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ISSUE PAPER

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Eliminating Complexity and Inconsistency in Federal Financial Aid Programs For Higher Education Students: Towards a More Strategic Approach

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The federal government plays a substantial, but often inconsistent and confusing, role in financing the costs incurred by individual students pursuing a higher education. Over 75% of graduating seniors receive federal grant money and/or borrow under federal student loan programs[1] and, although precise figures are difficult to calculate, many others benefit from financing their education through targeted tax benefits, such as 529 plans or Coverdell accounts. However, it is increasingly clear that as much as the individual student relies on federal programs to finance the cost of higher education, the myriad federal programs in this area (1) create undue complexity and confusion among users, leading to underuse of some programs and yielding little meaningful data on the impact these federal programs have on college access and retention, (2) create countervailing incentives and disincentives for buyers of higher education, therefore deterring families from developing an effective plan for financing a child's education, and (3) are overlapping and, in some cases, redundant. The many federal programs involved have never been strategically harmonized and tailored towards a comprehensive policy goal.

A simple listing of some of the Department of Education programs that provide direct financial aid or tax benefits to individuals illustrates these problems:

(1) Pell Grant;
(2) Supplemental Educational Opportunity Grant (SEOG);
(3) Federal work study;
(4) Perkins loan;
(5) Leveraging Educational Assistance Partnership (LEAP);
(6) Military aid;
(7) Federal Family Educational Loan Program (FFELP)
(8) The Direct Loan Program;
(9) HOPE Scholarship Credit;
(10) Lifetime Learning Credit;
(11) Federal PLUS Loans
(12) Coverdell education savings account (Education IRAs)

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[1] U.S. Department of Education, *Student Financing of Undergraduate Education: 1999-2000, Center for Education Statistics* (2002).

(13) Above-the-line tuition deduction;
(14) Tax-free employer-provided education benefit;
(15) Student loan interest deduction;
(16) Section 529 savings plan; and
(17) Penalty-free IRA withdrawal.

In addition, other federal agencies administer significant programs for higher education financing, including the Defense Department's G.I. Bill programs; numerous HHS programs such as Health Professional Student Loans, Nursing Student Loans, Primary Care Loans, National Health Service Corps Scholarships, and loans and grants to disadvantaged students; and Bureau of Indian Affairs grants and loans.[2]

The federal government spends money or foregoes tax revenue to provide financial assistance to individuals attending college in an amount totaling over $60 billion per year.[3] However, the effectiveness and efficiency of these programs remains in doubt, particularly in the context of an incoherent policy that fails to articulate clear and measurable goals for federal financial aid programs.

Historically, federal participation in the personal financing of the costs of higher education first took form through the G.I. Bill in 1944, followed in 1958 by the National Defense Loan Program (Perkins Loans), the first federal loan program.[4] The Higher Education Act of 1965 then created the framework for most of the current programs today, followed by the establishment of Pell Grants in 1972. Over the following 20 years, numerous other programs were implemented on a piecemeal basis, creating a confusing patchwork quilt of overlapping programs, goals, priorities, and procedures.

In the late 1990s, Congress moved away from direct funding, and toward implementation of tax incentives for college savings. The old expense side programs were left in place, albeit generally with reduced funding. What remains is a cumbersome maze of programs, each added to the mix over time but never strategically aligned towards an overarching policy that guides federal participation in financing the costs of higher education paid by students and their families. This paper argues that: (1) the federal government should articulate a strategic goal for higher education access that will serve as the guiding principle for direct student aid; (2) the application of the various programs should be harmonized to create a consistent set of incentives for buyers of higher education; and (3) to reduce complexity, the multitude of federal spending and tax-benefit programs in this area should be consolidated.

I. Articulating Strategic Goals

Federal government financial assistance to students of higher education generally falls into three broad categories: (1) grants; (2) loans; and (3) tax benefits. Each of these types of programs affects recipients differently.

