$40,000 by 26 percent. Average grants for this group would decline. About 300,000 independent students, or 9 percent of the current total, would no longer be eligible for Pell Grants. If the maximum income for Pell eligibility were to increase from 250 percent of poverty to 300 percent of poverty, the number of independent recipients would be about 3.3 million, compared to 3.2 million under the current formula and 2.9 million with an upper income limit of 250 percent of poverty.

Under the proposed system, the maximum eligible income would rise with the poverty level (which depends on the Consumer Price Index). Phasing out Pell eligibility from the maximum at 150 percent of the poverty level to zero at 250 percent of the poverty level, a maximum Pell Grant of \$4,950 would involve the same total expenditures as the maximum grant of \$4,731 under the current formula.

The estimated costs of the two possible allocation formulas illustrated in Tables 2 and 3 are reported in Table A1 below, along with current law, a maximum grant of \$4,731 under the proposed allocation formula, and the \$4,950 maximum grant that would maintain the federal spending level in 2008-09. Raising the maximum grant from \$4,731 to \$5,000 and maintaining the 250 percent of poverty maximum income level and the 150 percent of poverty minimum income for receipt of the maximum grant would have no effect on the number of recipients and would increase total expenditures by \$0.9 billion. Doubling the maximum grant to \$10,000 and raising the maximum eligible income to 300 percent of poverty would bring in an additional one million recipients and would more than double the cost of the program, to an estimated \$34.5 billion. Table A1 also illustrates the impact of raising the Pell Grant for students with incomes between 100 percent and 150 percent of the poverty level. This formula, with a maximum grant of \$7,500, would reach exactly the same students as the \$5,000 maximum grant phasing out from 150 percent to 250 percent of the poverty level and would award identical grants to all except those with incomes below 150 percent of poverty. The maximum grant would go to those with incomes at or below the poverty line. The total cost of the program would increase from \$16.2 billion to \$21.1 billion.

	Recipients (millions)	Expenditures (billions)
Current Law	5.5	\$16.0
Maximum Pell of \$4,731 at AGI of 150% FPL decreasing to zero at 250% FPL	5.2	\$15.3
Maximum Pell of \$4,950 at AGI of 150% FPL decreasing to zero at 250% FPL $$	5.2	\$16.0
Maximum Pell of \$5,000 at AGI of 150% FPL decreasing to zero at 250% FPL	5.2	\$16.2
Maximum Pell of \$7,500 at AGI of 100% FPL decreasing to zero at 250% FPL	5.2	\$21.1
Maximum Pell of \$10,000 at AGI of 150% FPL decreasing to zero at 300% FPL	6.2	\$34.5

Table A1: Estimated Number of Recipients and Total Expenditures Under Proposed Pell Grant Modification

Simplifying the Pell allocation formula as proposed would generate a relatively small transfer from independent to dependent students. Maintaining the \$4,731 maximum grant, the proportion of recipients who are dependent would increase from 41.9 percent to 44.3 percent, and these students would receive 44.2 percent of total funds, up from 41.7 percent.

Among dependent students, grant aid would be shifted from those with family incomes above \$40,000 to students from lower-income families. Increases in the maximum Pell Grant would shift funding up the income scale, although the effect is not dramatic.

