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# REBALANCING RESOURCES AND INCENTIVES IN FEDERAL STUDENT AID

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EDUCATION POLICY PROGRAM

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# Contents

<b>EXECUTIVE SUMMARY</b> .....	ii
<b>INTRODUCTION</b> .....	1
Proposal Overview .....	2
<b>PELL GRANTS</b> .....	<b>4</b>
Fix the Funding Cliff .....	5
Make the Pell Grant Program a True Entitlement .....	6
Increase the Maximum Pell Grant .....	7
Require Pell Matching for Underperforming Four-Year Colleges .....	8
Provide Pell Bonus for Four-Year Schools that Serve a Substantial Share of Pell Recipients .....	9
Provide Pell Bonus for Community Colleges with Strong Student Outcomes .....	10
Limit Pell Eligibility Limited to 125% of Program Length .....	11
Restore Year-Round Pell .....	12
Redirect Supplemental Educational Opportunity Grant Funding to Pell Grants .....	13
<b>LOANS</b> .....	<b>13</b>
<b>COMPLETING STUDENT LOAN REFORM</b> .....	14
Provide Incentives for Borrowers to Switch to Direct Loans .....	14
End the Non-Profit Loan Servicer Entitlement .....	15
<b>CREATE ONE FEDERAL STUDENT LOAN PROGRAM</b> ....	16
Make a Redesigned IBR Program the Sole Repayment Option for Borrowers .....	16
End the Subsidized Stafford Interest Rate Benefit.....	17
Create a Fixed Formula for Setting Student Loan Interest Rates .....	18
<b>CHANGE STUDENT LOAN LIMITS</b> .....	20
Set One Loan Limit for All Undergraduates, Irrespective of Their Dependency Status .....	20
End Grad PLUS, but Increase Stafford Loan Limits for Graduate Students .....	21
Give Colleges the Discretion to Lower Loan Limits...	22
End Parent PLUS Loans .....	23
Limit Loans to 150% of Program Length.....	23
<b>RESTORE BANKRUPTCY DISCHARGEABILITY FOR PRIVATE STUDENT LOANS</b> .....	24
<b>OTHER STUDENT AID ISSUES</b> .....	<b>24</b>
Reexamine How Cost of Attendance Is Defined .....	24
Expand Experimental Sites.....	25
Study the Effectiveness of Multiple Federal Student Aid Disbursements .....	26
<b>TAX EXPENDITURES</b> .....	<b>27</b>
Eliminate Tuition Tax Benefits.....	27
Eliminate Tax-Advantaged Savings Plans .....	28
Eliminate Student Loan Interest Deduction.....	28
<b>COLLEGE OUTREACH</b> .....	<b>29</b>
Triple Funding for GEAR UP.....	29
<b>ACCOUNTABILITY, TRANSPARENCY, AND REFORM</b> .....	<b>30</b>
Mandate Institutional Accountability Standards .....	30
Create a Federal Student Unit Record System .....	31
Restore “Ability to Benefit” at Schools with Strong Outcomes .....	32
Create a State Competitive Grant Program for Innovation and Reform .....	33
Make Better, More Consistent Consumer Information Mandatory .....	34
<b>CONCLUSION</b> .....	<b>34</b>
<b>APPENDIX I: PELL GRANT FUNDING SOURCES</b> ..	<b>36</b>
<b>TABLES &amp; FIGURES</b>	
<i>Table 1: Cost Estimate of Rebalancing Resources and Incentives in Federal Student Aid</i> .....	3
<i>Figure 1: The Pell Grant Funding Cliff</i> .....	5
<i>Table 2: Maximum Pell Grant Award, Proposed</i> .....	8
<i>Table 3: Benefit of Subsidized Stafford Loans to Borrowers in Income-Based Repayment</i> .....	18

## EXECUTIVE SUMMARY

The federal financial aid system is no longer up to today's demands. Built in a different era, its haphazard evolution over the decades has made it inefficient, poorly targeted, and overly complicated. With the need for higher education never greater and college growing increasingly unaffordable, students deserve a streamlined aid system that is more understandable, effective, and fair. Policymakers can achieve such reforms at no additional cost to taxpayers -- by rebalancing existing resources and better aligning incentives for students and institutions of higher education. Ultimately, those reforms will increase access to high-quality credentials and boost student success in higher education and the workforce.

In *Rebalancing Resources and Incentives in Federal Student Aid*, we offer more than 30 specific policy recommendations that are designed to create such a system. Nothing is off-limits. We recommend specific changes to federal grants, loans, tax benefits, college outreach programs and federal regulations to provide more direct aid to the lowest-income students, while strengthening accountability for institutions of higher education to ensure that more students are able to earn affordable, high-quality credentials.

Taken together, the package of proposals in our report is *budget-neutral* over the 10-year period from federal fiscal years 2013-2022.

### Pell Grants

The Pell Grant program is the cornerstone of federal student aid. In 1972, when the program was created, a Pell Grant covered most if not all college costs for large numbers of low-income students. But as college prices have soared over the years, the system has become less and less effective. Moreover, the program is now facing a major "funding cliff" in the 2014 fiscal year and each year thereafter.

To improve both the effectiveness and sustainability of Pell Grants, we would:

- Permanently eliminate the Pell Grant funding cliff;
- Put the program on a firm financial footing by shifting future Pell appropriations to the manda-

tory side of the budget, making it a true entitlement;

- Significantly increase the maximum Pell Grant to expand its purchasing power. The plan would increase the maximum award *over current policy* by \$500 in fiscal year 2014 to \$6,225; by \$600 in 2015 to \$6,410; by \$700 in 2016 to \$6,610, and \$800 in 2017 and in each year thereafter through fiscal year 2022 to \$6,830;

- Restore the year-round Pell Grant so that students can complete their degree programs more quickly;

- Limit eligibility for Pell Grants to 125 percent of program length to discourage extended and prolonged enrollments;

- Enact a Pell Grant matching requirement for four-year public and private non-profit colleges that enroll a relatively small share of low-income students but charge them high net prices. The goal of the proposal is to put an end to colleges' financial aid arms war by pushing schools to reallocate their existing institutional aid from merit to need-based aid.

- Create a Pell Grant bonus for four-year public and private non-profit colleges that enroll a substantial share of low-income students and graduate at least half of their students – with the aim of having the schools use this money to reduce the net price they charge their neediest students;

- Create a Pell Grant bonus for community colleges that have a combined graduation and transfer rate of at least 50 percent. Eligible schools could either use the additional money to reduce the net price they charge their neediest students or to create support programs to help low income students earn their degrees and transfer to four-year colleges; and

- Eliminate the outdated Supplemental Educational Opportunity Grant program that disproportionately benefits wealthy private institutions and use

the savings to shore up the Pell Grant program.

## Student Loans

Federal student loans have long been seen as a good investment for students – providing them with the means to obtain an education that will pay substantial dividends throughout their lifetimes. But in recent years, there has been growing concern that many students and their families are taking on unmanageable levels of debt. Meanwhile, the federal student loan program is extremely complex, offering students and their families a variety of choices, with each carrying different interest rates and borrowing limits. Borrowers also face a baffling array of repayment options, but often lack the counseling needed to understand these options.

To simplify the federal student loan program and reduce the dangers of default, we recommend consolidating various programs into a single, enhanced Stafford Loan system. Specifically, we would:

- Require all federal student loan borrowers to repay their loans based on a percentage of their earnings after they graduate;
- End the poorly targeted subsidized interest rate benefit, which is unnecessary with the default Income Based Repayment program;
- Create a new fixed formula for setting student loan interest rates that adjusts annually according to market conditions;
- Establish a single set of federal loan limits for undergraduate students, regardless of their dependency status. Under our proposal, the annual limits for all undergraduates would be \$6,000 for a first year student, \$7,000 for a second-year student, and \$9,000 for a third-, fourth-, or fifth-year student. The aggregate limit for undergraduates would be \$40,000;
- End the Graduate PLUS loan program, which allows for unlimited borrowing by graduate students and discourages prudent pricing on the part of institutions;

- Raise the annual limit on Unsubsidized Stafford loans for graduate students from the \$20,500 to \$25,500 to replace some of the borrowing ability graduate students lose with the elimination of the Grad PLUS loan program;

- Eliminate the Parent PLUS loan program, which allows parents to borrow up to the cost of attendance. This program can encourage families to over-borrow and provides colleges with a convenient source of funds if they wish to raise their prices;

- Give colleges the discretion to lower federal student loan limits at their schools or in certain programs to discourage excessive borrowing;

- Limit eligibility for federal student loans to 150 percent of program length to discourage prolonged enrollments; and

- Restore the ability of borrowers to discharge private student loans in bankruptcy to make private loan borrowing a safer option for students.

In 2010, Congress and the Obama administration reformed the federal loan program, eliminating wasteful subsidies to private lenders for government-backed student loans and shifting all student loans to the U.S. Department of Education's direct lending program. To complete the job of reform we would:

- Provide generous incentives to borrowers with older loans to refinance their debt into the Direct Loan program; and

- Eliminate the non-profit servicer entitlement by requiring all entities that wish to service Direct Loans to compete for contracts.

## Other Student Aid Issues

In addition to the student aid proposals above, our plan would:

- Reexamine how colleges calculate the Cost of Attendance so that policymakers can consider

whether to redefine or regulate it for an increasingly diverse student population;

- Improve and expand the U.S. Department of Education’s Experimental Sites Initiative to promote more innovation in the delivery of federal student aid;
- Call on the Education Department to study the efficacy of disbursing federal aid in multiple installments throughout the semester to create greater incentives for students to persist, to guard taxpayers and institutions from fraud, and to protect students who during the semester from having to pay back large amounts of aid; and
- Restore “Ability to Benefit” program so that students without a high school diploma or GED can participate in federal student aid programs. This option would be limited to schools that have a proven track record of serving their students well.

## Tax Expenditures

In addition to federal grants and loans, poorly targeted tax benefits comprise a substantial share of federal financial aid resources. Our plan would:

- Redirect more than \$180 billion in savings over 10 years primarily to the Pell Grant program by eliminating complicated tuition tax breaks, tax-advantaged savings plans, and the student loan interest deduction.

These programs provide overlapping and often highly regressive benefits. That is, they provide the lion’s share of assistance to upper-income taxpayers with the least financial need. Those funds can be better used providing direct aid for students.

## College Outreach

Since the creation of the Higher Education Act in 1965, federal policymakers have supported multiple programs aimed at raising the college aspirations and improving the academic preparation of disadvantaged students. The most promising of these programs is GEAR UP, which provides

services using a cohort model aimed at middle and high school students. Our plan would:

- Triple funding for GEAR UP, while requiring changes in the program to make it more effective.

## Accountability, Transparency, and Reform

While financial aid reform is contingent upon distributing available funding more efficiently, the federal government also needs to use federal aid more effectively to encourage institutions to improve student outcomes. Colleges have traditionally received federal financial aid with few strings attached. In order to create new accountability mechanisms for improving data collection and to require colleges to provide more information about their success in serving students, we would:

- Hold colleges accountable for quality and affordability by extending broad accountability metrics to all higher education institutions;
- Create a federal student unit record system to provide a clearer picture of how students fare as they proceed through the educational system and into the workforce;
- Create a competitive grant program that will incent state-level policy reforms to improve outcomes for the 80% of students who attend public institutions; and
- Mandate better and more consistent consumer information, including standardized financial aid award letters, a college scorecard, and improved entrance and exit counseling, so that consumers can make informed decisions before, during, and after college.

These proposals, taken together, rebalance the federal aid portfolio by providing a major increase in support to students at the margins of college completion, while creating new incentives for colleges to serve students well. They ask more of students and institutions, and they provide more in return. ♦

When Rhode Island Senator Claiborne Pell helped create the college student aid program that would become his legacy, American higher education looked very different than it does today. In 1972, the typical college student paid the equivalent of \$526 per year in tuition and fees, in today's dollars, to attend a public university in-state.<sup>1</sup> Private college tuition was often affordable, and undergraduate borrowing was all but unheard-of. There were no “for-profit” colleges as we know them now. The large majority of all public support for higher education came in the form of direct appropriations to colleges and universities from states.

The world has changed since then. Profound shifts in the structure of the global economy have put a premium on high-skill jobs that require advanced credentials while many well-paying blue-collar jobs have disappeared. Students have flooded onto college campuses, in America and, increasingly, around the world. At the same time, colleges and universities began a decades-long campaign in the early 1980s of constant price increases that continues, unabated, today. This happened in part because states, eager to cut taxes and facing rising costs for health care and public safety, reduced the portion of their budgets dedicated to higher education. At the same time, colleges competing for students and prestige ramped up spending year after year.

With middle-class wages stagnant and the post-recession recovery slow, students and parents have been unable to keep up. They know they need a college degree, but they don't have enough money to pay ever-rising tuition bills. As a result, the federal government has become the funder of last resort in American higher education. As recently as 2002, federal student aid totaled \$72 billion per year. By 2012, it had grown to \$174 billion—a \$102 billion increase in *annual* aid in just a decade's time.<sup>2</sup> Most of that money came in the form of federally-backed loans that students are increasingly struggling to repay.

Yet despite this wave of new funding, federal lawmakers are struggling to keep vital aid programs afloat. The engine of American higher education will seize up without a steady infusion of new federal dollars, but the demand for those dollars seems without limit. In a period of high-profile national debates about budget deficits and fiscal

austerity, this puts higher learning and national prosperity at risk.

At the same time, lawmakers are increasingly questioning what taxpayers are getting in return for record federal investments in college. Only half of students who start college earn a degree or credential within six years. Traditionally underserved minority students and those backed by need-based aid programs often do even worse. Rival nations, keenly aware of how knowledge workers will determine future economic competitiveness, have increased their rates of degree attainment much faster than the United States.

In short, the present federal financial aid system is no longer up to the demands of the times. It was built in a different era and has evolved haphazardly over the decades, in response to fiscal exigency and interest group pressures. It has become unwieldy, inefficient, and overly complicated, in a way that wastes taxpayer dollars and fails to provide institutions and students with the resources and incentives they need to complete high-quality college degrees.

More incremental change will not suffice. With the need to support higher learning never greater and fiscal pressures acute, the time has come for a top-to-bottom overhaul of how the federal government manages financial aid. Everything should be on the table: grant aid, loan programs, tax credits, and long-standing subsidies to institutions. Taxpayers and students need an aid system that is simpler, more understandable, more effective, and fairer.

Fortunately, decades of accumulated policy offer many

opportunities for such reform. Tucked away in the system are inefficiencies and obsolete subsidies that can be used for better purposes. Overlapping programs can be consolidated in ways that make them more generous and understandable. Overly expensive programs that have strayed from their original purposes can be made more affordable for the federal government and more effective at helping students earn degrees.

In fact, there is enough waste and inefficiency in the existing system to substantially *increase* funding for Claiborne Pell’s foundational grant program, put federal aid on a firm budgetary footing, solve the student loan repayment problem, and provide new incentives to spur college graduation—all for no additional cost to the taxpayer above what is already being spent today.

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**There is enough waste in the existing system to substantially *increase* funding for Pell, put federal financial aid on firm budgetary footing, solve the student loan repayment problem, and provide new incentives to spur college graduation—all at *no additional cost* to the taxpayer.**

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While some of the proposals in this report eliminate wasteful spending, others represent real tradeoffs and politically challenging changes in the distribution of federal aid. But there is no path forward for federal financial aid that avoids hard choices. Federal lawmakers have already begun to ration financial aid, narrow eligibility, and cannibalize other federal education programs to keep the old system running. The only choice is whether to continue on that treacherous course, setting policy haphazardly while managing a never-ending series of budget crises and watching college opportunities diminish for lower- and middle-class students, or to put the federal aid system on firm footing for generations to come. This report describes in detail exactly how to accomplish those reforms.

### Proposal Overview

The proposals in this report are, in total, budget-neutral over the 10-year period from federal fiscal years 2013-2022, based on the new budget baseline established in January

2013 (The proposal reduces aggregate spending slightly during the five-year period of FY 2013–2017). The table on page 3 describes many of the individual components of our proposal along with estimates of their budgetary effects.