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[2] This paper does not address the impact or effectiveness of these programs.

[3] Thomas R. Wolanin, ed., R*eauthorizing the Higher Education Act: Issues and Options*, Institute for Higher Education Policy (2003); http://studentaid.ed.gov/PORTALSWebApp/students/english/funding.jsp?tab=funding; http://www.whitehouse.gov/omb/budget/fy2005/education.html.

[4] Wolanin, at 52.

Recent research shows that individuals eligible for tax credits are not more likely to enroll in college than others.[5] This finding disputes claims by proponents of the HOPE and Lifetime Learning tax credits that the programs would serve to increase college enrollment. Because of cliff effects in the current tax code, low-income earners pay little, if any, taxes to begin with and therefore cannot take advantage of tax credits.[6] Even those individuals who take advantage of tax credits do not appear to do so as a means of gaining *access* to college.[7]

Similarly, loan programs do not appear to affect the aggregate level of college attendance.[8] If anything, for those who have already made the decision to enroll in college, loan programs appear to function as a tradeoff between work as a funding source as opposed to loans or other forms of debt.

In contrast, grants *do* appear to influence the initial decision to enroll in college.[9] However, federal grants have not kept pace with either inflation generally or tuition increases specifically.[10] The maximum Pell Grant only covers 36% of the costs of attending a public four-year college[11] and grants as a whole comprise less than one-fifth of the total federal student aid.[12]

Therefore, while policy-makers in Washington often talk of a comprehensive federal policy to increase access to higher education as a societal benefit, a shrinking minority of federal dollars allocated for student aid actually supports programs that have been empirically shown to increase enrollment. Often lost in the debate is the fact that many programs that do not increase college *access* still promote significant desirable societal benefits. Work study programs and loans may increase retention and improve graduation rates. In addition, work study may enhance work force readiness and provide invaluable employment experience. Tax credits may lessen the burdens of college attendance on families and free up dollars for other expenditures.

The effects of poorly-crafted programs are numerous. Students who are unable to receive enough grant money to enroll in college may be deterred from pursuing an education. Statistics show that a student working at minimum wage must work full-time for a full year ($10,712 annual gross wages)[13] just to

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[5] Bridget Terry Long, *The Impact of Federal Tax Credits for Higher Education Expenses*, p 30, 46 (2003), *reprinted* in *College Choices: The Economics of Which College, When College, and How to Pay for It*, Caroline M. Hoxby, ed (2004).

[6] Long at 12-13.

[7] Long at 46-47.

[8] Elaine M. Maag and Katie Fitzpatrick, *Federal Financial Aid for Higher Education: Programs and Prospects*, The Urban Institute (2004)

[9] Susan Dynarsky, *Loans, Liquidity, and Schooling Decisions* (2003 abstract).

[10] Edward P. St. John, *Refinancing the College Dream: Access, Equal Opportunity, and Justice for Taxpayers*, Johns Hopkins University Press (2003); Amanda Sharkey, *Paying for Postsecondary Education*, The Center for American Progress 9 (2005).

[11] Sharkey at 12-13.

[12] James B. Stedman, Federal *Pell Grant Program of the Higher Education Act: Background and Reauthorization*, Report for Congress, 1 (2003).

[13] Department of Labor, *Minimum Wage Guidelines*, Government Printing Office, 2006.

earn enough money -- and not counting any living expenses while working -- to enroll in a public university or college for one year. Students who are forced to work while attending college may take fewer classes per semester, therefore taking longer to graduate and tying up valuable spots in already-crowded campuses. Some students cannot afford to continue their education and drop out of college altogether to work. Badly-indebted graduates may be forced to postpone marriage, starting a family, buying a house, or saving for retirement in order to pay back student loans that greatly exceed their earning capacity.[14]

Indeed, it appears that goals for aid programs should be threefold: (1) Increased access, or enrollment in college by those students who would not otherwise be likely to attend; (2) Increased retention, or graduation by students who might not have been able to complete college due to the cost, and (3) Decreased debt burden, or the amount of student loan debt that might prevent lower-income graduates from pursuing employment in low-paying, socially-beneficial areas, such as teaching, social work, or community service. Overall, the dollars spent on federal aid programs are not tailored to achieve any of these goals, nor has there ever been a clear articulation of these priorities by Congress.