	Current Law	\$4,731 Pell, 100%–250% FPL Phase Out	\$4,950 Pell, 100%–250% FPL Phase Out	\$5,000 Pell, 100%–250% FPL Phase Out	\$7,500 Pell, 100%–250% FPL Phase Out	\$10,000 Pell, 100%–250% FPL Phase Out
Independent						
Recipients	58.1%	55.7%	55.7%	55.7%	55.7%	53.9%
Expenditures	58.3%	55.8%	55.8%	55.8%	56.9%	54.6%
Dependent						
Recipients	41.9%	44.3%	44.3%	44.3%	44.3%	46.1%
Expenditures	41.7%	44.2%	44.2%	44.2%	43.1%	45.4%
	Bre	eakdown of Depe	ndent Students b	y Parent AGI		
<\$0						
Recipients	1.7%	1.7%	1.7%	1.7%	1.7%	1.4%
Expenditures	2.1%	2.1%	2.1%	2.1%	2.4%	1.8%
\$0 to 20K						
Recipients	38.4%	39.8%	39.8%	39.8%	39.8%	32.2%
Expenditures	46.9%	50.0%	50.0%	50.0%	56.5%	43.2%
\$20 to 40K						
Recipients	37.5%	41.7%	41.7%	41.7%	41.7%	38.4%
Expenditures	35.0%	39.5%	39.5%	39.5%	34.5%	39.8%
\$40 to 60K						
Recipients	19.3%	15.4%	15.5%	15.5%	15.5%	23.0%
Expenditures	13.5%	7.8%	7.8%	7.8%	6.2%	13.6%
\$60 to 80K						
Recipients	2.3%	1.2%	1.2%	1.2%	1.2%	4.7%
Expenditures	1.6%	0.5%	0.5%	0.5%	0.4%	1.5%
\$80 to 100K						
Recipients	0.4%	0.1%	0.1%	0.1%	0.1%	0.3%
Expenditures	0.3%	0.1%	0.1%	0.1%	0.1%	0.1%
\$100K and up						
Recipients	0.4%	0.0%	0.0%	0.0%	0.0%	0.0%
Expenditures	0.5%	0.0%	0.0%	0.0%	0.0%	0.0%

Table A2: Estimated Distribution of Pell Grant Recipients by Dependency Status and Income

## Validity of AGI as a Basis for Ability to Pay

Adjusted Gross Income (AGI) is an imperfect measure of family income. It is important to gain some perspective on how many families who actually have significant resources would be eligible for Pell Grants because of reliance on this simple indicator, as proposed by the Rethinking Student Aid study group. The current methodology is far from perfect in this regard, despite its complexity. Aid applicants eligible to file 1040A or 1040EZ tax forms who have incomes under \$50,000 are currently

subject to the Federal Methodology's Simple Needs Test, which ignores all assets. Home equity and the value of businesses with fewer than 100 employees are excluded for all applicants. However, other assets are included for these filers. Moreover, income includes non-taxable income in addition to AGI. It is important to examine the extent to which simplifying Pell eligibility by relying only on AGI will misdirect Pell funds to relatively affluent filers whose AGI is deceptively low.

Table A3 provides some insight into this issue. Of the 52 million tax units with AGI between \$0 and \$40,000, only about 4 percent report business losses and about 7 percent report capital losses, with a similar proportion reporting capital gains. In other words, low AGI hides other financial resources that might be available to evaluate Pell eligibility for a very small number of filers. The proportion of filers with negative AGI who report gains and losses is much higher. Almost a third report business losses, and almost as many report capital losses. This suggests that it might be efficient to consider negative AGI a disqualifying factor for Pell. However, only 1.2 million tax filers out of a total of over 97 million are in this category. For this reason, the added complication is likely not worth the cost.