This reform proposal both augments and improves the Pell Grant program. It includes funding for a series of significant increases in the maximum Pell award while simultaneously eliminating the so-called “Pell cliff” in the federal budget and shifting future Pell appropriations to the mandatory, non-appropriations side of the budget. It restores the “all-year” Pell Grant award that allows students to earn degrees more quickly and reinstates the “Ability to Benefit” eligibility criteria for federal aid, but only for high-performing colleges. It brings additional financial aid to needy students by requiring public and private four-year schools that fail to meet certain price and Pell Grant student enrollment criteria to match federal aid dollars with institutional aid. It creates a new, additional Pell Grant bonus for high-performing community colleges and public and private non-profit four-year colleges, while creating a new competitive grant fund for higher education innovation.

To improve institutional and student incentives for completion, eligibility for Pell Grants will be limited to 125 percent of program length, while student loans are available for 150 percent of program length. The Department of Education will be directed to study the disbursement of federal aid in multiple installments throughout the semester. At the same time, the proposal calls on policymakers to reexamine the use of Cost of Attendance for the purposes of calculating federal aid, evaluate its definition, and consider regulation of the term. The proposal also triples the size of the federal GEAR-UP program.

Together, these reforms will return the Pell Grant program to its historic role as a major guarantor of access and affordability for low- and moderate-income students.

The proposal also overhauls the federal student loan system. Instead of the present system of multiple loan programs with contradictory goals, the proposal consolidates various programs into a single, enhanced Stafford Loan system. Overall federal loan limits would be increased for dependent undergraduates, but there would be no unlimited loan programs, and institutions would have the option to further reduce loan limits below the maximum established in federal law.



Table 1: Cost Estimate of Rebalancing Resources and Incentives in Federal Student Aid

(-) savings (+) cost, \$ billions

YEAR	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2013-2017	2013-2022
<b>GRANTS</b>												
Budget Control Act spending caps reduced	-	-22.800	-23.370	-23.954	-24.553	-25.167	-25.796	-26.441	-27.102	-27.780	-94.677	-226.963
Pell Grant appropriation as entitlement (net cost)	-	22.800	23.370	23.954	24.553	25.167	25.796	26.441	27.102	27.780	94.677	226.963
SEOG Program funds redirected*	-0.753	-0.764	-0.776	-0.787	-0.799	-0.811	-0.823	-0.836	-0.848	-0.861	-3.879	-8.059
Pell eligibility max set at 125% of program length	-0.310	-0.316	-0.321	-0.332	-0.345	-0.345	-0.359	-0.371	-0.377	-0.382	-1.624	-3.457
Pell matching requirement	-	-	-	-	-	-	-	-	-	-	-	-
Triple funding for GEAR UP	0.604	0.619	0.635	0.650	0.667	0.683	0.700	0.718	0.736	0.754	3.175	6.767
State innovation competitive grant	-	3.358	-	7.000	-	-	-	-	-	-	10.358	10.358
Pell grant bonus for 4-year schools	-	2.400	2.448	2.497	2.547	2.611	2.676	2.743	2.811	2.882	9.892	23.614
Pell grant bonus for community colleges	-	3.547	3.618	3.691	3.764	3.858	3.955	4.054	4.155	4.259	14.620	34.901
Accelerated/year-round Pell Grant	-	3.000	3.075	3.152	3.231	3.311	3.394	3.479	3.566	3.655	12.458	29.864
Maximum Pell Grant increased	-	7.025	8.359	9.743	11.154	11.306	11.457	11.626	11.785	11.941	36.280	94.395
Pell Grant "funding cliff" eliminated	-	5.755	8.652	8.652	6.096	6.820	7.166	7.600	8.323	8.714	29.155	67.778
<b>LOANS</b>												
Subsidized Stafford benefits eliminated	-3.000	-3.100	-3.350	-3.600	-3.850	-4.100	-4.400	-4.800	-5.300	-5.900	-16.900	-41.400
Interest rates set at 10-yr Treasury note plus 3%	4.599	7.671	5.376	1.377	-2.754	-5.886	-7.790	-8.798	-9.214	-9.503	16.269	-24.922
Direct Loan consolidation incentive for FFEL loans**	-8.520	-8.520	-	-	-	-	-	-	-	-	-17.040	-17.040
Two-tiered Income-Based Repayment	-0.100	-0.150	-0.158	-0.165	-0.174	-0.182	-0.191	-0.201	-0.211	-0.222	-0.747	-1.754
Non-profit loan servicer program terminated	-0.008	-0.018	-0.023	-0.025	-0.027	-0.029	-0.030	-0.016	-0.004	-0.001	-0.101	-0.182
Loan limit for independent undergrads decreased**	0.393	0.050	-0.448	-0.922	-1.373	-1.652	-1.866	-1.945	-2.006	-2.069	-2.300	-11.839
Loan limit for dependent undergrads increased**	-0.262	-0.033	0.299	0.614	0.915	1.101	1.244	1.297	1.338	1.379	1.534	7.893
Graduate Stafford loan limit increased by \$5,000**	-0.262	-0.033	0.299	0.614	0.915	1.101	1.244	1.297	1.338	1.379	1.534	7.893
Grad PLUS loans eliminated**	2.150	1.772	1.069	0.327	-0.454	-0.944	-1.332	-1.463	-1.560	-1.658	4.864	-2.092
Parent PLUS loans eliminated**	2.975	2.482	1.795	1.131	0.501	0.151	-0.087	-0.121	-0.125	-0.129	8.884	8.573
<b>TAX EXPENDITURES</b>												
Higher education tax benefits eliminated	-	-27.202	-26.860	-27.207	-27.581	-14.150	-14.347	-14.547	-14.748	-14.950	-108.850	-181.591
<b>ACCOUNTABILITY</b>												
Institutional outcome standards	-0.132	-0.135	-0.139	-0.142	-0.146	-0.149	-0.153	-0.157	-0.161	-0.165	-0.694	-1.479
Ability to Benefit test restored (select schools)	0.178	0.178	0.178	0.178	0.178	0.178	0.178	0.178	0.178	0.178	0.890	1.779
<b>NET BUDGET EFFECT</b>												
	-2.449	-2.415	3.728	6.446	-7.534	2.873	0.635	-0.263	-0.325	-0.698	-2.223	0.000

\*Non-defense appropriations caps must be reduced by the same amount to ensure no net impact on the budget.

\*\*Based on fair-value accounting

Source: New America Foundation Note: All budgetary effects are estimated relative to current law as of January 10, 2013. Does not include the following key recommendations for which we were unable to provide cost estimates: 1) creating a federal unit record system; 2) expanding experimental sites; 3) mandating better, more consistent consumer information; and 4) reexamining Cost of Attendance definitions.

Rather than subsidize the cost of loan repayment through arbitrary interest rates, the proposal would set interest rates on all newly-issued student loans to the 10-year Treasury note, plus 3.0 percentage points. To ensure that loans remain affordable under different interest rate scenarios, the sole repayment option for all federal loans would be a modified version of the current Income-Based Repayment (IBR) program. (Students could still pay their loans back more quickly if they desire.)

To create this new system of simpler, more generous, and more effective grants and loans, the proposal eliminates a number of poorly targeted and duplicative aid programs. It reduces federal outlays by terminating the non-profit student loan servicer program that will no longer be needed as students move to IBR and saves additional funds by establishing a Direct Loan consolidation incentive program for all outstanding loans in the Federal Family Education Loan Program. It eliminates the outdated Supplemental Educational Opportunity Grant program that disproportionately benefits wealthy private institutions, along with all tuition tax benefits, student loan interest deductions, and new tax-advantaged savings plans. These programs have become an increasingly large drain on the federal treasury even as their benefits mostly accrue to wealthier taxpayers with no demonstrated effect on improving the number of students with college degrees.

Finally, the proposal puts the new system of grants and loans in a stronger context of consumer information and constructive accountability. It improves data collection and publishing efforts at the U.S. Department of Education and requires institutions to provide more information about their success in serving students. It expands the “gainful employment” measures of loan repayment and post-graduation earnings to all higher education programs, including those at public and non-profit institutions, and uses them to augment an improved system of holding institutions accountable for helping students earn affordable, high-quality degrees. It also develops new “experimental site” templates to promote more innovation in the delivery of federal aid.

Crucially, these proposals work best in combination. They ask more of students and institutions, and provide more in return. They rebalance the federal aid portfolio, providing a major increase in support to students at the margins

of college completion, while creating new incentives for colleges to serve students well. The aid system envisioned here is much simpler and fairer, helping students and parents who struggle with the thicket of confusing programs that exist today. In total, this reform package would benefit the large majority of students and colleges at no additional federal cost. ■

## PELL GRANTS

The Pell Grant program is the cornerstone of federal student aid. It aims to reduce the cost barriers that all too often keep low-income students from attending college. When Pell Grants were first created in 1972, tuition and fees were relatively low, and a Pell Grant covered most if not all college costs for large numbers of low-income students. For these individuals, student loans were considered only as a last resort.

But over the years, as college prices have soared, the system has become less and less effective. Today, the Pell Grant program is in drastic need of restructuring, for the following reasons:

- The program is facing a serious budget crisis (See Figure 1 on page 5). This is primarily because supplemental funding that Congress has provided to maintain the maximum award at \$5,550 over the last several years is set to run out by the time lawmakers enact the fiscal year 2014 appropriations bill, near the end of 2013. Without a permanent fix, lawmakers will have to come up with an additional \$67.8 billion over the next 10 years just to maintain the maximum grant at its current level.<sup>3</sup>

- A significant share of Pell Grant funds go to colleges that have an extremely poor record of retaining and graduating students<sup>4</sup> – including some unscrupulous schools that prey on low-income students.<sup>5</sup>

- Many four-year public and private non-profit colleges are undermining the federal government’s efforts to lower the barriers to higher education for low-income students by using their institutional aid primarily to attract the students they desire, rather than to meet the financial need of the students they enroll.<sup>6</sup> As a result, Pell Grant recipients who choose to attend these institutions often go deeply in debt to do so – which could leave them worse off if they fail to graduate.<sup>7</sup>

- The program does not provide enough incentives for students to make steady progress and complete a degree or credential on-time.

The proposals in this paper would address all of these problems at no additional cost to taxpayers. They would better target federal student aid dollars to bolster the Pell Grant program – allowing policymakers to eliminate the Pell funding cliff; significantly raise the maximum grant; provide Pell Grant bonuses to public and private non-profit four-year and two-year colleges that serve a substantial

share of Pell Grant recipients and meet certain quality metrics; and restore the year-round Pell Grant to help students accelerate their studies. Moreover, the plan would achieve a long-elusive goal of the program’s founders: to turn the program into a true entitlement for low-income students.

At the same time, the proposals would demand better performance from both colleges and students. For example, public and private non-profit colleges that enroll a relatively small proportion of Pell Grant recipients and charge their lowest income students a high net price would be required to match a share of the Pell Grant disbursements they receive to ensure that the most disadvantaged students have the resources they need to succeed in college. The plan would also further limit the amount of time students are eligible for the grants in order to encourage more timely degree completion.

### Fix the Funding Cliff

We estimate that the combination of proposals outlined in this report is sufficient to permanently correct the Pell Grant funding cliff (See text box for an explanation of the funding cliff). By implementing the policies proposed here, lawmakers can maintain the maximum grant level that students have been provided in recent years, preserve the inflationary increases set to take effect under current law, and even set aside funding for further increases in the maximum award in the coming years.

### Figure 1: The Pell Grant Funding Cliff

In recent years, lawmakers have provided annual funding for the Pell Grant program in three parts: a regular annual appropriation, an entitlement formula, and supplemental funding. Historically, Congress has funded the Pell Grant program entirely through the annual appropriations process. Lawmakers establish a maximum grant level that a student may receive and then appropriate as a one-time sum what the Congressional Budget Office estimates to be the necessary funding each year. In 2007, Congress added a funding formula that operates like an entitlement (i.e. funding is provided in advance, outside of the annual appropriations process) to build on the annual appropriation for the program.<sup>8</sup> In 2010, lawmakers increased the benefits that the formula provides and made it permanent.<sup>9</sup> The entitlement formula provided \$690 toward the maximum grant of \$5,550 in 2012, and beginning in 2013, it will increase with inflation for each of the subsequent five years. Despite these changes, the third funding source – the supplemental funding – creates a funding cliff for the program.

As part of the American Recovery and Reinvestment Act, Congress approved a \$619 increase in the maximum grant in 2009 and pledged to provide an \$819 increase for 2010, compared to the maximum award of \$4,731 in 2008.<sup>10</sup> To achieve those increases, lawmakers enacted a \$17.2 billion supplemental appropriation for the program that would

last for less than two years. Since 2009, lawmakers have opted to maintain the size of the maximum grants first achieved using this supplemental funding, but have not increased the regular annual appropriation to a level sufficient to do so. Consequently, they must allocate new rounds of supplemental funding on a regular basis and/or change the eligibility rules of the program to reduce costs.

Lawmakers provided the second round of such funding in 2010 when they included \$13.5 billion as part of the Health Care and Education Reconciliation Act.<sup>11</sup> In 2011, Congress increased the regular appropriation, but not enough to fully fund the maximum grant provided to students in the past year; it also opted to close the funding gap by reducing the costs of the program, eliminating year-round Pell Grant eligibility (which had been in effect for one year).<sup>12</sup> Later in 2011, as part of the Budget Control Act, Congress provided another round of supplemental funding – \$17 billion – that would help fund the program in 2011, 2012, and 2013.<sup>13</sup> Finally, to further reduce costs in the program, lawmakers adopted a number of eligibility changes on the fiscal year 2012 appropriations bill and provided another round of supplemental funding by temporarily suspending the grace period interest benefit on Subsidized Stafford loans for undergraduate borrowers.<sup>14</sup>

Those sources of supplemental funding for Pell Grants will be exhausted by the time lawmakers enact the fiscal year 2014 appropriations bill, near the end of 2013. This is the Pell Grant funding cliff. To maintain the Pell Grant program in its present form, the fiscal year 2014 appropriation bill must include at least a \$5.8 billion increase to make up for the exhaustion of the supplemental funding or lawmakers must cut the maximum grant substantially, radically alter eligibility rules, or some combination of the two. That funding level must then be maintained and increased in future years to sustain the program in its current form. In each of fiscal years 2015 and 2016, for example, an additional \$8.7 billion will be needed, over today's regular appropriation of \$22.8 billion. Over the next 10 years, the additional amount needed totals \$67.8 billion.<sup>15</sup>

Lawmakers are unlikely to provide such an increase in the annual appropriation. The Budget Control Act of 2011 established nominal limits for total appropriations funding for future fiscal years, and lawmakers did not “make room” within those limits for such a large increase in funding for Pell Grants.<sup>16</sup> Consequently, lawmakers could only increase the regular appropriations for Pell Grants if they reduced spending for other programs by a similar amount. Yet other programs are under fiscal strain as well, and their supporters will surely oppose any funding reduction. Other budget challenges – such as historically large budget deficits and slow economic growth – make it unlikely that lawmakers would address the Pell Grant funding cliff by allocating new spending outside the appropriations process (so called “mandatory spending”) that is not offset with commensurate spending reductions in other areas.

Lawmakers must therefore work within the existing set of federal student aid policies to find efficiencies and cost savings that can be reallocated to permanently address the Pell Grant funding cliff.

### **Make the Pell Grant Program a True Entitlement**

Implementing our package of reforms to federal student aid outlined in this paper would permanently address the Pell Grant funding cliff. Absent other budgetary changes, however, Pell Grant funding will still be subject to the annual appropriations process. Even if lawmakers manage to find the resources to shore up funding for the Pell Grant program over the long term, those efforts will still ultimately rest on year-to-year budgeting decisions made

through the always-uncertain appropriations process. Therefore, as part of a complete package of budget-neutral reforms to student aid, lawmakers should move the 60 percent of total Pell Grant funding currently provided through the appropriations process to the so-called “mandatory” or “entitlement” side of the federal budget, through which the remaining 40 percent of funding has been provided in recent years. Policymakers could accomplish this by turning the eligibility rules and maximum grant speci-

fications for Pell Grants into a formula that is permanently funded unless otherwise altered by Congress.