One critical element of any strategic plan is solid, reliable data showing the effects of loans, grants, and tax benefits on targeted student populations with respect to access, retention, and debt burden. With the information yielded from a study of potential students at both the access point to and departure from higher education, federal programs can be specifically structured to maximize impact. Other relevant questions include (1) what type of educational institution (two-year, four-year, public, private, etc.) is most affected; (2) at what age can will students be most impacted by programs (high school seniors, graduation from junior college, after military service); and (3) can programs be structured to maximize access and retention, while limiting or reducing the debt burden of targeted populations?

If access, retention or reduced debt burden are indeed the overarching goals of federal student aid, then the federal government should clearly state those goals with more precision and then adapt the overall structure of federal student financial assistance to better serve its ends. Many ideas are worth investigating. Because the evidence suggests that grants are the most effective tool for increasing college enrollment, one solution might be to include least some grant dollars packaged with *all* forms of student financial aid.[15] For example, low-income students could be given larger grants for the first year, slowly phasing into loans over a four or five year period. Higher income students might receive smaller grants, with a greater emphasis on loans or reliance on family resources.

No comprehensive study has ever been done to investigate the post-matriculation achievement level of grant recipients as opposed to other student populations. The results of such research could be used to accurately and specifically target grants not just to at-risk low-income students, but also to those with the best chance of succeeding in college. Students could receive loan-related incentives for early or on-time graduation, such as interest rate reductions or even discounts of the principal. Because many students who utilize student loans are more likely to hold a job during college,[16] and thus take longer to graduate

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[14] Heather Boushey, *Student Debt: Bigger and Bigger*, Center for Economic and Policy Research 3 (2005); Wolanen at 58-62.

[15] For a comprehensive discussion, *see* Edward P. St. John, *Refinancing the College Dream: Access, Equal Opportunity, and Justice for Taxpayers*, 2003.

[16] Bouchey at 2.

from college due to work requirements, it might be more cost-efficient to give grants rather than loans to certain groups of students. Finally, the federal government could structure grants as a "multiplier" of scholarship money, creating "access leverage" and an incentive to achieve – i.e., for every dollar of scholarship money the student receives, the federal government will match at a 2-1 ratio. These and many other ideas are worth exploring as the federal government seeks to develop a clear set of goals and priorities for financial aid programs.

With the answers to these questions, and with an overarching purpose clearly articulated, and all federal financial assistance programs can be restructured to meet the goals. As the system stands now, a guiding principle is conspicuously absent from the patchwork of federal financial aid programs.

II. Harmonizing Program Incentives/Criteria

Once key policy goals have been clearly stated, program eligibility criteria and benefit incentives should be tailored to achieve a measurable success rate. However, programs must be cohesively harmonized to consistently reflect the goals. At present, eligibility criteria, rather than being standardized to best support the "big picture" purpose of student aid, remain a confusing hodgepodge reflecting incoherent program objectives.

For example, the key eligibility factor for federal financial aid is a student's EFC – Expected Family Contribution.[17] In general, a student's total cost of attendance minus EFC equals financial need. That financial need can then be met by one or more of grants, loans and work study funds. However, there are serious inconsistencies in the calculation and application of EFC across federal student aid programs. Moreover, there are at least four different variations of the basic EFC calculation that hinge on the student's individual circumstances (dependent, independent, has dependents, very low income). A separate problem relates to evidentiary verification of the EFC calculation – i.e., is the student really estranged from his parents? Tax forms could be used to verify eligibility.