			Business Losses		sses Capital Losses		Capital Gains	
Adjusted Gross Income	Percent Filing 1040	Tax Units (in thousands)	Percent Reporting	Median Dollars	Percent Reporting	Median Dollars	Percent Reporting	Median Dollars
Less than zero	100.0%	1,189	33.0%	-\$6,677	30.7%	-\$3,000	12.9%	\$3,224
\$0-\$20,000	61.5%	35,390	2.5%	-\$3,636	4.8%	-\$3,000	4.5%	\$792
\$20,000-\$40,000	51.3%	16,316	6.8%	-\$3,165	10.2%	-\$3,000	11.2%	\$836
\$40,000-60,000	73.1%	13,830	6.9%	-\$3,274	11.3%	-\$3,000	13.8%	\$841
\$60,000-\$80,000	87.9%	10,865	6.4%	-\$2,548	13.7%	-\$3,000	16.1%	\$1,063
\$80,000-\$100,000	93.9%	7,105	5.7%	-\$2,740	15.5%	-\$3,000	19.1%	\$1,527
\$100,000-\$125,000	98.3%	4,653	6.1%	-\$2,699	19.3%	-\$3,000	23.5%	\$2,318
\$125,000-\$150,000	100.0%	2,678	5.4%	-\$2,750	22.5%	-\$3,000	29.3%	\$2,475
\$150,000 or more	100.0%	5,363	6.2%	-\$4,563	30.3%	-\$3,000	39.8%	\$16,390
All	68.5%	97,389	5.3%	-\$3,407	11.3%	-\$3,000	13.0%	\$1,540

Table A3: Tax Filers with Gains and Losses by Adjusted Gross Income, 2004

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0208-1).

## **Estimated Budgetary Impact of Revision of Education Tax Benefits**

	Assuming Current Hope Participation	Assuming 100% Participation
Baseline cost of Hope Credit, Lifetime Learning Credit, and Tuition & Fees Deduction	\$8.6	\$10.0
Option 1: Repeal Tuition & Fees Deduction, Lifetime Learning Credit; extend Hope Credit eligibility to all degree or credential-seeking students	\$8.6	\$11.9
Option 2: Option 1 plus include room and board, books, transportation, and other associated costs as qualifying expenses for the credit (based on fixed allowance of \$7,000 for full-time students)	\$12.6	\$16.5
Option 3: Option 2 plus make the credit fully refundable	\$24.3	\$29.9
Option 4: Option 2 plus reduce the maximum credit to \$1,200 by eliminating the 50 percent match	\$8.7	\$12.4
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0208-1). Assumes current law plus extension and indexation of the 2007 Alternative Minimum Tax pat	ch and extension	of the tuition and

Table A4: Budgetary Impact of Revision of Education Tax Benefits (in Billions)

fees deduction.

Combining the existing deduction and credits into one credit modeled on the Hope Tax Credit but extended to all degree-seeking students would be essentially revenue neutral, assuming taxpayers took advantage of the benefit at the rate that filers now participate in Hope. If 100 percent of those eligible claimed the credit, the federal government would lose an additional \$1.4 billion in tax revenues under the current system of multiple benefit options, compared to an additional \$3.3 billion under the consolidated system. This difference is explained by a lower current utilization of the Hope credit compared to the tuition tax deduction. Higher-income taxpayers are more likely than lower-income taxpayers to take advantage of available education tax benefits.

Extending the credit to cover non-tuition expenses would, under Hope current usage patterns, increase the cost by about \$4 billion, to \$12.6 billion. In order to make this policy change approximately revenue neutral, it would be necessary to reduce the maximum credit to about \$1,200, eliminating the 50 percent match on the next \$1,200 in expenses. Making the credit refundable at the same time would be much more expensive, costing the federal government an additional \$11.7 billion in 2008-09, a total of about \$24.3, compared to the \$8.6 baseline.

	CURRENT POLICY			ON #1 to one credit)	OPTION #2 (cover non-tuition expenses)		
2008 Cash Income	% with credit or deduction	Average credit	% with credit	Average credit	% with credit	Average credit	
<\$40,000	4.4%	\$577	3.8%	\$794	4.7%	\$924	
\$40,000- \$100,000	10.3%	\$939	7.9%	\$1,309	9.8%	\$1,584	
More than \$100,000	9.9%	\$848	4.9%	\$1,187	5.8%	\$1,390	
	come differs from A	, , ,			come.		

Table A5: Distributional Impact of Proposed Change in Education Tax Benefits

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0208-1).