Until recently, federal budget rules would have made it virtually impossible for lawmakers to accomplish this long-elusive goal. However, Congress and the President provided an avenue for doing so in enacting the Budget Control Act of 2011. The law set aggregate limits on the amount of non-defense appropriations Congress allocates each year and made them enforceable through automatic spending cuts called sequestration.<sup>17</sup> To make Pell Grants a true entitlement, lawmakers can reduce the aggregate limits by an amount that equals future, anticipated Pell Grant appropriations and then reallocate the funding to the mandatory side of the budget. Described differently, lawmakers could commit to eliminate future appropriations for Pell Grants by lowering aggregate appropriations limits and committing those same funds to a Pell Grant entitlement. Lawmakers would need to reduce the caps by approximately \$25.0 billion per year, or \$94.7 billion over five years and \$227.0 billion over 10 years. (The spending limits laid out in law do not extend beyond fiscal year 2021; however, should Congress and the President agree to maintain them after that year, the extension should reflect the permanent reduction in Pell Grant appropriations to offset mandatory funding.)

In summary, lawmakers can adopt the student aid changes recommended in this report and provide sufficient funding to address the Pell Grant funding cliff permanently without requiring additional spending. As part of this effort, lawmakers can solidify reforms and eliminate any uncertainty about future funding for the program by financing it through the mandatory, rather than the appropriations, side of the budget.

### Increase the Maximum Pell Grant

The Pell Grant program provides targeted, direct aid to low-income undergraduate students. However, College Board estimates show that increases in the maximum award have not kept pace with increases in tuition, particularly at four-year colleges.<sup>18</sup> Only 10 years ago, the maximum Pell Grant amount covered 98 percent of the average tuition and fees at public four-year institutions, but challenging economic circumstances and diminishing state investments in higher education mean that in the 2012-13 academic year, the grant covered only 64 percent of tuition

and fees. At private four-year colleges, the grant covered an even smaller portion of the cost, although the decline – from 22 percent of average tuition and fees in 2003 to 19 percent a decade later – was less pronounced.

We propose increasing the maximum Pell Grant award each year from 2014 to 2022, beginning after the implementation of other reforms to the Pell Grant program. Significant increases to the maximum grant will also allow more students from families with middle incomes to receive Pell Grants, due to the program's sliding-scale eligibility rules. This newly available aid should partially offset the reduction in aid some middle-income families would experience through the elimination of tax benefits, as this paper proposes.

The expanded Pell Grant would provide other benefits that tax benefits do not. It would cover more categories of expenses; would be provided when expenses are incurred (rather than many months later, like tax credits); and would be subject to the new incentive and accountability rules proposed in this paper. The Pell Grant increases would not, however, reach families with incomes as high as those who qualify for some temporary tax benefits, such as the American Opportunity Tax Credit and the deduction for tuition and fees.

The proposal recommends a \$500 increase over the maximum Pell Grant under current policy in fiscal year 2014; a \$600 increase over the grant under current policy in fiscal year 2015; a \$700 increase in fiscal year 2016; and an \$800 increase in every year thereafter through fiscal year 2022, such that the maximum grant in fiscal year 2022 is \$6,830, \$800 greater than under current policy.

### Cost Estimate

5-year: \$36.3 billion cost

10-year: \$94.4 billion cost

*Using U.S. Department of Education 10-year projections for Pell Grant recipients and costs, updated in August 2012, we estimate that a \$100 increase in the annual maximum Pell Grant translates into an approximately \$1 billion annual increase in cost compared to current policy, although that figure increases in later years. Other policy proposals recommended in this report – specifically, accelerated Pell Grants and restoring the ability-to-benefit test – would increase those costs by approximately 20*

Table 2: Maximum Pell Grant Award, Proposed

Fiscal Years 2013-2022, \$

YEAR	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Maximum Grant (Base)	5,645	6,225	6,410	6,610	6,830	6,830	6,830	6,830	6,830	6,830
Possible Maximum Grant (Bonus Schools)	11,290	12,450	12,820	13,220	13,660	13,660	13,660	13,660	13,660	13,660

Source: New America Foundation

percent, such that the annual cost of a \$100 increase in the maximum Pell Grant is \$1.2 billion. Based on those figures, the series of increases to the maximum Pell Grant recommended in this report would cost \$36.3 and \$94.4 billion over the next five and 10 years, respectively, compared to current policy.

### Require Pell Matching for Underperforming Four-Year Colleges

From the inception of the federal student aid programs nearly 50 years ago, the government has committed itself to removing the financial barriers that prevent low-income students from enrolling in and completing college. Federal policymakers have sought to achieve this goal primarily through the Pell Grant program.

The federal government, however, can't achieve this essential goal on its own. For many years, colleges complemented the government's efforts by using their institutional financial aid dollars to make higher education more accessible and affordable for the neediest students. Unfortunately, those days are increasingly in the past. Many institutions today work at cross purposes with the government.<sup>19</sup> They spend a larger share of their institutional aid dollars on attracting the students they desire than they do on meeting the financial needs of the low-income students they enroll.<sup>20</sup> Worse yet, there is compelling evidence to suggest that schools are capturing a significant share of the Pell Grant funds they receive and using them for other purposes, such as providing non-need-based aid to recruit high-achieving and wealthier students.<sup>21</sup> This is one reason public demand for Pell Grants remains high even after historic increases in funding for the program: not all of the money is actually going to students and families as intended.

The enormous growth in non-need-based, or "merit," aid at four-year colleges over the last two decades has come

largely at the expense of the neediest students.<sup>22</sup> Low-income students who attend these institutions often face high levels of "unmet need," defined as the difference between their cost of attendance and the amount of financial aid they receive. Unmet need forces students to take on significant amounts of debt, including risky private student loans. Financially strapped students also frequently engage in activities that lessen their likelihood of completing their degrees, such as working full-time while attending college or dropping out until they can afford to return.

To review how this dynamic plays out on campuses, we analyzed U.S. Department of Education data showing the proportion of Pell Grant recipients that individual colleges serve and the average net price – the amount of money students and their families pay after all grant and scholarship aid is taken into account – charged to the lowest-income students.

Overall, only 54 of the 479 private colleges examined charge students and families with incomes of \$30,000 or less each year a net price under \$10,000. In comparison, 291 private colleges, or about 60 percent of those examined, charge the poorest students a net price over \$15,000 each year; and 105, or 22 percent, leave these individuals to come up with \$20,000 or more annually. The news is better at public four-year colleges, the majority of which charge the lowest-income students an average net price under \$10,000. Still, more than 150 of the 336 examined charge those students an average net price over that amount, and 22 charge over \$15,000.<sup>23</sup>

Certainly a number of these colleges have small endowments, making it extremely difficult for them to provide adequate support to students with the greatest need. It is often the poorest schools that enroll the largest proportions of Pell Grant recipients and charge these students high net

prices because of their limited resources. However, it is not simply a question of wealth. Some of the country's most affluent colleges are the stingiest with need-based aid. These institutions tend instead to use their financial aid as a competitive tool to reel in students who will help them increase their prestige in the *U.S. News & World Report* rankings or maximize their revenue.<sup>24</sup>

To help put an end to colleges' financial aid arms war, we propose to create a new Pell Grant matching requirement for four-year public and private non-profit colleges that enroll a relatively small share of low-income students but charge them high net prices. Research suggests that low-income students often drop out of college for financial reasons<sup>25</sup> and that providing additional grant aid to these students has a positive impact on their persistence.<sup>26</sup> Therefore, the goal of our proposal is to ensure that these institutions are using their institutional aid to bolster the federal government's mission of making college more affordable and accessible for low-income students, rather than hindering it by diverting their resources to merit aid. Meanwhile, it would increase student success by providing low-income students with the resources they need to stay in college.

Under the plan, four-year public and private non-profit colleges at which Pell Grant recipients make up less than 25 percent of the student body would have to match a share of the Pell Grant disbursements they receive if they charge students with annual family incomes of \$30,000 or less a net price exceeding \$10,000. These institutions would be required to use the additional money to supplement the aid that the neediest students receive.

Under the proposal:

- High net price colleges that enroll less than 15 percent Pell Grant recipients would be required to provide a 100 percent match;
- High net price colleges that enroll between 15 and 20 percent Pell Grant recipients would have to provide a 50 percent match;
- High net price colleges that enroll between 20 and 25 percent Pell Grant recipients would be required to provide a 25 percent match.

Colleges could reduce their required match amount by increasing the share of Pell Grant recipients they enroll, or eliminate it altogether by lowering the net price charged to the lowest income students below \$10,000. Meanwhile, colleges that decline to make the match would lose eligibility to participate in federal student aid programs altogether.

The proposal would, however, include exemptions for colleges that don't currently have the resources to provide a substantial amount of institutional aid to students. Under the plan:

- Schools required to make a 100 percent match are exempt from the mandate if the total amount of money they receive in Pell Grant funding exceeds the amount they give out in institutional aid;
- Schools required to make a 50 percent match are exempt if they receive twice as much money in Pell Grant funding as they award in institutional aid; and
- Schools required to make a 25 percent match are exempt if they receive four times as much Pell Grant funding as they give out in institutional aid.

The Pell matching proposal includes no additional costs to taxpayers. Rather, institutions that meet the criteria laid out in the proposal would be encouraged to reallocate their existing institutional aid.

### **Provide Pell Bonus for Four-Year Schools that Serve a Substantial Share of Pell Recipients**

Among public and private four-year colleges, the schools with the fewest resources tend to serve the largest share of low-income students. Financially strapped, these colleges have a hard time supporting those students. Our analysis of school-by-school Pell Grant and net price data found that at private colleges with endowments of less than \$100 million, Pell Grant recipients made up an average of 36 percent of the student body, compared to only 16 percent at colleges with endowments of \$1 billion or more. At the same time, the wealthiest schools could afford to charge the lowest-income students at their institutions a net price under \$10,000, while the poorest schools charged these students a net price of over \$17,000.

Under this proposal, the government would double the amount of Pell Grant funding it provides to colleges that enroll a substantial share of Pell Grant recipients (more than 25 percent) and graduate at least half of their students schoolwide – with the aim of having the schools use this money to boost their institutional aid budgets and therefore reduce the net price charged to the neediest students. Colleges could also use a portion of this additional money to create support programs to further increase the retention and graduation rates of low-income students on their campuses.

Schools that meet these criteria would have to enroll a minimum of 1,000 students to qualify for the additional funds. However, in future years, participating colleges would lose eligibility for the bonus if they significantly reduce the percentage of Pell Grant recipients they serve, increase the net price they charge the lowest-income students, or if their graduation rates among Pell recipients drop substantially (As noted elsewhere in this paper, New America’s plan would require colleges to report their Pell student graduation rates to the U.S. Department of Education.)

If enacted, this proposal would increase student success at these institutions by providing low-income students with the resources and support they need to stay in college.

### Cost Estimate

5-year: \$9.9 billion cost

10-year: \$23.6 billion cost

*We estimate the Pell Grant bonus proposal for four-year colleges would cost about \$9.9 billion over five years and \$23.6 billion over 10 years. Using 2010 data, we estimate which schools would qualify for the program and totaled the Pell disbursements at those schools in that year. In sum, they received \$1.2 billion in 2010.*

*Calculations show that a number of schools are on the margins of qualifying for the programs. We found that 86 of those schools are within reaching distance and could strive to meet and ultimately reach the new criteria; their 2010 Pell Grant disbursements totaled about \$344 million. That brings the total cost of the proposed program to about \$1.5 billion in its first year of implementation. Recognizing the costs of the program could be higher than the data suggest if schools are more willing than anticipated to meet the new metrics, the cost was rounded*

*up to \$2 billion in its first year. Because the size of the maximum Pell Grant and therefore, program will increase annually beginning in fiscal year 2014 under proposals in this paper, a twenty percent upward estimate was applied to the costs of the program. Additionally, we incorporated inflationary increases to those figures for future years in the amount of 2 percent for the first three years and 2.5 percent for every year thereafter to calculate annual costs.*

### Provide Pell Bonus for Community Colleges with Strong Student Outcomes

When it comes to educating low-income students, community colleges are the workhorses of higher education. Yet they receive the fewest resources from their states and the federal government, which may help explain why many community colleges have poor student outcomes.<sup>27</sup>

Most states provide much more generous subsidies to their public flagship universities than to community colleges, even though the two-year schools are doing the heavy lifting.<sup>28</sup> California, for example, currently spends about three times as much per student educating University of California students as it does educating students at the state’s 112 community colleges.<sup>29</sup>

Federal student aid programs also shortchange community colleges. Because the Department of Education distributes campus-based aid funds largely according to a formula that was set in 1980, two-thirds of the money Congress appropriates each year for the Federal Work Study and Supplemental Educational Opportunity Grant (SEOG) programs go to the private colleges and public universities that have dominated the programs since their start. However, those institutions tend to serve a smaller share of low-income students than community colleges. For example, Bunker Hill Community College receives about one-tenth the amount of SEOG funds than Harvard University, but Bunker Hill’s share of Pell Grant recipients enrolled is nearly four times larger than Harvard’s.<sup>30</sup>

Our proposal would double the amount of Pell Grant funds provided to community colleges that have a combined graduation and transfer rate of at least 50 percent. Eligible schools could either use the additional money to reduce the net price they charge the neediest students or to create support programs to help low income students earn their degrees or certificates and potentially transfer to four-year



colleges. However, participating schools would lose eligibility for the bonus if they significantly reduce the percentage of Pell Grant recipients they serve, increase the net price they charge the lowest income students, or see their combined graduation and transfer rates drop substantially (As noted later in this report, New America's plan would require community colleges to report combined graduation and transfer rates to the Department of Education.)

Like the Pell Grant Bonus for four-year colleges, this proposal would increase student success by providing low-income community college students with additional support to encourage them to complete their academic programs.

### Cost Estimate

5-year: \$14.6 billion cost

10-year: \$34.9 billion cost

*The community college Pell Grant bonus proposal is more costly than the proposal for four-year colleges, totaling about \$14.6 billion over five years and \$34.9 billion over 10 years. To arrive at those figures, we first calculated a combined graduation and transfer rate by using the enrollment data, graduation rate, and transfer rate data available from 2010. Many of the schools had not reported enough data to perform the calculation, but of the remaining schools, 262 had a combined graduation and transfer rate of 50 percent or above. Those schools' Pell Grant disbursements totaled \$1.5 billion in 2010.*

*Calculations again showed that a number of schools are on the margins of qualifying for the programs. We assume that 120 of those schools are close enough to qualification that they would be able to meet the criteria set forth in this proposal; their total 2010 Pell Grant disbursements totaled \$1.2 billion. However, the costs of the program may be higher than anticipated if schools are sufficiently motivated to meet the higher standards and if many schools with unavailable data do, indeed, qualify. Thus, the cost was rounded up to \$3.0 billion from the combined \$2.6 billion costs of the already-qualified colleges and potential future-qualifying institutions. Because we call for the size of the maximum Pell Grant and the program to increase annually beginning in fiscal year 2014, a twenty percent upward estimate was applied to the costs of the program. Using the same assumption that the costs will increase by 2 percent in each of the first three years and 2.5 percent in every year thereafter, the five- and 10-year costs were calculated.*

### Limit Pell Eligibility Limited to 125% of Program Length

Eligibility for Pell Grants is linked to an arbitrary, one-size-fits-all time limit. Currently, students eligible for a Pell Grant may receive the aid for up to 12 semesters of study, prorated for students attending half-time. That time limit applies to students regardless of the type of credential that they are pursuing, and thus includes both two-year and four-year degree candidates. Furthermore, this six-year time limit effectively allows students pursuing the degree with the longest time to completion (a four-year bachelor's degree) with two full years of additional time in which to complete their programs. The policy therefore encourages prolonged enrollment, and in the case of a two-year degree funds 300 percent of the time needed to complete on time.