Real complications arise when tax benefits are factored into the EFC calculation. One comprehensive analysis states, "The current rules and guidelines governing how these various tax provisions are treated for purposes of Title IV financial aid are often inconsistent and in many cases unclear enough to raise serious questions about how these [tax] benefits and amounts are being reported by applicants for federal financial aid." (*See attached chart)*.[18] Different types of tax advantaged college savings are valued differently for the EFC calculation.[19] Moreover, if such college savings are held by grandparents, they do not affect the EFC at all. It is arguable that college savings should always be counted in the EFC. By counting a Coverdell plan against a low- or middle-income family, eligibility for a grant and loan money goes down, and lower-income families who anticipate eligibility for aid are actually *discouraged* from saving for their children's education, out of fear of jeopardizing their child's eligibility for aid. In other words, the

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[17] Wolanen at 79.

[18] Wolanen at 82-84.

[19] Maag & Fitzpatrick at 18.

current formulation of EFC actually creates a disincentive to make use of tax-advantaged college savings plans.[20]

In sum, the current system of calculating eligibility for federal student aid is inconsistent and overly complex. The administrative costs of determining eligibility could be greatly reduced through the use of a uniform formula. One possible solution would be to use income tax forms or eligibility for other federal programs; families who would qualify for Medicaid or the EITC might automatically be eligible for certain benefits. Use of federal tax forms, used by many state governments as the preferred documentation for income tax calculations as well as social program eligibility, would establish an easily verified documentation requirement as well as a uniform eligibility resource.

The federal government should also develop and rely upon one federal aid eligibility formula that treats assets uniformly and calculates EFC in a consistent, simple manner. In addition, the consideration and application of EFC to federal financial student aid should be geared towards the goals articulated as the governing principles of federal financial aid programs. In other words, the calculation of EFC should be slanted towards access, retention, and debt burden priorities. For example, research might indicate that certain categories of assets that currently count towards calculation of EFC cannot be realistically used for college expenses. Accordingly, these assets should be removed from the EFC formula, as their inclusion in the present scheme only serves to prevent otherwise-needy students from qualifying for aid.

A simplified, uniform approach to eligibility calculation should yield positive results in the areas of (1) access to and efficiency of the federal student aid system; (2) equity among applicants; (3) clearer understanding among students and families of how best to utilize financial aid programs; and (4) a clearer understanding of the impact of the federal programs on targeted student populations.

III. Consolidating for Simplicity . . . *and* Efficiency

The issue here is straightforward. Why have over 20 different flavors of federal student aid? As discussed above, federal aid falls into three broad categories: grants, loans, and tax benefits. The benefits of federal financial aid can be categorized into three groups as well: access, retention, and debt burden. Yet nearly two-dozen programs attempt, sometimes in dissonant confusion, to meet these simple needs.

The complexity and inconsistencies inherent in multiple, often redundant programs creates serious consequences. Evidence indicates that many of these programs are underused compared to projections. For example, use of the Higher Education Tax Credit tax benefits for education may be as low as 20% of all eligible households.[21] It is also evident that only a fraction of eligible low-income families applies for grants.[22] Further, studies show the ineffectiveness of tax-benefit programs to increase enrollment, while these programs cost the government over $12 billion in annual revenue.[23] Could that money be more efficiently spent on grants or in ways that help achieve the goals of access, retention, and debt limitation?

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[20] United States Senate, Committee on Finance, *The Role of Higher Education Financing in Strengthening U.S. Competitiveness in a Global* Economy, Hearing of July 22, 2004, Testimony of Dr. Susan Dynarski at 4, Government Printing Office (2004).

[21] Long at 11, 54.

[22] Maag and Fitzpatrick at 22.

[23] Maag & Fitzpatrick at 26.