Taxpayers with incomes up to \$160,000 are currently eligible for tax deductions. Under the Rethinking Student Aid proposal, only those with incomes up to \$110,000, the income limit for the Hope and Lifetime Learning tax credits, would be eligible for the combined credit. As a result, higherincome taxpayers would lose benefits. Removing the benefit for non-degree-seeking students would cause some taxpayers at all income levels to become ineligible for the tax credit. Consolidating the current credits and deduction into one credit for all degree-seeking students with the current Hope income limit would reduce the proportion of taxpayers at all income levels who receive the benefit, but would have the largest impact on those with incomes above \$100,000. Those who remained eligible would receive higher average credits than under the current system, since the excluded nondegree-seeking students get relatively low dollar benefits.

Option 2 represents the Rethinking Student Aid proposal to extend the tax credit to cover nontuition expenses. More low-income taxpayers would be covered under this proposal than under current policy. (Increased coverage would be among those with AGI between \$20,000 and \$50,000.) Average credits would be higher at all income levels, both because of the elimination of non-degreeseeking students and because of the increased eligibility for the maximum credit.

## The Cost of Improving the Student Loan Program

The estimates of the budgetary impact of proposed changes in the student loan program reported are unofficial calculations from the U.S. Department of Education. The proposal to eliminate the distinction between subsidized and unsubsidized Stafford Loans can best be evaluated against the background of how these two types of loans are currently distributed across income categories. Table A6 shows this distribution for 2006-07.

	Subsidized	Unsubsidized			
Dependent	50.2%	37.5%			
\$10,000 and under	5.3%	2.2%			
\$10,001-\$30,000	11.3%	4.1%			
\$30,001-\$60,000	16.5%	5.9%			
\$60,001-\$90,000	10.7%	8.9%			
Over \$90,000	6.3%	16.3%			
Independent	49.8%	62.5%			
\$5,000 and under	10.9%	11.4%			
\$5,001-\$15,000	13.7%	15.8%			
\$15,001-\$30,000	6.5%	8.4%			
\$30,001-\$45,000	12.2%	12.8%			
Over \$45,000	6.4%	14.1%			
Source: Budget Service, U.S. Department of Education 4/14/2008					

Table A6: Distribution of Undergraduate Stafford Loan Volume by Income and Dependency Status, 2006-07

A larger proportion of subsidized than unsubsidized Stafford Loans go to lower-income students. However, in 2006-07, 17 percent of subsidized Stafford Loans (compared to 25 percent of unsubsidized loans) went to dependent students from families with annual incomes above \$60,000, and 19 percent of subsidized Stafford Loans (compared to 27 percent of unsubsidized loans) went to independent students with annual incomes above \$30,000.

Table A7 shows the budgetary impact of the Rethinking Student Aid proposals in 2008-09. The figures represent estimates of the present value of all future cash flows of loans originated in a given year. Removing the in-school interest subsidy for all Stafford Loans would save the federal government about \$5.24 billion in 2008-09. Increasing the loan limits would increase the savings because unsubsidized loans carry a small positive income for the federal government.

The proposals in this report include extending the income-based repayment benefits that are now reserved for subsidized Stafford borrowers to all Stafford borrowers. Adding three years of interest forgiveness for those currently not benefiting from this provision would add about \$120 million to the annual cost of the Stafford Loan program.

Cable A7: Estimated Budgetary Impact of Changes to Stafford Loan Program (in Billions)
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	Two-Year Not- For-Profit	Two-Year Proprietary	Four-Year Freshman/ Sophomore	Four-Year Junior/ Senior	Total Undergraduates
Make All Stafford Loans Unsubsidized <sup>1</sup>	-\$0.66	-\$0.34	-\$2.34	-\$1.90	-\$5.24
Make All Stafford Loans Unsubsidized and Increase Undergraduate Loan Limits <sup>1,2</sup>	-\$0.70	-\$0.35	-\$2.71	-\$2.17	-\$5.93
Allow for 3 Years of Interest Forgiveness in IBR for Unsubsidized Loans					\$0.12

Source: Unofficial Estimates, Budget Office, U.S. Department of Education, June 2008, <sup>1</sup>Estimates do not include savings due to interest payments no longer required on subsidized loans that eventually consolidate. <sup>2</sup>Loan limits increased to a minimum of \$10,000 or currrent loan limit per year with borrowers able to carry over unused borrowing to future years.