To make the time limit more sensitive to students' particular programs, policymakers should limit Pell Grant eligibility to no more than 125 percent of a student's program length. A low-income student pursuing a two-year degree would be eligible to receive a Pell Grant for no more than two and a half years; a student pursuing a four-year degree would be limited to five years of Pell Grant aid. Since giving students more time to complete a credential has not been shown to increase graduation rates, limiting Pell Grant eligibility to 125 percent of program length would focus an institution's attention on providing students with new and accelerated pathways that help them to accomplish their goals in a timely manner.<sup>31</sup> Students would still be eligible for federal loans (up to 150 percent of program length), which would enable students who had not completed their program in the allotted time a means to finish their credential.

This policy should, however, leave in place the current 12-semester eligibility period as an aggregate limit for students who begin one type of program but switch to another. The 125 percent time limit would start over when the student enrolled in a new program, but the aggregate 12-semester limited would still apply. Time spent in remedial education should not count toward the 125 percent program length limit.

Like many of the other recommendations in this paper, we do not see this recommendation standing alone. It is part of a broader package of reforms that are meant to change both student and institutional behavior by providing bet-

ter information and incentives. Under our plan, the Pell program would be protected from the yearly whims of legislators by moving it to the mandatory spending side of the budget. The maximum Pell grant would also be increased and schools that serve Pell students well will receive Pell bonuses. Policies that encourage students to pursue their degrees in a timely fashion should help increase the overall number of graduates, reduce time-to-degree, and encourage colleges to ensure that courses are made available. The frame of greater accountability and information is also critical. If institutions see it in their interest to help students complete and minimize student debt, and students understand the financial implications of on-time completion and are better supported by their institutions, then a time-limited Pell is more likely to help, rather than harm, students.

### Cost Estimate

5-year: \$1.6 billion savings

10-year: \$3.5 billion savings

*The cost estimate for this proposal is derived from a Congressional Budget Office analysis of a related change to Pell Grants in 2011. That year, policymakers reduced the maximum amount of time for which a student may claim a Pell Grant from the full-time equivalent of 18 semesters to 12 semesters.<sup>32</sup> According to the Congressional Budget Office, that change reduced baseline spending on the Pell Grant program by \$2.8 billion and \$6.4 billion over five and 10 years, respectively. Because a limit on Pell Grant aid of 125 percent of program length is somewhat similar to the semester limit, albeit more complicated and nuanced, we assume that the limit will reduce the cost of the Pell Grant program by an amount equal to half of the savings generated by the 2011 policy change, with a small adjustment to that calculation to account for the rate at which the policy would take effect. Therefore, our estimated savings over five and 10 years are \$1.6 billion and \$3.5 billion, respectively.*

### Restore Year-Round Pell

For the first time ever, students were eligible for a second Pell Grant in 2009 to pay for additional classes – particularly in the summer – if they had already exhausted their aid eligibility during the fall and spring semesters. More than 800,000 students received year-round Pell, many of them nontraditional.<sup>33</sup> In 2011, however, the program was eliminated to help shore up funding for the Pell Grant program and maintain the maximum grant amount. The

Obama Administration argued that providing students with two Pell Grants in a single year was too costly and was not achieving the program's aim of accelerating students' progress.<sup>34</sup> Yet with only two years of data on the program, it's hard to know whether it was effective or not.

Instead of eliminating year-round Pell, it should be redesigned so that it works better for students and institutions. Allowing students to collect two grants in a single award year offers the neediest students, especially nontraditional students, the ability to speed up their studies by attending school year round. This proposal would give them the financial support they need to get to a credential faster, allowing them at least one additional semester of funding each year.

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### Instead of eliminating year-round Pell, it should be redesigned so that it works better for students and institutions

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### Cost Estimate

5-year: \$12.5 billion cost

10-year: \$29.9 billion cost

*According to a Congressional Budget Office estimate from March 2011, the year-round Pell Grant rule cost \$4.1 billion annually, which reflects both the appropriations and mandatory funding streams for the program.<sup>35</sup> Based on that estimate, we estimate that adding a new accelerated grant rule to the Pell Grant program would cost approximately 25 percent less than the earlier policy, or \$3.0 billion in the first year, inflated for each future year.*

*The program would cost less than the prior policy because other proposals outlined in this paper would restrict year-round Pell Grant aid in a way that prior policies did not, resulting in a reduced cost for the policy. For example, limiting Pell Grant eligibility to 125 percent of program length will help ensure that students and institutions do not use the accelerated aid to augment, rather than carry forward, educational time. The more rigorous debt-to-income ratios, loan repayment rate, and other metrics by which institutions would be judged would also reduce the number of institutions and programs that might otherwise abuse the availability of a year-round Pell Grant program. The total cost over five and 10 years is estimated at \$12.5 billion and \$29.9 billion, respectively.*

## Redirect Supplemental Educational Opportunity Grant Funding to Pell Grants

The Supplemental Educational Opportunity Grant (SEOG) program is one of the federal campus-based aid programs. It issues federal dollars to colleges, which supplement the funding with institutional aid and then award the grants to financially needy students.<sup>36</sup> Congress appropriated nearly \$735 million to the program in fiscal year 2012.<sup>37</sup> However, the formula that the federal government uses to distribute SEOG funds is outdated, and as a result, the grants are not well targeted.<sup>38</sup> Elite private and public colleges and universities receive a disproportionate share of the funding, even though they enroll a much smaller share of low-income students than regional state schools and community colleges.<sup>39</sup> Multiple efforts to make the formula more equitable have been met with fierce resistance from lobbyists and members of Congress representing the elite colleges that receive a disproportionate share of the funding from the program.<sup>40</sup>

To better ensure that these funds are going to assist the low-income students who need them the most, SEOG funding should be diverted to our larger Pell Grant program and distributed according to that program's more equitable formula.

### Cost Estimate

5-year: \$3.9 billion savings

10-year: \$8.1 billion

*We would redistribute the \$735 million currently available for SEOG into the Pell Grant program. Assuming that Congress would otherwise fund the program in the future at its fiscal year 2012 funding level (plus a 2.5 percent annual inflationary increase), eliminating the program reduces spending by \$3.9 billion and \$8.1 billion over the next five and 10 years, respectively. Lawmakers would need to reduce the annual aggregate appropriations limits for non-defense programs in place under the Budget Control Act<sup>41</sup> by an amount that reflects the elimination of SEOG. That would make the spending reduction enforceable and allow lawmakers to spend those funds on other priorities in a budget neutral manner. Therefore, a portion of that funding can be used to increase the size of the standard Pell Grant award, while the remainder is devoted to the Pell Grant bonus program. ■*

## LOANS

The federal government has subsidized loans to college students for nearly 50 years. When the Stafford loan program was created in 1965, its main aim was to help middle-income students afford to attend the college of their choice. As late as the early 1990s, less than half of all bachelor's degree recipients graduated with student debt. Today, two-thirds do, with an average debt load of \$26,600 per borrower.<sup>42</sup> Overall, students and parents borrow an estimated \$112 billion annually through the federal student loan program.

For students, federal loans have historically been a good investment – providing them with the means to obtain an education that will pay substantial dividends throughout their lifetimes. But in recent years, there has been growing concern that many students and their families are taking on unmanageable levels of debt that could hamper future life choices, such as getting married, buying a house, having children, and retiring.<sup>43</sup> Policymakers should redesign the federal loan program to address the following problems:

- The federal student loan program is extremely complex, offering students and their families a variety of choices, with each carrying different congressionally set interest rates and borrowing limits. Borrowers also face a baffling array of repayment options but often lack the counseling needed to understand these options. Benefits often overlap.

- The consequences that borrowers face if they default on their federal student loans are severe.<sup>44</sup> Student loans are much more difficult to discharge in bankruptcy than other forms of consumer debt. Additionally, there is no statute of limitation for prosecuting those who fall behind on their loans. As a result, collection agencies working on behalf of the government can literally chase borrowers – who may never have earned enough money to repay their debt – to their graves.

- Graduate students and the parents of undergraduates can take out loans up to the full cost of attendance. This may not only encourage and enable imprudent borrowing, but also make it easier for colleges and universities to raise their prices with impunity.<sup>45</sup>

- The benefits of the loan program are poorly targeted. The programs provide generous federal subsidies to some students based on their incomes before they enroll in school, rather than after they graduate. Students are also charged the same interest rates regardless of changes in market interest rates, such that students are provided different levels of subsidies from year to year for no particular reason.

- The program does not provide enough incentives for students to make steady progress and complete a credential on time. In some cases, it does the opposite.

In 2010 Congress and the administration began to reform the federal loan program by ending the wasteful practice of subsidizing private lenders to make government-backed student loans and shifting 100 percent to the U.S. Department of Education's direct lending program. The proposals in this paper would finish that effort, by significantly simplifying the program and reducing the dangers of default. Under these proposals, all undergraduates would be subject to the same borrowing limits and pay a fixed, subsidized interest rate that adjusts to market conditions. They would also repay their loans based on a percentage of their earnings after they graduate. Moreover, the proposed changes aim to encourage colleges to

hold down their costs, while at the same time giving these institutions more control to limit unnecessary borrowing by their students.

The proposals would also complete the job of reform by providing generous incentives to borrowers with older loans to refinance their debt into the Direct Loan program so that the government no longer has to provide banks and other private lenders unnecessary subsidies for outstanding loans.

If taken together, these changes would produce a streamlined federal loan system that works better for students. When combined with the other proposals in this paper, the changes do not require policymakers to commit any new budgetary resources.

### **Completing Student Loan Reform Provide Incentives for Borrowers to Switch to Direct Loans**

Prior to 2010, federal student loans were issued through two separate administrative structures: as loans made directly from the federal government, or as loans made by private financial institutions but backed by government guarantees. The terms of the loans were nearly identical for borrowers with Federal Family Education Loans (FFEL) and Direct Loans from the U.S. Department of Education. Colleges chose which of the two programs they wanted to use to distribute federal loans to their students. Because of the generous subsidies that the government provided lenders to entice them to make guaranteed student loans, the FFEL program had a 67 percent higher cost structure than direct loans. As a result, when Congress decided to end the FFEL program in 2010, the policy change resulted in significant budgetary savings for the government.

While no new loans have been made under the FFEL program since 2010, approximately \$400 billion in federally guaranteed loans remain outstanding.<sup>46</sup> These loans continue to be more costly for taxpayers than Direct Loans that carry the same terms for borrowers. Therefore, we propose the creation of a new incentive program aimed at encouraging FFEL borrowers to convert their loans to Direct Loans. Under this policy, the U.S. Department of Education would offer borrowers with guaranteed loans a one percentage point interest rate reduction for agreeing to “refinance” their debt into the direct loan program. The

Department would also maintain any voluntary interest rate or principal reductions FFEL borrowers had received from their private lenders. The policy should be available indefinitely, and the Department should actively advertise it to borrowers.

The Obama administration enacted a similar incentive program in the first half of 2012, but it was more limited than the one proposed here. That program provided borrowers whose loans were split among the Direct Loan program and the guaranteed loan program with a 0.5 percentage point interest rate reduction if they converted solely to the Direct Loan program and did not honor any reductions that the private lender had already provided. The program also required borrowers to apply by the July 2012 deadline. Under the proposal outlined here, borrowers need not have loans in both programs to enroll, and they could convert their loans at any time. In addition, the interest rate reduction incentive would be in addition to any benefits their private lenders had previously provided.

#### Cost Estimate

5-year: \$17.0 billion savings  
10-year: \$17.0 billion savings

*We estimate that this policy would reduce federal outlays by \$17.0 billion, according to a fair-value methodology divided equally over the two years. (Congress may, under existing budget rules, laws, and practices, use fair-value estimates for measuring the cost of federal loan programs.) The estimate is based on a 2010 Congressional Budget Office study that concluded the fair value subsidy rate on the average guaranteed loan was 20 percent versus 12 percent for the same loan made as a Direct Loan.<sup>47</sup> That difference of eight percentage points, when applied to the \$426 billion outstanding guaranteed loan balance, equals \$34 billion. Therefore, if all outstanding guaranteed loan volume were converted to Direct Loans, the savings should be on the order of \$34 billion. Because changes to loan programs are reflected in the federal budget on an accrual basis, all of the savings are realized in the year that the loans are converted. However, the policy provides borrowers with an interest rate reduction as an incentive which is assumed to reduce the potential savings by half. Savings are also assumed to accrue over two years as the Department implements the program and advertises it, and as borrowers subsequently enroll.*

#### End the Non-Profit Loan Servicer Entitlement

The 2010 law that eliminated the FFEL program in favor of direct lending vastly simplified the federal student loan system and removed unnecessary administrative costs from the program.<sup>48</sup> However, vestiges of the old program remain in place. The law effectively grandfathered over two dozen non-profit student loan agencies that had participated in FFEL into the Direct Loan program by guaranteeing them the right to service at least 100,000 newly issued loans at competitively set compensation rates plus a premium rate. The remaining loans are allocated to four non-profit and for-profit servicing companies that won competitively bid contracts from the U.S. Department of Education; those companies are paid a fee based on their bids.

The non-profit servicer entitlement has made the federal student loan program more complicated and costly than it should be. First, the shuffling of student loan accounts that has occurred as the Department brings each of the non-profit loan servicers on board has been confusing and disruptive to affected borrowers. In some instances, borrowers have experienced serious accounting and repayment errors.<sup>49</sup> Second, because the non-profit servicers were awarded contracts that cost the government more per loan than do the competitively bid servicers' contracts, the federal government is spending more than necessary to run the federal loan program.

We propose ending the non-profit servicer program and allocating all student loan servicing among companies that win competitively bid contracts. Furthermore, lawmakers should allow borrowers to switch among the servicers if they are unhappy with the one to which they have been assigned.

#### Cost Estimate

5-year: \$101 million savings  
10-year: \$182 million savings

*We estimate that eliminating the non-profit servicer program will save \$101 million over five years and \$182 million over 10 years. This estimate is based on calculating the difference in per-unit payments awarded to the servicers with competitively bid contracts and those awarded to non-profit servicers, as reported in the Department of Education's annual budget justifications.<sup>50</sup> On average, the cost of the competitively bid contracts is*

5 percent lower than the cost of non-profit servicers. Therefore, to estimate the net savings, we assumed the funding for the non-profit servicer program as reported by the Congressional Budget Office in March 2012 (adjusted to reflect an estimate CBO provided to Congressional staff) would be 5 percent lower if all loans were serviced by competitively bid contracts.<sup>51</sup>

## One Federal Student Loan Program Make a Redesigned IBR Program the Sole Repayment Option for Borrowers

Federal student loans have long been considered “good debt,” but for borrowers who fall behind on their payments they can become a nightmare.

Policymakers have made it much more difficult for borrowers to discharge their student loans in bankruptcy than other forms of consumer debt and have removed any statute of limitations on the collection of these loans – allowing the government to unleash an army of student loan collection companies to pursue individuals who default on their loans. They have also empowered the government to garnish the wages of defaulters without a court order and seize tax refunds and other federal benefits such as a portion of Social Security payments from elderly and disabled borrowers. Worse yet, the system doesn’t distinguish between borrowers who are deliberately trying to skip out on their student loans and those who are too financially distressed to repay them. Both are subject to the same harsh treatment.

The real tragedy is that most students who default on their federal student loans probably could have avoided doing so. The federal government offers borrowers a wide array of repayment options, many of which are specifically designed to help borrowers avoid default, including forbearance, deferment, and Income-Based Repayment. But these choices each have their own rules and regulations and require borrowers to actively take steps to enroll in them and stay in them. Unfortunately, many borrowers simply don’t receive the counseling they need to understand the choices that are available to them or what they need to do to take advantage of them.