Another issue raised by proponents of reform is the rate gap between what students pay private lending institutions and the rates the institutions themselves pay on guaranteed loans. Totaling approximately $3 billion annually; these funds would, under newly-proposed legislation, be paid to the government rather than to private institutions,[24] saving billions for other educational assistance programs. Additional billions could be saved, or diverted to other educational programs, by converting guaranteed loan programs to direct loans.[25]

Each of the many programs has different eligibility requirements and in theory was formulated for a different purpose. This complexity creates confusion in the marketplace. Without clear direction as to who is eligible and for what, benefits are often unused or underused by the target population. While some progress has been made in recent years towards uniformity in the application process, the remaining formulas and application forms presents a formidable obstacle to understanding the eligibility requirements and how to best plan for a family's educational future. Consolidation and simplification will undoubtedly yield more accurate data about who is accessing federal financial aid for higher education and what effect those programs have upon access, retention, and debt burdens. In sum, why not have one federal grant program, one federal loan program and one uniform tax benefit schedule, or better yet one program with complimentary facets all working together in concert to achieve common, well-articulate goals? Such clarity should yield user benefits, be much more cost-efficient for the taxpayer, and if structured to support the overarching strategic goals, will significantly benefit American society as a whole.

IV. Conclusion

The current labyrinth of federal higher education financial aid was developed over the years as the cumulative product of individual programs enacted one at a time by Congress, often lacking a defined purpose or even the efficiency of a well-coordinated uniform application process. Federal policymakers have never attempted to integrate and restructure that system into a cohesive policy-driven program, despite the obvious benefits and cost savings. The resulting tangle of bureaucracy yields results that are difficult to measure while generating confusion in the marketplace of higher education consumers.

Instead, the federal government should work to develop a strategically-oriented, result-driven federal program of coordinated financial aid that works to serve clearly-articulated goals. This program should be implemented with the use of a uniform set of eligibility standards and delivered through a simple set of programs that are understandable, transparent and easily evaluated against comprehensive and measurable objectives. Such an approach would yield significant benefits to students, their families, taxpayers, and society as a whole.

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[24] Jonathan D. Glater, *Budget Measure Increases College Loans and Rates*, N.Y. Times, February 2, 2006.

[25] Dynarsky testimony at 9.

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Figure 4: Interaction Between Tax Benefits and Federal Need Analysis of Parents' Available Income

Provision	Impact on AGI	Treated as an Asset?	Assessment Rate	Added Back on FAFSA?
Savings Incentives				
529 Savings Plan	Contributions to a plan do not change AGI. Qualified withdrawals reduce AGI by the amount of interest income excluded.[a]	Yes, if the account owner is either a parent or student, but FAFSA instructions do not provide clear guidance about how to report.	If reported as a parental asset, assessed at a maximum rate of 5.64 percent; if reported as a student asset, assessed at a 35 percent rate.	No
529 Prepaid Plan	Contributions to a plan do not change AGI. Qualified withdrawals reduce AGI by the amount of interest income excluded.	No, plan redemptions reduce a student's cost of attendance, irrespective of who owns the account.	100 percent	No
Treasury EE Bonds	Neither purchases nor qualified redemptions directly change AGI.	Yes, generally as a parental asset[b]	Maximum rate is 5.64 percent.	Yes
Coverdell ESA	Contributions to a plan do not change AGI. Qualified withdrawals reduce AGI by the amount of interest income excluded.	Yes,[c] as a student asset	35 percent	No
Retirement Plans	Employee contributions generally decrease AGI when made.[d] Qualified withdrawals increase AGI.	No	Penalty-free withdrawals increase parental income, which is assessed at rates ranging from 22 to 47 percent.	Both employee and employer contributions are added back on FAFSA.