## The Cost of Federal Savings Accounts for Low- and Moderate-Income Families

Eligibility Age Range	54% college continuation rate		60% college continuation rate		
	10% of Pell	25% of Pell	10% of Pell	25% of Pell	
Ages 0–18					
<b>Recipients (millions)</b>	33.9	33.9	33.9	33.9	
Budget Cost (billions)	\$7.3	\$18.3	\$8.1	\$20.3	
Ages 5–18					
Recipients (millions)	24.7	24.7	24.7	24.7	
Budget Cost (billions)	\$5.3	\$13.3	\$5.9	\$14.7	
Ages 12–18					
<b>Recipients (millions)</b>	12.6	12.6	12.6	12.6	
Budget Cost (billions)	\$2.8	\$7.0	\$3.1	\$7.8	

Table A8: Estimated Cost of Proposed Savings Account

Note: Recipients include all for whom accounts are opened, whether or not the funds are eventually withdrawn. Budget cost is based on expected withdrawals assuming specified college-going rates.

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0308-5).

The cost of the proposed savings program depends on the age at which children become eligible, the percentage of the Pell Grant amount that is deposited into the accounts annually, and the proportion of account holders who enroll in college. The estimates in Table A8 are based on the Pell allocation formula that involves a \$5,000 maximum grant, with the maximum going to students with incomes of 150 percent of the federal poverty level or lower and awards diminishing until they are eliminated at 250 percent of poverty or higher. The budget cost represents the present value of the dollars deposited in 2008-09 that would be withdrawn by students who begin college within a year of high school graduation. The actual cost would be increased by withdrawals of individuals who postpone enrollment in college.

The 54 percent college continuation rate approximates current patterns for students from families with incomes in the lower 40 percent of the income distribution. Because we anticipate that implementation of this savings program would increase enrollment rates of the recipients, we also show the budgetary impact of a successful policy.

## **Estimated Cost of Campus-Based Incentive Grants to Support Student Success**

In 2008-09, the federal government will spend about \$1.8 billion on campus-based student aid, including Federal Supplemental Educational Opportunity Grants (FSEOG), Federal Work-Study (FWS), and Federal Perkins Loans. In the initial phase of the Rethinking Student Aid proposals, these funds would be distributed to colleges in the form of block grants. However, after successful pilot programs to develop the incentive-based campus-based program for student success, the existing programs would be discontinued and these funds would be available to help support the new program.

## **Table A9:** Estimated Cost of Campus-Based Incentive Grants to Support Student Success, 2008-09 (with percentage of total funds by sector)