A redesigned federal student loan program would substantially reduce the dangers of borrowing by offering a single repayment plan that is similar to both the “Pay-As-You-Earn” plan that the U.S. Department of Education recently

enacted (which itself is meant to mimic a plan in statute set to take effect in 2014) and the Income-Based Repayment plan (IBR) that was enacted in 2007.<sup>52</sup> Under this proposal, all borrowers would repay their loans as a percentage of their income. Such a system would recognize that some people will never earn enough to fully repay their debt, no matter how earnestly they try.

The default IBR program that this paper proposes, however, would have some important differences than the current system to ensure that it doesn’t provide windfall benefits to higher income borrowers who have the means to repay their debt.

Under our proposal, the single repayment plan would allow borrowers to repay under the more generous terms of the recently enacted IBR program if their incomes are less than 300 percent of federal poverty guidelines, and they leave school with an initial loan balance that is less than \$40,000. Those rules allow borrowers to repay at a rate of 10 percent of their incomes after deducting 150 percent of the federal poverty guidelines, and any remaining debt after 20 years is forgiven. Borrowers who enter repayment with more debt would have any remaining debt forgiven after 25 years, and those who earn incomes above 300 percent of federal poverty guidelines would repay at a rate of 15 percent of their incomes.

The proposed policy would also eliminate the repayment cap that exists under both IBR formulas currently in place. Under that policy, should a borrower’s income increase after enrolling in IBR, his payments cannot exceed those under the 10-year repayment plan on his original loan balances.<sup>53</sup> Our proposal eliminates the cap because the limit allows higher income borrowers to pay less on their loans than lower income borrowers; in other words, it upends the principle of Income-Based Repayment.<sup>54</sup>

While this two-tiered plan shares many of the benefit terms with the recently enacted IBR program, it scales those benefits back for high-debt borrowers (most of whom are graduate students) or middle- and upper-income borrowers who can afford to repay the debt without the help. The reduced benefits also aim to address perverse incentives for borrowers to take on higher amounts of debt than they believe they could reasonably repay, or for institutions of higher education to charge higher tuitions and fees with-

out any financial consequences to themselves or their students.<sup>55</sup>

Besides simplifying the student loan system through a single repayment option for borrowers, the two-tiered IBR plan would allow borrowers who took out federal student loans prior to 2008 to access the more generous benefits of the new IBR plan if their incomes are lower and/or they have loan balances below \$40,000. Under current law, those borrowers are eligible only for the original 2007 version of IBR.<sup>56</sup> Our proposal would, however, require that many borrowers make *higher* monthly payments than they currently do. That is because current repayment plans allow borrowers to make payments that can represent a smaller share of their incomes—particularly for middle- and upper-income borrowers. These borrowers would see an increase in their monthly payments under a universal repayment plan. However, that is not necessarily a cost for those borrowers; they will repay their loans faster and incur less interest.

To ensure that loan servicers have the requisite income information from borrowers when they begin repaying their loans, all borrowers would be required to agree in their promissory notes to allow their loan servicers and the U.S. Department of Education to access necessary information from their most recent federal income tax return. At the same time, loan servicers would be required to clearly indicate to borrowers whether their minimum monthly payment is sufficient to cover the accruing interest on their loans, and if not, how much more they may want to pay so that their loan balances do not increase. The servicers should also project total payments and repayment period based on current payments so that borrowers understand the effects of repaying their loans at a faster or slower pace.

### Cost Estimate

5-year: \$747 million savings

10-year: \$1.8 billion savings

*The Congressional Budget Office estimated in 2010 that the incremental changes to IBR would cost \$490 million per year once fully implemented.<sup>57</sup> Based on that estimate, we assume that our recommended modifications to that plan would reduce the incremental costs by about \$175 million per year on average over the next 10 years. The savings over five and 10 years are \$747 million and \$1.8 billion, respectively. Our proposal*

*reduces the cost of the program because it scales back some—but not all—of the benefits that the recently enacted IBR provides and leaves in place benefits for low-income and lower-debt borrowers. Additionally, the estimated savings are lower than they would otherwise be because the proposal makes all current borrowers eligible to opt into the plan and exempts loan forgiveness from federal income taxes, a policy change that would increase costs compared to current law.*

### End the Subsidized Stafford Interest Rate Benefit

Since the passage of the Higher Education Amendments of 1992, all undergraduate borrowers have been able to take out federal Stafford loans regardless of income or other need-based tests, at terms that have been generally more favorable than those in the private market.<sup>58</sup> Prior to the enactment of that policy, the federal loan program allowed only financially needy students to borrow.<sup>59</sup> These loans had always included an interest-free benefit under which the loan would not accrue interest while the borrower was in school. However, when policymakers opened up the federal student loan program to borrowers of all income backgrounds in 1992, they maintained the interest-free benefit for borrowers who met a needs analysis test that accounted for the cost of attendance at students' institutions, but did not provide a similar benefit for other borrowers. That interest-free benefit remains the distinction between the two loan types that still exist in today's program: Subsidized Stafford loans and Unsubsidized Stafford loans.

In other words, Subsidized Stafford loans were not created to provide benefits over and above those on Unsubsidized Stafford loans. Rather, it is a benefit that was always provided as part of the federal student loan program. The Subsidized and Unsubsidized Stafford loan distinction remains current policy mainly due to historical circumstances. That fact is made clearer by some of the policy's shortcomings and how it interacts with the myriad changes policymakers have made the student loan programs in recent years.

In fact, Subsidized Stafford loans do not always provide the greatest benefits to the lowest-income students. Subsidized Stafford loans are awarded to borrowers in part according to the cost of attendance of their schools. That means a borrower with a high family income will be eligible for the loans if he attends the most expensive type of institution,

Table 3: Benefit of Subsidized Stafford Loans to Borrowers in Income-Based Repayment

Borrower	Income Level: Repayment Year 1	Income Level: Repayment Year 20	Total Payments: Max Unsub Stafford, 5 Years*	Total Payments: Max Sub & Unsub Stafford, 5 Years**	Benefit of Sub Stafford Loans
Borrower 1	\$22,000	\$38,577	\$10,360	\$10,360	\$0
Borrower 2	40,000	70,140	77,406	61,760	15,646
Borrower 3	25,000	128,542	84,426	63,582	20,844
Borrower 4	50,000	87,675	60,459	55,478	4,981
Borrower 5	40,000	121,024	65,988	55,339	10,649

\*Loan balance at graduation totals \$33,448  
 \*\*Loan balance at graduation totals \$39,296  
 Source: New America Foundation

while a similarly situated borrower who opts to attend a low-cost institution will qualify only for Unsubsidized Stafford loans. This is why, in spite of income and assets tests targeting the aid to lower income families, 12 percent of borrowers who receive Subsidized Stafford loans come from families earning over \$100,000 per year.<sup>60</sup>

Furthermore, the Income-Based Repayment Plan better aligns repayment with a borrower’s ability to repay, whereas Subsidized Stafford loans are provided to borrowers based largely on their family income when they enter school. For example, borrowers with Unsubsidized Stafford loans begin repayment with higher loan balances than students with Subsidized Stafford loans (assuming everything else is equal) because interest has accrued on the loan. Under IBR, the higher loan balance does not necessarily mean the borrower will pay more than if he had a lower loan balance—monthly payments are based on a borrower’s income, not loan balance. Therefore a borrower who earns a persistently low income over his repayment term would make the same payments regardless of the size of his initial loan balance. Only borrowers with higher incomes in repayment stand to gain from Subsidized Stafford loans.<sup>61</sup>

Lastly, graduate students were eligible for Subsidized Stafford loans until 2012. The Obama administration recommended in 2011 that graduate students be eliminated from the program going forward, and Congress acted on that policy, redirecting the budgetary resources to the Pell Grant program. The administration noted that, in addition to the Income-Based Repayment option available to graduate and professional students, “eligibility for the interest subsidy is based on ‘ability-to-pay’ at the time of

enrollment, but the borrower realizes the benefit later – typically years later – in the form of lower loan payments after leaving school.”<sup>62</sup> The administration also argued that government aid should be targeted to the highest-need students.<sup>63</sup> All of those arguments apply to the case for eliminating the Subsidized Stafford loan interest-free benefit for undergraduate students, particularly if IBR is the only repayment option for borrowers.

#### Cost Estimate

5-year: \$16.9 billion savings  
 10-year: \$41.4 billion savings

*Based on a 2010 Congressional Budget Office cost estimate, eliminating Subsidized Stafford loan benefits would save \$16.0 billion from fiscal years 2011 through 2015 and \$41.0 billion over 10 years, through 2020. Extrapolating those figures, we estimate that from fiscal years 2013 through 2017, the policy change would save \$16.9 billion; and through 2022 would save \$41.4 billion.*

#### Create a Fixed Formula for Setting Student Loan Interest Rates

There are three flaws in the interest rates set on federal student loans that any wholesale redesign of federal student aid programs must address: the rates are arbitrary, they do not adjust to reflect changes in interest rates in the economy, and the temporary rate cut lawmakers set for two cohorts on Subsidized Stafford loans for undergraduates will expire as of July 1, 2013.

The rates are arbitrary and inflexible because Congress set the rates as nominal figures in law based on what would



have been a subsidized interest rate in the year 2001.<sup>64</sup> They are not based on any formula, nor do they bear any relation to changes in related interest rates in the market since then. The rate on all newly-issued Unsubsidized Stafford loans as of 2006 is 6.8 percent, and under current law will remain so in perpetuity. The effect of such a policy is to provide very different levels of subsidies to borrowers depending on when they take out their loans. The subsidy on loans issued at the 6.8 percent interest rate in 2007 when the economy was booming and interest rates were relatively high was much larger than the subsidy provided to students in today's low-interest rate, slow-growth economy. That means students receive larger subsidies when they are least needed; the policy is both inefficient and unfair. In fact, the Congressional Budget Office estimates that the loans issued in fiscal year 2013 will not provide any subsidies (meaning the terms provide no value over loans in the private market) to the vast majority of borrowers.<sup>65</sup> This will be the first time that federal student loans provide no subsidy, based on fair-value estimates.

In an attempt to better align student loan interest rates with the lower rates available in the market, Congress proposed in 2007 to cut them in half to a fixed rate of 3.4 percent.<sup>66</sup> That proposal was costly, so lawmakers opted instead to limit the cut to only one type of loan for undergraduate students — Subsidized Stafford loans. To further reduce the cost, lawmakers phased in the reduction beginning in the 2008-09 school year.<sup>67</sup> Consequently, only loans issued for the 2011-12 school year were to carry the 3.4 percent rate. The interest rates on Subsidized Stafford loans issued after that year were to rise back to 6.8 percent.<sup>68</sup>

In short, the policy cut interest rates in half for loans issued only in one year. Moreover, the expiration of that short-term policy prompted President Obama to call for a one-year extension<sup>69</sup> at a cost of \$6 billion,<sup>70</sup> which student aid advocates supported and Congress ultimately adopted.<sup>71</sup> That means the policy will once again expire for newly-issued loans as of July 1, 2013, and extending it will cost an estimated \$6 billion per year. Policymakers will likely be under pressure to extend the rate as a way to make interest rates appear more in line with other types of loans in the market. Such an effort would be misguided, considering that the benefits of keeping the 3.4 percent rate would be minimal for borrowers and would not apply to all undergraduates. It would also tie up budgetary resources

that could be better spent shoring up funding for the Pell Grant program.

We believe that a better policy would be to set interest rates on all newly-issued federal student loans at 3.0 percent, plus a markup equal to long-term U.S. Treasury borrowing rates. The fixed rate of 3.0 percent would ensure that the government partially covers the costs of making the loans (i.e. administrative costs and costs associated with defaults, collections, and delinquencies), and the markup would allow the loan rates to adjust based on long-term interest rates. The interest rates charged to borrowers would still be fixed for the life of the loan, but the rate for new loans would change each year based on the market rates for 10-year Treasury notes.

Under that formula, the interest rate for federal loans issued for the 2012-13 school year would be about 4.9 percent, a big drop from the 6.8 percent rate that is currently charged on Unsubsidized loans. Our proposal would make that rate available to all undergraduate and graduate borrowers.

Because the rate offered on newly-issued loans would adjust annually, it could be higher in future years. However, Income-Based Repayment on federal student loans, coupled with loan forgiveness after 20 or 25 years in repayment, ensures that the rate a borrower pays cannot rise to unaffordable levels regardless of the loan's nominal rate. It also ensures that borrowers earning higher incomes, those who are most able to pay, are the only ones who could face higher interest rates under the policy. Income-Based Repayment is effectively an income-based interest rate cap that provides benefits to borrowers based on need, but it determines the cap in repayment, rather than at the time of enrollment.

For example, consider a borrower who has \$35,000 in federal loans with an interest rate of 4.9 percent. Assume he earns an initial income of \$33,000 with an annual 3 percent raise—an income level that could be considered middle-income but hardly affluent. His total loan payments under our proposed Income-Based Repayment will then be \$50,485 over 20 years, and he will have approximately \$17,000 in debt forgiven. Now assume his loan has an interest rate of 12 percent, much higher than the 4.9 percent in the first scenario. His monthly and total payments

are unchanged. They total \$50,485 over 20 years even at the higher interest rate, because he does not earn a high enough income to increase his monthly payments, regardless of the interest rate. The only difference under the higher interest rate is that he has about \$68,000 forgiven after that time. Income-Based Repayment therefore caps interest rates, but only for borrowers who meet income requirements in repayment.<sup>72</sup>

That effect also highlights why the concept of a Subsidized Stafford loan, where eligibility for a lower interest rate is based on a borrower's family income when enrolled in school, poorly targets benefits to borrowers. Some of those borrowers may need the added benefit of a lower rate but others may not if they earn a higher income in repayment. Income-Based Repayment for all ensures that only borrowers who need the assistance most can repay at effectively lower interest rates.

#### **Cost Estimate**

5-year: \$29.3 billion costs

10-year: \$6.2 billion savings

*The Congressional Budget Office estimated that pegging fixed interest rates on newly-issued federal student loans to the 10-year Treasury note plus 3.0 percentage points would increase costs in the short term but reduce costs over the long term. An estimate provided to Congressional staff by the CBO, assuming all loans (Subsidized and Unsubsidized Stafford and Parent and Grad PLUS) would be set by the new formula, shows a five-year cost of \$29.3 billion and a 10-year savings of \$6.2 billion. An estimate that assumed higher interest rates for Parent and Grad PLUS loans showed a five-year cost of \$19.1 billion and 10-year savings of \$29.3 billion.<sup>73</sup>*

*The costs arise because the policy would reduce rates compared to current law in the first few years, but it would increase them in the later years, which results in long-term savings compared to current law. We have modified those estimates to account for interactions with other loan proposals in this paper, mainly the elimination of Parent and Graduate PLUS loans, lower loan limits for independent undergraduate students, but higher limits for dependent undergraduate borrowers and Stafford loans for graduate students. The effect of those policies would reduce federal student loan volume compared with current law to approximately 85 percent of the volume projected by the Congressional Budget Office.<sup>74</sup> Therefore, to estimate the*

*budgetary effects of the interest rate changes proposed here, we assume the proposal will generate 85 percent of the budgetary effects of the policy as estimated by CBO. The five-year cost is \$16.3 billion and the 10-year budget effect is a savings of \$24.9 billion.*

#### **New Student Loan Limits**

Policymakers have established a mismatched and confusing array of borrowing limits within the federal student loan program. Undergraduates who are dependents face one set of limits, while independent undergraduates may borrow significantly more. Parents of undergraduates may borrow to pay for the entire cost of their child's education without any annual or aggregate limit. Graduate students can borrow two types of loans, one with limits (Stafford) and one that is limited only by the annual cost of attendance at the institution they attend.

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### **A redesigned student aid system should simplify federal loan limits and reform them to guard against excessive borrowing**

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A redesigned federal student aid system should simplify these limits and reform them to guard against excessive borrowing and tuition inflation. For example, allowing students to borrow up to the full cost of attendance for graduate school is not a good policy, as it encourages over-borrowing and frees higher education institutions from having to charge prices that match the labor market value of the credentials that they offer. At the same time, federal loan limits may be unnecessarily low for certain borrowers—particularly for dependent undergraduates whose parents might not be contributing to their education.