Figure 4: Interaction Between Tax Benefits and Federal Need Analysis of Parents' Available Income *(continued)*

Provision	Impact on AGI	Treated as an Asset?	Assessment Rate	Added Back on FAFSA?
Savings Incentives				
Roth IRA	Contributions to a Roth IRA do not change AGI. Qualified withdrawals reduce AGI by the amount of interest income excluded.	No	If reported as parental income, they would be assessed at rates ranging from 22 to 47 percent.	Instructions do not provide guidance.[e]
UGMA/UTMA	Interest income increases student's AGI.	Yes	If reported as a parental asset, assessed at a maximum rate of 5.64 percent; if reported as a student asset, assessed at a 35 percent rate.[f]	No
Tuition Provisions				
HOPE Tax Credit	No impact	No	N/A	Yes
Lifetime Learning Tax Credit	No impact	No	N/A	Yes
Tuition Deduction	Reduces AGI by amount of allowable deduction.	No	N/A	Instructions do not provide guidance.
Section 117, 127, and 132 Benefits	Reduces AGI by amount of allowable exclusion.	No	If reported as parental income, assessed at rates ranging from 22 percent to 47 percent; if reported as student income, assessed at 50 percent rate.	Instructions do not provide guidance.[g]

Figure 4: Interaction Between Tax Benefits and Federal Need Analysis of Parents' Available Income *(continued)*

Provision	Impact on AGI	Treated as an Asset?	Assessment Rate	Added Back on FAFSA?
Tuition Provisions				
Gift Tax Exclusion	No impact[h]	No	N/A	No
Student Loan Provisions				
Student Loan Interest Deduction	Reduces AGI by amount of allowable deduction.	No	If reported as parental income, assessed at rates ranging from 22 to 47 percent; if reported as student income, assessed at 50 percent rate.	Instructions do not provide guidance.[i]
Forgiveness of Student Loan Exclusion	Reduces AGI by amount of allowable exclusion.	No	If reported as parental income, assessed at rates ranging from 22 to 47 percent; if reported as student income, assessed at 50 percent rate.	Instructions do not provide guidance.[j]

Notes:

[a] The income portion of a qualified withdrawal is excluded from income. Thus, these plans indirectly reduce the applicant's AGI.

[b] In order to be eligible for the interest income exclusion, the bonds must be purchased by an individual age 24 or older and issued in his or her name. Thus, an individual could use this provision to help finance his or her own education, in which case that individual would almost certainly be considered an independent student for purposes of need analysis.

[c] The instructions that accompany the FAFSA indicate that these accounts should be reported as a student's asset if the account is in his or her name. Since the account owner can change the designated beneficiary at any time (as long as the new beneficiary is a member of the same family, and has not reached age 30), this reporting requirement may be circumvented.

[d] Certain contributions to qualified retirement plans may be made with after-tax income. For these contributions, only the income earned on nondeductible contributions is taxed when amounts are subsequently withdrawn.

[e] The growth in the value of a Roth IRA is untaxed income and thus could be reported on the FAFSA. However, the instructions do not call for this, and it is reasonable to assume that most applicants do not report the "untaxed income" component of any Roth IRA withdrawals.

[f] Whether or not the UGMA or UTMA account is legally considered the student's asset is a matter of state law. Generally, control over UGMA accounts automatically transfers to the beneficiary at age 18, while the transfer of full control over UTMA accounts occurs when the beneficiary turns 21.

[g] While these benefits are arguably "other untaxed income or benefits not reported elsewhere" and hence should be reported on Worksheet B of the FAFSA, the absence of clear instructions and the difficulty an applicant may have in knowing the value of the benefit they received mean that few if any applicants would report this benefit.

[h] Gift tax is paid by the donor and thus is not considered income to the recipient.

[i] While the deduction for student loan interest renders the income used to repay interest "untaxed" (or at least, not subject to federal income tax), applicants may not consider the benefit of the student loan interest deduction in this way and thus may not report the deduction on Worksheet B. The FAFSA instructions are silent on this point.

[j] While the exclusion for forgiveness of student loans is arguably "other untaxed income or benefits not reported elsewhere," without clear instructions, it is unlikely that applicants will know to report this benefit on Worksheet B.