	TOTAL	Sophomores (10% Pell)	Juniors (15% Pell)	Seniors (20% Pell)	A.A. Grads (15% Pell)	B.A. Grads (20% Pell)
Expenditures by Sector (in bi						
Public 2-year (9% of current campus- based funds)	\$0.32 (16.5%)	\$0.17	\$0.04	\$0.01	\$0.11	\$0.00
Public 4-year (39% of current campus- based funds)	\$0.96 (49.7%)	\$0.12	\$0.21	\$0.38	\$0.02	\$0.23
Private 2-year	\$0.02 (1.2%)	\$0.01	\$0.00	\$0.01	\$0.01	\$0.00
Private 4-year (46% of current campus- based funds)	\$0.42 (21.6%)	\$0.07	\$0.11	\$0.14	\$0.02	\$0.08
Proprietary (7% of current campus- based funds)	\$0.21 (11.0%)	\$0.08	\$0.05	\$0.04	\$0.03	\$0.02
Total	\$1.93	\$0.44	\$0.41	\$0.57	\$0.19	\$0.33
	TOTAL	Sophomores (15% Pell)	Juniors (20% Pell)	Seniors (25% Pell)	A.A. Grads (20% Pell)	B.A. Grads (25% Pell)
Expenditures by Sector (in billions)						
Public 2-year	\$0.45 (17.6%)	\$0.25	\$0.05	\$0.01	\$0.14	\$0.00
Public 4-year	\$1.25 (48.6%)	\$0.18	\$0.28	\$0.48	\$0.03	\$0.29
Private 2-year	\$0.03 (1.2%)	\$0.01	\$0.01	\$0.01	\$0.01	\$0.00
Private 4-year	\$0.55 (21.5%)	\$0.11	\$0.15	\$0.17	\$0.03	\$0.10
Proprietary	\$0.29 (11.2%)	\$0.11	\$0.07	\$0.05	\$0.04	\$0.02
Total	\$2.58	\$0.66	\$0.55	\$0.71	\$0.25	\$0.41
	TOTAL	Sophomores (20% Pell)	Juniors (25% Pell)	Seniors (30% Pell)	A.A. Grads (25% Pell)	B.A. Grads (30% Pell)
Expenditures by Sector (in billions)						
Public 2-year	\$0.59 (18.2%)	\$0.34	\$0.06	\$0.01	\$0.18	\$0.00
Public 4-year	\$1.54 (47.8%)	\$0.23	\$0.35	\$0.58	\$0.04	\$0.34
Private 2-year	\$0.04 (1.2%)	\$0.01	\$0.01	\$0.01	\$0.01	\$0.00
Private 4-year	\$0.69 (21.5%)	\$0.15	\$0.18	\$0.21	\$0.03	\$0.12
Proprietary	\$0.37 (11.4%)	\$0.15	\$0.09	\$0.05	\$0.05	\$0.03
Total	\$3.22	\$0.88	\$0.69	\$0.86	\$0.31	\$0.49

Note: Certificate recipients and transfers from two-year to four-year institutions who do not receive A.A. degrees are not included because of inadequate data. As a result, actual expenditures would be somewhat higher than these estimates. Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0308-5). U.S. Department of Education, Student Financial Assistance, FY 2009 Budget Request,

http://www.ed.gov/about/overview/budget/budget09/justifications/n-sfa.pdf

Table A9 shows the estimated cost of three possible funding formulas for the campus-based incentive grant programs, along with the distribution of the funds across sectors. All of these estimates are based on the Pell Grant formula that would award a maximum Pell Grant of \$5,000 to students with incomes at or below 150 percent of the poverty line, with the award diminishing to zero at 150 percent of the poverty level. Higher Pell Grants would automatically result in higher incentive awards to institutions.

A program that granted institutions 10 percent of the value of Pell Grants received by their second-year students, 15 percent of the value of the Pell Grants received by their third-year students, 20 percent of the value of the Pell Grants received by their fourth-year students, plus 15 percent of the Pell Grant of each A.A. graduate and 20 percent of the Pell Grant of each B.A. graduate would cost just under \$2 billion per year, about the cost to the federal government of the existing campus-based programs.

Because the three formulas illustrated in the table reflect different proportional relationships among the grants by year of study, slightly higher shares of the funding go to two-year public and proprietary institutions as the generosity of the formula increases. The shares received by these schools are actually underestimated here to some extent, because certificate recipients and transfers to four-year institutions who do not receive A.A. degrees were not included in the estimates. Under this new policy, public two-year colleges would receive about 18 percent of the funds, compared to about 9 percent of current campus-based funds. The share received by public four-year institutions would rise from 39 percent to 48 percent, while the share received by private four-year institutions would receive about 22 percent. Proprietary institutions would receive about 11 percent of the subsidies, compared to about 7 percent of current campus-based funds.



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