Therefore, we believe that policymakers should make the following changes to federal loan limits:

#### **Set One Loan Limit for All Undergraduates, Irrespective of Their Dependency Status**

Policymakers should simplify the federal loan program by eliminating the distinction between dependent and independent undergraduates and allowing both types of students to borrow the same amount of loans. Under our proposal, the annual limits for all undergraduates would be \$6,000 for a first year student, \$7,000 for a second-

year student, and \$9,000 for a third-, fourth-, or fifth-year student. The aggregate limit for undergraduates would be \$40,000.

These proposed limits are higher than dependent undergraduates can currently borrow on their own, but less than independent undergraduates can take out. This is appropriate because of our proposed changes to the PLUS program, described further in the paper, and the fact that current loan limits for independent students can lead to excessive amounts of debt. As of now, an independent undergraduate student who borrows the maximum in federal loans would begin repayment with a principal and interest balance of approximately \$74,000, an amount that would require \$486 monthly payments over 30 years to repay under the currently available repayment plans. The limits are so high that some institutions of higher education have urged policymakers to give them discretion to reduce the limits for independent students on their campuses out of concern that the students will struggle to repay the debt and eventually default.

#### **Cost Estimate**

5-year: \$767 million savings

10-year: \$4.0 billion savings

*Establishing new loan limits for undergraduates regardless of their family status would produce net savings for the federal government over the next five and 10 years. Specifically, we estimate that the reduction in federal spending compared to current law would be \$767 million over five years and \$4.0 billion over 10 years. Those estimates were made according to the fair-value methodology that the Congressional Budget Office recommends Congress use.<sup>75</sup>*

*The estimate combines projected loan volume (for Subsidized and Unsubsidized Stafford loans) and subsidy rate data (for Unsubsidized Stafford loans) over a 10-year window from the CBO March 2012 baseline<sup>76</sup> with a projected fair-value subsidy rate for Unsubsidized Stafford loans that the CBO published as supplemental data for a June 2012 publication.<sup>77</sup> The estimate utilizes a derived fair-value subsidy for each of the next 10 years of loan cohorts. The subsidy rates are extrapolations of the difference between the CBO-published fair-value and Federal Credit Reform Act subsidies for 2012. Under that methodology, Unsubsidized Stafford loans are made at a negative subsidy (earnings for the federal government) for the first three years of*

*the budget window, but are made at a positive subsidy (a cost to the government) in the latter seven years of a 10-year budget window.*

*The estimate assumes that the proposed policy would result in an increase in loan volume for what are currently defined as “dependent undergraduates” because they would be able to borrow more than under current law. That change increases federal costs over five and 10 years because the CBO baseline (adjusted using fair-value estimates) shows that those loans are provided at a subsidy to borrowers for most of the years in the 10-year budget window. Therefore, increasing the volume of these loans increases costs. On the other hand, “independent undergraduates” would be able to borrow less annually and in aggregate under the proposal, reducing total borrowing from this group. Because the loans under current law are provided at a cost for most years in the 10-year budget window, according to the CBO baseline estimates adjusted to reflect fair-value methodology, a reduction in loan volume results in a reduction in federal spending over five and 10 years. When the effects on loan volume are added together, the estimate assumes a net decrease in borrowing for undergraduates, which reduces costs. On net, the reduction in federal spending, compared to current law would be \$767 million over five years and \$4.0 billion over 10 years.*

#### **End Grad PLUS, but Increase Stafford Loan Limits for Graduate Students**

Policymakers should end the Grad PLUS loan program. This program allows graduate and professional students to borrow up to the full cost of attendance at an institution of higher education, with no time or aggregate limit. Such a policy, especially when coupled with loan forgiveness and Income-Based Repayment, can discourage prudent pricing on the part of institutions and prudent borrowing by students. However, policymakers should increase the annual limit on Unsubsidized Stafford loans for graduate students from the current \$20,500 to \$25,500 to replace some of the borrowing ability graduate students will lose when the Grad PLUS loan program is eliminated. Although this change will likely push some graduate students into the private loan market, this could ultimately be beneficial in addressing the high costs of graduate schools. If institutions can no longer rely on PLUS loans to fund their high-tuition programs and if the private market is responsive to the ability of borrowers to repay (based on changes to bankruptcy law recommended later), then graduate

schools may have to set their pricing based, in part, on students' expected earnings. Since those in graduate school already have an undergraduate degree and are preparing for a profession, it is more reasonable to expect that loans above the Stafford limits be based on prospective ability to repay. Underwriters will likely focus most intently on institutional characteristics to determine risk, meaning that programs that poorly prepare students to repay their debts will not find that their students can access much credit in the private market, which should change institutional behavior in terms of quality and pricing. It should also be noted that graduate students are likely to benefit from the changes this paper has recommended in the way student loan interest rates are set. If this plan was in place now, graduate students would see their interest rates drop from 6.8 to 4.9 percent.

### Cost Estimate

5-year: \$4.9 billion costs

10-year: \$2.1 billion savings

*We estimate that eliminating the Grad PLUS program would increase budgetary costs for the federal government by \$4.9 billion over five years and reduce costs by \$2.1 billion over 10 years. Those estimates were done according to the fair-value methodology that the Congressional Budget Office recommends Congress use.<sup>78</sup>*

*The estimate combines projected loan volume and subsidy rate data over a 10-year window from the CBO March 2012 baseline with a projected fair-value subsidy rate for Grad PLUS loans that the CBO published as supplemental data in June 2012.<sup>79</sup> The estimate uses an extrapolated fair-value subsidy for each of the next 10 years of loan cohorts based on the CBO-published fair-value and Federal Credit Reform Act subsidies for 2012. Under that methodology, Grad PLUS loans are made at a negative subsidy (earnings for the federal government) for the first four years, but are made at a positive subsidy (a cost to the government) in the latter six years of a 10-year budget window. Therefore, eliminating this loan volume reduces the government's collections early on, but reduces subsidies in the latter six years. On net, the two effects mostly cancel each other out, but over 10 years there remains a \$2.1 billion cost savings from the proposed policy.*

*The proposed \$5,000 annual increase in Unsubsidized Stafford loan limit for graduate students would also increase budgetary*

*costs of the loan program. Over five and 10 years the costs are estimated to be \$1.5 and \$7.9 billion respectively. Those estimates were made according to the fair-value methodology that the Congressional Budget Office recommends Congress use.<sup>80</sup> The estimate combines projected loan volume and subsidy rate data over a 10-year window from the CBO March 2012 baseline<sup>81</sup> with a projected fair-value subsidy rate for Unsubsidized Stafford loans that the CBO published as supplemental data in June 2012.<sup>82</sup> The volume for the share of loans issued to graduate students is 30 percent of the CBO-projected volume for Unsubsidized Stafford loans according to figures published by the College Board and based on U.S. Department of Education data. Increasing the annual limit by \$5,000 is assumed to increase total Unsubsidized Stafford borrowing for graduates by 20 percent (given that not all borrowers would borrow up to the full amount of newly-available credit). The estimate uses an extrapolated fair-value subsidy for each of the next 10 years of loan cohorts based on the CBO-published fair-value and Federal Credit Reform Act subsidies for 2012. Under that methodology, Subsidized Stafford loans are made at a negative subsidy (earnings for the federal government) for the first two years, but are made at a positive subsidy (a cost to the government) in the next eight years of a 10-year budget window. Therefore, increasing Stafford loan limits for graduate student volume reduces the government's collections in the first two years, but increases subsidies provided to borrowers in the latter eight years.*

### Give Colleges the Discretion to Lower Loan Limits

A redesigned federal student loan program should give institutions of higher education the ability to reduce loan limits on federal student loans for their students. This policy would make federal loan limits a maximum, and allow colleges to set a limit below those levels. If a school opts to reduce the loan limits, it must do so for all students attending a particular program or for the institution as a whole. The college may not limit loans based on the needs of different categories of students (e.g students living at home or enrolled in particular educational programs).

Allowing institutions to adjust federal loan limits by program or as an institution-wide policy ends the current federal policy of one-loan-limit-fits-all and removes the direct link between cost of attendance and loan limits. Nor in the absence of a one-size-fits-all policy do policymakers need to establish differing loan limits for categories of programs or types of institutions. Instead, schools have the option

to do that themselves. Because of the new accountability measures for institutions outlined in this paper, which include debt-to-income thresholds and loan repayment rate thresholds for cohorts of graduates, schools will have a strong incentive to tailor their loan limits to levels that students can repay.

Furthermore, granting schools the flexibility to adjust loan limits allows institutions to guard against imprudent borrowing. While borrowers are eligible within current limits for federal loans in an amount that can meet the full cost of attendance at an institution, institutions may believe it unwise for students to borrow such amounts. Under current policy, schools are effectively unable to prevent their students from borrowing the maximum. The proposed policy would address that shortcoming, but to ensure that access to needed loans are not denied baselessly, schools would be required to justify adjusting loan limits by developing an explicit policy.

#### **Cost Estimate**

*We are unable to provide an estimate for this proposal. However, the policy is likely to reduce costs.*

#### **End Parent PLUS Loans**

In addition to ending the Grad PLUS loan program, policymakers should eliminate the Parent PLUS loan program. As the cost of attending college has soared, so too have Parent PLUS loan disbursements. According to a recent article in *The Chronicle of Higher Education*, the government issued \$10.6 billion of Parent PLUS loans to approximately one million families last year.<sup>83</sup> That is nearly double the numbers of borrowers and an increase of \$6.3 million over the past decade alone. Many colleges are using these loans when packaging financial aid to fill large gaps in financial aid awards.

Parents can borrow up to the cost of attendance at the schools their children attend, which means families can easily over-borrow and institutions have an easy source of funds if they wish to raise tuition. Moreover, the federal government does not track or publish the rate at which parents default on PLUS loans at each institution. Lastly, the loans carry a relatively high fixed interest rate of 7.9 percent and origination fee of four percent, which can pose a financial risk to vulnerable families, and the loans are not

eligible for repayment options designed to help struggling borrowers, like Income-Based Repayment.

#### **Cost Estimate**

*5-year: \$8.9 billion costs*

*10-year: \$8.6 billion savings*

*We estimate that eliminating the Parent PLUS program would increase budgetary costs for the federal government by \$8.9 billion over five years and reduce cost by \$8.6 billion over 10 years. Those estimates were made according to the fair-value methodology that the Congressional Budget Office recommends Congress use.<sup>84</sup> The estimate combines projected loan volume and subsidy rate data over a 10-year window from the CBO March 2012 baseline<sup>85</sup> with a projected fair-value subsidy rate for Parent PLUS loans that the CBO published in June 2012.<sup>86</sup> The estimate uses an extrapolated fair-value subsidy for each of the next 10 years of loan cohorts based on the CBO-published fair-value and Federal Credit Reform Act subsidies for 2012. Under that methodology, Parent PLUS loans are made at a negative subsidy (earnings for the federal government) for the first six years, but are made at a positive subsidy (a cost to the government) in the latter four years of a 10-year budget window. Therefore, eliminating this loan volume reduces the government's collections in the first six years, but reduces subsidies in the latter four years. On net, the reduction in collections is twice as large as the reduction in subsidies; thus the five- and 10-year budgetary effects are similar.*

#### **Limit Loans to 150% of Program Length**

The package of student aid reforms presented here proposes both annual and aggregate limits for federal student loans and gives colleges the flexibility to adopt lower limits for their students. We also believe that policymakers should add a new program-length limit that would apply in addition to the annual and aggregate limits. The new limit would end loan eligibility once a borrower exceeds 150 percent of the time needed to complete the degree or program that he is pursuing. For instance, a student who borrows \$5,000 per year over six years to complete a four-year degree would, under this proposal, exhaust his eligibility for federal student loans, even though he did not exceed the annual or aggregate borrowing limit. This policy is meant to discourage extended and prolonged enrollments beyond 150 percent of the time the student would need to complete his or her program.

The policy would leave in place the annual limit and aggregate limit on borrowing for students who may begin one type of program but switch to another. In other words, the 150 percent time limit would start over when the student enrolls in a new program, but the overall aggregate and annual limits would still apply. Meanwhile, time spent in remedial education would not count toward the 150 percent program-length limit. The proposal would also prorate annual loan limits if a student pursues his or her program on a half-time basis. For example, the proposed \$6,000 annual limit would be reduced to \$3,000 for a student attending only half-time. While protecting students against excessive debt is an overarching policy goal, so too is using financial aid to encourage both access and completion. Coupled with the other incentives in this paper and better information provided to students, limiting loans to 150 percent of program length will provide an additional incentive for more timely completion.

#### *Cost Estimate*

*We are unable to provide an estimate for this proposal. However, the policy is likely to reduce costs.*

### **Restore Bankruptcy Dischargeability for Private Student Loans**

The above set of proposals further limits borrowing for all borrowers except dependent undergraduates (although borrowing for undergraduates, in the form of Parent PLUS loans, will be eliminated). One of the purposes of reducing these limits, in combination with other aspects of our proposals, such as increased institutional accountability for loan repayment rates, is to reduce institutional incentives to increase tuition and fees. There is the potential, however, for this series of proposals to result in some students attending very high cost schools turning to private student loans.

Given current policies, private student loans are often riskier than federal loans for students despite the fact that, theoretically, the private market should be a relatively safe source of additional credit. Unlike the federal government, which has an expressed policy goal of providing access to students who may not be able to obtain credit on their own, private companies have an interest in maximizing their profits by creating criteria, such as income, credit history, or future employment prospects that make it likely that

borrowers will repay. While this screening is counter to the access motive of federal policy, theoretically the private markets can be a relatively safe source of credit—and provide a reasonable amount of it—credit for those who are able to access it. But federal policy undermines the checks and balances of the private student loan market since, unlike other forms of private credit, including credit cards and mortgages, private students loans are not dischargeable in bankruptcy.

Thanks to lobbying efforts of the student loan industry leading up to the 2005 Bankruptcy Reform Act, private student loan debt is treated more harshly than most other private debt. This means that someone who has found his life ruined by a credit-card supported \$100,000 gambling excursion to Las Vegas can declare bankruptcy, pick up the pieces, and begin the long and difficult process of rebuilding his financial life. A student who borrowed the same amount in a private student loan to invest in his education, however, does not even have the option of going through the painful process of bankruptcy. This borrower—but not the lender who made the loans—is out of luck.

The lack of a bankruptcy provision means that those with private student loans are essentially on the hook for a lifetime, which provides the lenders with little incentive to consider whether borrowers will be able to repay their loans. We recommend that private student loans be subject to the same bankruptcy policies as other unsecured consumer credit. If borrowers can declare bankruptcy, like they can with credit cards, lenders might reconsider giving loans to those who can't afford to pay them back and borrowers will have a safety net should they experience unexpected financial hardship. ■

### **OTHER STUDENT AID ISSUES**

#### **Reexamine How Cost of Attendance Is Defined**

Widespread national anxiety over rising college costs and excessive student loan debt demands a reexamination of Cost of Attendance (COA)—the foundation on which all financial aid is based. Students or their families can borrow up to the COA to finance their education, so it is impossible to address the growing concerns over student debt without fully examining how COA, as defined by the federal government and as calculated by postsecondary institutions, interacts with the awarding of financial aid.

Put simply, COA is an estimate of a student's educational expenses for a period of enrollment (i.e. semester or academic year). The components of COA include both direct costs, like tuition and fees, and indirect costs, like books and supplies.<sup>87</sup> A student's COA can vary depending on certain situations, such as if he has a dependent. For the most part though, COA is a sum of the following costs:

- Tuition and fees
- Books and supplies
- Room and board (on campus/off campus/with family member)
- Transportation/travel
- Miscellaneous personal expenses

The maximum amount of aid a student or his parents may receive through federal student loans, TEACH grants, Pell Grants, and campus-based aid is derived from the vague components within COA that Congress first set forth when it reauthorized the Higher Education Act in 1972.<sup>88</sup> The problem is that the student population does not look like it did in 1972. As students have increasingly become non-traditional (i.e. attend school part time, have dependents, work a full time job, or are 24 or older), piecemeal changes have been made to the COA without considering a wholesale redefinition that works better for students.<sup>89</sup>

We call on policymakers to reexamine Cost of Attendance and determine how best to define and potentially regulate it for an increasingly diverse student population. Among other things, federal officials should consider whether it still makes sense to have a one-size-fits-all definition of COA for all sectors of higher education.

### **Cost Estimate**

*We believe that this proposal would ultimately save money by preventing over-borrowing among students who may be less able to repay their loans. However, we are unable to provide an accurate estimate of the savings. At many of the schools most likely to be affected by the regulation, particularly public and for-profit two-year and less-than-two-year colleges, data on how many students receive federal student loans, the average federal loan, and the institution-defined Cost of Attendance are not available. Therefore, any data analysis from which a cost estimate could be extrapolated would be heavily skewed against the very institutions most affected by a change to Cost of Attendance regulations. More complete data on the students attending*

*these institutions and their financial aid backgrounds could better inform this argument, but as it stands, the Integrated Postsecondary Education Data System (IPEDS) maintained by the federal government is not sophisticated enough to allow for such estimates.*

### **Expand Experimental Sites**

Higher education generally suffers from a lack of rigorous experimentation, both in terms of practice and policy. Federal financial aid is no exception. In a constrained budgetary environment, this lack of research means that programs and policies are left almost entirely to the whim of budgetary and political forces. Given the increased individual and national need for higher education and the escalating costs of obtaining it, much better information is needed to test out financial aid policies and assess which are working.

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### **Higher education generally suffers from a lack of rigorous experimentation, both in terms of practice and policy**

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Fortunately, the ability to conduct such evaluations already exists, thanks to legislation passed in 1992. The Experimental Sites Initiative (ESI) allows the Department to waive regulatory and/or statutory financial aid requirements for a small, voluntary group of institutions to reduce burden, improve delivery of aid, or “otherwise benefit” students.<sup>90</sup> Congress can then use the results of these experiments to inform its broader policy making. The vast majority of experiments that the Department has approved over the years, however, have focused on reducing institutional burden associated with administering financial aid, rather than “otherwise benefitting” students. This has been a lost opportunity to see how federal financial aid policy might be used to change institutional and/or student behavior in a way that leads to better student outcomes.

Yet there are a few examples of experimental sites being used to improve student success. Until 2009, students were eligible for federal financial aid only if they had a high school diploma or GED or if they had passed a federally-approved Ability to Benefit Test (ATB). The reasoning was that students who had not passed these hurdles would be insufficiently prepared to benefit from college.

Institutions, however, claimed to have numerous students who had not met these requirements but were doing just fine in college and deserved access to financial aid. In 2006-07, the Department conducted an experiment with 14 institutions in which it waived existing requirements and extended financial aid eligibility to students without a diploma or GED who had completed at least 6 core college credits and earned a C or better. It turned out that students in the experimental group had similar grades and rates of course completion as those with high school diplomas, and *higher* grades and higher rates of course completion than those who had passed an Ability to Benefit test. The results led Congress to extend financial aid eligibility to all such “6-credit” students in 2008.

Congress ended financial aid eligibility for ATB students in fiscal year 2012 for budgetary reasons. Despite this setback, the story of the six-credit student illustrates the potential power of these experiments. The current round of experiments includes granting Pell eligibility to students in short-term, career-oriented training programs and allowing institutions to reduce the amount of unsubsidized loans offered to students. The results of these studies, which have both treatment and control groups, could shed light on how providing aid for short-term training affects employment and wage rates and on how reducing loan limits affects student retention, completion, and indebtedness. This is a promising start, and there is much more to be done—including looking at whether financial aid could be used to pay for learning, rather than time, in a way that ensures both access and quality.<sup>91</sup>

Because experimental sites could be a true incubator for innovation, we propose to substantially expand and improve upon the program. Experiments should be carefully designed and rigorously evaluated to determine the true impact of policy changes on student outcomes.

#### **Cost Estimate**

*We are unable to provide an estimate for this proposal. However, it is unlikely to increase costs given that the programs must not increase costs.*

### **Study the Effectiveness of Multiple Federal Student Aid Disbursements**

One area ripe for experimentation is how colleges disburse federal student aid. Financial aid is typically distributed

in one or two lump sums, which may work well for students attending traditional four-year colleges that generally require large upfront payments from students and their families. But in cases where the primary costs students face are not large upfront payments, but more regular, ongoing costs of living, it may be counterproductive to distribute aid in one or two large disbursements. Such students may have difficulty managing their money and be left with insufficient funds at the end of the semester. Changing aid delivery to smaller, more regular disbursements at low-cost institutions could provide these students with more reliable income, create greater incentives to persist, and protect students who have to withdraw during the semester from having to pay back large amounts of aid.

Making this change may also reduce fraud in the federal financial aid programs. At many community colleges, the maximum Pell grant is larger, and in some cases, much larger, than the tuition and fees they charge. This means that students at these schools typically use the majority of Pell dollars they receive to help pay for critical living expenses during the semester. But unscrupulous individuals may seize the opportunity to “enroll” in an institution or multiple institutions to pocket as much Pell Grant aid as they can possibly get. However, if students have to demonstrate that they are still enrolled and actively participating in class every two weeks in order to obtain the aid, the number of “ghost students” who enroll simply to access federal aid would be curtailed.

The Institute for College Access and Success and MDRC are currently running a small pilot project, Aid Like a Paycheck, to examine the effects of this delivery method on student outcomes.<sup>92</sup> While the work is promising, there have only been pilots at two institutions. We recommend that the Department of Education accelerate the exploration of this delivery model and run its own experiments in which a portion of Pell Grant funds would be used immediately to pay for upfront costs like tuition, fees, and books. The remainder would be distributed bi-weekly throughout the semester, contingent upon continued enrollment. The experiment would be carefully designed and rigorously evaluated to determine how smaller, more consistent aid disbursement affects students and colleges.

#### **Cost Estimate**

*We are unable to provide an estimate for this proposal. ■*



## TAX EXPENDITURES

The federal government provides a variety of tax benefits to help students and their families save for and pay for college. They include the tuition tax break programs, college savings plans, and the student loan interest deduction. These programs provide overlapping benefits, and several of them are highly regressive, providing the lion's share of benefits to upper-income taxpayers who have the least financial need and are least likely to change their college choices based on the availability of federal aid.

We propose to eliminate these tax benefits for higher education starting in 2014. Some of the aid that these benefits provide to families with middle incomes will be replaced with the significant increases to the maximum Pell Grant that are proposed in this paper. The Pell Grant's sliding-scale eligibility rules allow more middle-income families to qualify for grant aid as the maximum grant is increased. Ending the tax benefits as of 2014 would save a total of \$108.9 billion over five years and \$181.6 billion over 10 years. Much of the savings would be redirected to the Pell Grant program, but other priorities outlined in this paper would also be supported with the reallocated funding.

### Eliminate Tuition Tax Benefits

Since 1998, the federal government has created four different tuition tax benefits, each with its own rules and eligibility requirements. The largest is the American Opportunity Tax Credit (AOTC), which Congress created temporarily as part of the American Recovery and Reinvestment Act of 2009 and recently made available through 2017.

Championed by the Obama administration, the AOTC is a \$2,500 partially-refundable income tax credit that individuals earning up to \$90,000 a year and families with annual earnings of up to \$180,000 can claim for up to four years of college.

In addition to the AOTC, the government also offers the Lifetime Learning Credit, a \$2,000 nonrefundable tax break that is available to students who take at least one postsecondary education course in a given year; and a \$4,000 tuition and fees tax deduction that is available to individuals earning up to \$80,000 a year and joint filers making as much as \$160,000 annually. Meanwhile, the AOTC has temporarily replaced the Hope Tax Credit, a nonrefundable \$1,800 tax credit that was available until 2009 to help students cover their tuition and fees in their first two years of college.

While these tax benefits have undoubtedly been helpful for students and families facing ever-increasing college prices, providing tens of billions of dollars in financial aid through the tax code each year is ineffective and wasteful for the following reasons:

- The tuition tax break programs are not well targeted, with a substantial share of the benefits going to affluent families who can afford to send their children to college without the aid.<sup>93</sup> According to the College Board, about a quarter of the benefits from the higher education tax credits and deductions in 2010 went to families with incomes over \$100,000.<sup>94</sup> In comparison, about three quarters of all Pell Grant recipients in 2010-11 had family incomes of \$30,000 or less, according to the U.S. Department of Education.<sup>95</sup>
- The tax breaks arrive months after students and their families pay their tuition bills. The timing of the benefits is not only impractical but also obscures their purpose. A 2011 study by a professor of government at Cornell University found that nearly 60 percent of tuition tax credit recipients didn't realize that they have received help from the government to pay for college.<sup>96</sup>
- These programs are complicated and confusing. Because of the complexity of navigating the

tax code, many families do not appear to know whether they are qualified for these benefits. The Government Accountability Office reported in May that it had found that 1.5 million filers who were eligible for tuition tax credits or deductions in 2009 failed to claim them – leaving a total of approximately \$726 million on the table.<sup>97</sup> Meanwhile, the U.S. Treasury Department’s Inspector General for Tax Administration has estimated that more than two million taxpayers may have mistakenly claimed the AOTC in 2009.<sup>98</sup>

For these reasons, policymakers should eliminate the tuition tax break programs and use the savings to strengthen the Pell Grant program, make more middle-income families eligible for Pell Grants, and help pay for other priorities outlined in this paper.

#### Cost Estimate

5-year: \$99.7 billion savings  
10-year: \$158.9 billion savings

*All education tax credits and deductions for tuition, as estimated by the White House Office of Management & Budget (OMB), and published in the President’s annual Budget Request (extrapolated for future years and adjusted to reflect extensions enacted in 2013) are expected to cost \$124.8 billion over the next five years, and \$184.0 billion over the next 10 years. For this cost estimate, we include the AOTC through 2017, the HOPE tax credit thereafter, and the Lifetime Learning tax credit in each year. The benefits would be eliminated starting in 2014, therefore producing savings of \$99.7 billion over five years and \$158.9 billion over 10 years. Note that these estimates follow a “current-law” baseline and are based on the assumption that the AOTC will expire after tax year 2017 as it is set to under current law.*

#### Tax-Advantaged Savings Plans

The federal government offers tax advantages for three main types of savings plans that individuals can use to pay for higher education expenses: pre-paid tuition plans, 529 plans, and Coverdell Savings Accounts. Generally, these plans allow individuals to make after-tax contributions to a savings plan from which earnings, appreciation, and distributions are not taxed as income by the federal government so long as they are used to pay for qualified higher education expenses. (The savings plans are the only tax benefits that

can be claimed to pay for living expenses incurred while a beneficiary pursues an education, in addition to tuition and fees. Other tax benefits may be used only for tuition, fees and other minor expenses.) Combined, the plans’ tax benefits result in about \$2.5 billion per year in lost revenue for the government, according to the president’s fiscal year 2013 budget and adjusted to reflect changes to the Coverdell Savings Accounts enacted January 2013.<sup>99</sup>

Policymakers should eliminate the tax benefits on these plans for new contributions as part of a comprehensive reform of federal student aid. While other federal tax benefits for higher education are not well targeted – providing large benefits to individuals with high incomes – the savings plans provide the most regressive benefits of all. Moreover, they provide the largest tax benefits on a per-individual basis than any other federal tax benefit for higher education. The General Accounting Office estimates that in 2010, families earning over \$150,000 realized a median tax benefit of \$3,132 on \$18,039 in distributions from 529 plans.<sup>100</sup> That is \$632 more than any individual can receive under the American Opportunity Tax credit and \$1,632 more than under the Lifetime Learning Credit. The forgone revenue that occurs through these benefits could be put to better use by policymakers in a redesign of federal financial aid.

#### Cost Estimate

5-Year: \$1.1 billion savings  
10-Year: \$2.5 billion savings

*Because we propose to eliminate the tax benefits for future contributions to tax-advantaged savings plans for higher education starting in fiscal year 2014, but allow the benefits to remain for prior contributions, the savings from the proposed policy will likely be far less than the \$2.5 billion average annual cost of the current policy. Therefore, we assume that the annual revenue loss will be reduced by 10 percent under the proposed policy, which translates into \$1.1 billion over five years and \$2.5 billion over 10 years in savings, based on information from the president’s fiscal year 2013 budget and adjusted for changes to the programs enacted January 2013.<sup>101 102</sup>*

#### Student Loan Interest Deduction

Another overlapping and complicated benefit is the above-the-line deduction for student loan interest that borrowers may claim on their federal tax returns. Middle- and lower-

income borrowers do not actually pay the nominal interest rate on student loans. They pay a lower rate because the federal government rebates a portion of their payments in the form of a tax deduction once a year.

The student loan interest tax deduction allows individuals making less than \$60,000 a year and joint filers making less than \$120,000 a year to deduct up to \$2,500 in student loan interest payments from their taxable income. Eligibility phases out for individuals earning between \$60,000 and \$75,000 or joint filers earning between \$120,000 and \$150,000. It is an “above-the-line deduction” and is therefore available to all filers, including those who do not itemize. As such, the deduction reduces a borrower’s Adjusted Gross Income and reduces his monthly (and possibly total) payments on his student loan if he repays using Income-Based Repayment, another overlapping feature of student loan benefits.

The deduction is also a regressive benefit. It provides larger benefits to borrowers in the higher tax brackets (at least until the borrower earns enough to reach the phase-out limit). Someone earning \$30,000 a year pays 15 percent federal income tax on the last dollar he makes (the 15 percent marginal tax rate). When taking the interest deduction, this borrower lowers his student loan interest rate by 15 percent (i.e. the rate is not 6.8 percent but actually 5.8 percent). Someone making \$60,000, on the other hand, pays the 25 percent marginal income tax rate, and therefore an interest rate of 5.1 percent (6.8 percent reduced by 25 percent, his marginal tax rate).

Given that the deduction provides overlapping benefits with other federal student loan programs, that it is moderately regressive, and that its benefits are delayed, it should be eliminated, and budgetary resources should be redirected.

### **Cost Estimate**

5-year: \$5.1 billion savings

10-year: \$20.4 billion savings

*According to the President’s fiscal year 2013 budget request, the deduction reduces federal tax revenue by \$5.1 billion over five years.<sup>103</sup> Extrapolating from that estimate, and adjusting it to reflect permanent changes enacted in 2013, we estimate that eliminating the policy starting in fiscal year 2014 will produce savings of \$20.4 billion over 10 years.<sup>104</sup> ❏*

## **College Outreach**

Since the creation of the Higher Education Act in 1965, federal policymakers have supported multiple programs aimed at raising the college aspirations and improving the academic preparation of disadvantaged students. The most promising of these programs is GEAR UP, which provides early intervention and support services to entire grades, or cohorts, of middle school and high school students to help improve college readiness and enrollment rates.<sup>105</sup> The mission of GEAR UP is not only to help individual students, but to make lasting changes in the middle schools and high schools these students attend.<sup>106</sup>

### **Triple Funding for GEAR UP**

While early research on GEAR UP has been positive, it’s clear that funding limitations and problems with the program’s design have hampered the program’s ability to accomplish its most ambitious goals.<sup>107</sup> The program’s budget has barely budged over the last decade. In fact, the final fiscal year 2012 spending bill cut the program’s budget back to \$302 million, a slight decrease from 2005 levels. Over that time, the number of grants the program supports has plummeted from 245 to 132.<sup>108</sup>

At the same time, the program suffers from several significant structural flaws that have limited its success. GEAR UP grantees generally work in middle schools and high

schools for only a few years, making it very difficult for them to effectuate change.<sup>109</sup> Many grantees, for example, work with only one cohort of students in a middle school, and therefore don't have much of an impact on the rest of the school. In addition, the program has trouble with the transition from middle school to high school.<sup>110</sup> The cohort approach – one of the most promising aspects of the program – is lost as students disburse into different high schools, some of which end up with very few GEAR UP participants. Current regulations require GEAR UP grantees to continue serving students at high schools that enroll a “substantial majority” of the students in a given cohort; as a result, many participants stop being served.

Our proposal would immediately increase funding for GEAR UP by 200 percent. At the same time, the plan would require grantees to work with at least three cohorts of students in a given middle school. It would also require state grantees and partnerships to better coordinate their programs so that all GEAR UP participants continue to be served as they make the transition from middle school to high school.

#### **Cost Estimate**

*5-year: \$3.2 billion costs*

*10-year: \$6.8 billion costs*

*In fiscal year 2012 Congress appropriated \$302 million for GEAR UP. Assuming that baseline funding would increase at an inflationary rate of 2.5 percent each year, tripling funding for the program would cost an additional \$3.2 billion and \$6.8 billion over the next five and 10 years respectively, compared to the baseline.*

## **Accountability, Transparency, and Reform**

### **Mandate Institutional Accountability Standards**

Part of reforming financial aid lies with distributing funds more efficiently. But the federal government also needs to create new incentives for institutions to *use* federal aid more effectively. Colleges have traditionally received federal financial aid with few strings attached. The federal government has outsourced responsibility for ensuring minimal levels of institutional quality to a combination of state governments, voluntary non-profit accrediting associations, and the implicit discipline of a market in which colleges compete for students. Regulatory accountability measures

have been limited to preventing worst-case scenarios that are tantamount to fraud, as with existing regulations that expel colleges with unusually high student loan default rates from federal aid programs. Because withdrawal of aid eligibility is the equivalent of the “death penalty” for aid-dependent institutions, the standards for these regulations are meant only to catch the worst of the worst institutions, which is why the rules have failed to prevent a sharp increase in aggregate loan default rates in recent years.

During the 2000s, this traditional set of accountability mechanisms was severely tested. New, nationally focused, for-profit higher education corporations began using aggressive marketing techniques to enroll tens of thousands of new students, many of them online. In some cases, up to 90 percent of all corporate revenues accrued from federal aid programs. Many students struggled to find good jobs or repay outsized loans. The existing accountability regime proved insufficient to accommodate the new economic realities of higher education.

In 2011, the U.S. Department of Education finalized a new set of rules designed to solve these problems, called the “gainful employment” rules. In addition to existing eligibility criteria, for-profit colleges and workforce-oriented programs would be judged by additional measures, including the percent of program graduates paying back their loans and the ratio of students’ debt loads to their annual income. Colleges that failed to meet certain thresholds would ultimately become ineligible for federal aid.

The “gainful employment” rules are currently held up in federal court. But they established a crucial precedent that can be applied beyond the for-profit sector. For while it's true that for-profit colleges have grown quickly and enroll a disproportionate share of students who take out large loans and fail to pay them back, the fact remains that the large majority of students are still enrolled in traditional public and non-profit institutions. Many, if not most, of these programs are essentially pre-professional in nature. By far the most popular undergraduate major is business, with over 350,000 students earning business bachelor's degrees. It seems reasonable to assume that business programs are designed to prepare students for gainful employment in businesses—and to judge those programs, too, based on loan repayment rates and how much the cost of their education compares to their earnings in the labor market after graduation.

Some institutions, particularly public universities and community colleges, may not have enough student borrowers for evaluation via loan volume and loan repayment rates. But other measures can be used, such as the percentage of students who graduate or transfer to another college, compared to rates at other institutions with like academic missions and a similar student body in terms of academic preparation and socioeconomic status.

We propose an accountability regime using a combination of eligibility thresholds and financial incentives to encourage colleges to keep higher education affordable and help students earn degrees. All higher education programs, for-profit and non-profit, would be publicly evaluated using the gainful employment metrics. Institutions with extremely poor results would, as is the case now with default rate regulations, lose eligibility entirely. Those with mediocre results would be subject to limits in the aggregate amount of financial aid they can receive per student.

### Cost Estimate

5-year: \$694 million savings

10-year: \$1.5 billion savings

*A Congressional Budget Office estimate of a House of Representatives appropriations provision to prevent the implementation of gainful employment said that the provision would cost about \$33 million annually.<sup>111</sup> That means the gainful employment regulations, as published by the Department of Education, would save that same amount. Because our recommendation for gainful employment regulations would be far more expansive, in that it would apply to all types of institutions rather than only for-profit and vocational programs and would impose more stringent standards, we assume savings of four times the original gainful employment regulation. In total, that means the program would produce \$694 million in savings over five years, and \$1.5 billion over 10 years. Those savings arise from a reduction in the amount of federal student aid committed over that time frame.*

### Create a Federal Student Unit Record System

As anxiety over student debt and college costs reaches new heights, the public is increasingly questioning the value of college degrees. While students and their families can access reasonable estimates of the *average* value of college degrees, they have very little data on the value of specific degrees from specific colleges. With some students cross-

ing state lines to attend traditional colleges and others enrolling in relatively new institutions that serve online students from across the nation, the best data sources need to be national in scope. National data also provide richer comparisons of institutional success. But while there is increasing public and political interest in helping consumers choose colleges, the data infrastructure needed to answer many basic questions does not exist.

Currently, there is only a jumble of clunky, uncoordinated, and incomplete federal and state data systems that don't talk to each other and, therefore, cannot answer basic—and critical—questions. We don't know, for instance, whether students at particular institutions graduate, whether they get jobs, and whether they can comfortably pay back their loans. We also don't know how students receiving federal aid are faring and whether they are graduating. Despite the government's huge investment in the Pell Grant program, and despite a requirement in law that institutions should keep track of the graduation rates of their Pell students, these data are not collected in many cases and not reported in others. Institutions feel overwhelmed by the amount of data they have to report to their accreditors, states, and the federal government, and yet students and policymakers still don't have the information they need to make informed choices. Federal data, for example, only allow us to examine graduation rates of first-time full-time undergraduates, meaning that a student who starts at a community college, and subsequently transfers to and graduates from a four-year institution doesn't "count" as a graduate. And we have no high-quality comparable data about further education or employment outcomes for most students.

Despite the hundreds of billions of dollars the government spends in financial aid, policymakers cannot answer basic questions like, "Do Pell Grant students from X institution graduate?" or, "Can students from Y institutions comfortably pay back their loans?," let alone more granular questions like, "How do Latino, male, or students from Z high school fare at A, B, or C institution?" Without better information, there can be no meaningful transparency or accountability, which limits our ability to improve education outcomes.

Yet proposals to build a better information infrastructure have been stymied by narrow interest groups whose members would rather avoid scrutiny. Institutional self-interest

is often masked by concerns about privacy. This institutional self-interest resulted in a major setback to consumer information and choice in the 2008 Higher Education Opportunity Act: the ban on a national education database or system that would allow student progress to be followed over time.<sup>112</sup>

If the goal was to protect students against the danger and indignity of having information about them stored in a huge database, the unit record ban has been a miserable failure. As of now, 19 states have created their own such databases that include information from the early elementary grades all the way through college, and 20 more states are in the process of building them. At the same time, over 3,000 colleges and universities that collectively enroll 96 percent of all the colleges students in America regularly send individual student records to the National Student Clearinghouse, a private non-profit organization founded by the student loan industry.

The government, meanwhile, has found other ways to gather information. For example, the “gainful employment” regulations imposed on for-profit colleges judge programs, in part, based on a comparison of students’ debt to their incomes after graduation. To get the income data, federal officials merged student unit records from the Federal Student Aid office with wage records from the Social Security Administration (SSA). Meanwhile, the National Institute for the Deaf, working in partnership with SSA, has four decades of employment, earnings, and Supplemental Security Income (SSI) data on over 14,000 students who applied to the school. These data have allowed the institute to unequivocally demonstrate that graduates had far greater earnings and relied less on SSI than those who did not attend or who dropped out. But these are small, and incomplete, pieces of the puzzle.

Since the student unit record ban was instituted, the data landscape has changed significantly. We now live in a world of big data and big databases. The question is whether we are going to use them to improve higher education. And while none of these other student databases have resulted in the privacy breaches warned by doomsayers, they also weren’t designed for researchers and policymakers to conduct fair, nuanced, nationwide analyses of how well colleges help different kinds of students earn different kinds of credentials. State databases are idiosyncratic,

only cover single states, and don’t capture information on self-employed, military, or other federal employees. The Student Clearinghouse data paints a richer overall national picture of student outcomes than other data sources, but it doesn’t release information on individual colleges, making institutional transparency or accountability difficult, if not impossible.

Many of this paper’s recommendations are predicated upon much better data than are currently available. Serious reform will not be possible unless we get serious about collecting and using better data. To do this, we recommend a student-level, longitudinal federal system that allows students, families, taxpayers, and policymakers to know how students fare as they proceed through the educational system and into the workforce.

### Restore “Ability to Benefit” at Schools with Strong Outcomes

“Ability to Benefit” (ATB) was a policy in place until July 2012, when it was eliminated as part of a money-saving maneuver to shore up funding for Pell Grants.<sup>113</sup> As previously discussed, the ATB program permitted students who hadn’t earned a high school diploma or GED to receive federal financial aid funds for postsecondary education, provided they either passed a federally-approved exam or successfully completed at least 6 credit hours of postsecondary education.<sup>114</sup>

While the ATB program has benefited many students, it has also experienced substantial controversy. In 2009, an undercover investigation by the Government Accountability Office (GAO) revealed that some publicly traded for-profit colleges were helping students cheat on the exam so that they could pump up their enrollment numbers and collect more federal student aid funds.<sup>115</sup> While such abuses are clearly unacceptable, they should not obscure the importance of the program: that it gives students who dropped out of school for one reason or another the only opportunity they may have to earn certificates or degrees to advance their careers. The Department’s own experimental site demonstrated that “6-credit” ATB students did as well as those with a high school diploma and better than those who had passed an ATB exam.

For these reasons we propose reinstating ATB, but limiting it to schools with a proven track record of serving their

students well. Under this proposal, only schools that have a cohort default rate under 15 percent or that meet the institutional accountability metrics described in this paper will be able to take part in the program. This restriction should prevent the type of abuses that have occurred in the past.

### Cost Estimate

5-year: \$890 million costs

10-year: \$1.8 billion costs

*According to the Congressional Budget Office, eliminating the program entirely saved \$2.9 billion over 10 years.<sup>16</sup> Our proposal would restore Ability to Benefit for schools with cohort default rates below 15 percent (about 2,500 schools using 2009 default rates). Those schools received \$11.3 billion in Pell Grant disbursements in 2010, while institutions with default rates of 15 percent or above received \$6.9 billion through the Pell Grant program. That means the new version of the program would cost about 62 percent of the savings as estimated by the CBO, or \$890 million and \$1.8 billion over the next five and 10 years, respectively.*

### Create a State Competitive Grant Program for Innovation and Reform

One of the most important, yet rarely targeted, actors in higher education is the states. More than 80 percent of college students attend public institutions, and states are a major funder of higher education, providing over \$78 billion in 2011 for higher education. Yet they are rapidly disinvesting in higher education as they face decreasing revenues and increased healthcare costs. In 2011-12, state spending on colleges declined nearly 8 percent—the largest decline in half a century.<sup>17</sup> Forty-one states cut their spending, ranging from a 1 percent cut in Indiana to a 41 percent cut in New Hampshire. To make up for these cuts, institutions are passing the costs on to students in the form of increased tuition and fees. Over the course of the past decade, tuition went from less than 30 percent of all public higher education revenue to over 43 percent. Any comprehensive package of reforms must include states as key players in improving college access, completion, quality, and affordability.

But the government has little leverage to change state behavior. The flow of federal financial aid is related only to institutional and student eligibility. There is currently only one federal program dedicated to improving state efforts

in postsecondary education, the College Access Challenge Grant (CACG) program.<sup>18</sup> But this is a formula grant to all states that provides broad discretion for how the dollars are used. While the additional dollars may be welcomed by states, they are not targeted towards policy reforms states should undertake to improve student outcomes.

We recommend the creation of a 10-year, \$10 billion dollar competitive grant program, similar to President Obama's proposed Race to the Top for College Affordability and Completion, to states that implement systemic reforms to improve student outcomes.<sup>19</sup>

All states would be eligible for a one-year, \$1 million planning grant. States would then apply to the U.S. Department of Education to compete for funding to implement the plans. Although the numbers of states that will ultimately receive implementation grants will be few, providing the opportunity for every state to receive funding to focus on strategic reforms should have a positive, long-lasting effect on students nationwide.

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### One of the most important, yet rarely targeted, actors in higher education is the states

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The reforms include establishing statewide access and completion goals, paying particular attention to closing achievement gaps for at-risk subgroups; funding higher education based on student outcomes, rather than enrollments; improving alignment and coordination between different parts of the system, including secondary to postsecondary, two-year to four-year, and postsecondary to the workforce; creating or allowing access to student-level data that will allow the state to follow students, irrespective of their path, through education and employment; ensuring that the majority of state aid goes to students with significant financial need; increasing the availability and usability of data to students and families; and maintaining or increasing state support for higher education.

Many of these reform elements require political, rather than financial, capital. Governors and state legislators may have to work together to pass legislation that enables these reforms, whether it be for establishing a performance-based funding formula, allowing for the sharing of data, or requiring a common transfer core across state institutions.

To be eligible for the competitive grant program, states must have already removed legislative and regulatory barriers to implementing their plans. States that are furthest along in implementing these reforms will be most competitive, but funding will be spread out over four years to provide states time to implement reforms.

### Cost Estimate

5-year: \$10.4 billion

10-year: \$10.4 billion

*To make the competitive grant program sufficiently large as to compel states to participate, significant amounts of money will be required; however, because of the long application and review periods associated with competitive grant programs, funding need not be provided annually. Additionally, because states will likely require heavy investments in the early years of their plans to build capacity and infrastructure for their implementation, we propose a program that begins with a significant, \$3.4 billion investment in fiscal year 2014. Then, utilizing lessons learned to improve the program, provoke more interest from the states, and fund more ambitious efforts, the amount of the competitive grants available would increase to \$7.0 billion in a follow-up competition in fiscal year 2016. Because all costs occur in the first five years of the program, both the five- and 10-year costs total \$10.4 billion.*

### Make Better, More Consistent Consumer Information Mandatory

The financial-aid and college-going process can be difficult for all but the savviest students and families. Over the past several years, the federal government has tried to address this knowledge deficit by introducing such consumer measures as FAFSA simplification, a model financial aid award letter that helps students compare financial aid packages from different colleges (known as the Shopping Sheet), net-price calculators that give students personalized estimates of financial aid by institution, and an overhaul of the studentaid.gov website. But there is still much work to be done—the Shopping Sheet, for example, is only voluntary. So far only 500 institutions out of more than 6,000 have adopted it, greatly limiting its effectiveness in helping students. Students and families need better information, provided at key decision-making points, in ways that are easily understandable and actionable.<sup>120</sup>

Even though our proposals simplify the components

of federal financial aid—one loan, one grant, and one Income-Based Repayment system—students still need access to transparent information about federal financial aid. They also need to understand exactly how much college will cost, no matter how many schools they apply to or where they decide to attend. They need to understand the incentives built into the various components of financial aid, including time limits for Pell grants and loans. For this reason, we propose to:

- Make the Shopping Sheet, or other proposed standardized financial aid award letters, mandatory for all colleges that participate in federal financial aid programs. To ensure that the model aid letter meets the needs of students and institutions, third-party testing must be included in the development and refining process.
- Improve entrance and exit counseling for federal loans. This may be done by requiring institutions to adopt the Federal Student Aid’s Financial Awareness Counseling Tool (FACT), which aggregates a student’s existing loans and helps them decide on a repayment plan and develop a monthly budget.
- Continue to redesign Federal Student Aid’s web resources and house them under the improved, consumer-friendly studentaid.gov.
- Continue to research ways to simplify the FAFSA process, including considering whether an application is necessary at all for tax-filers.

### Cost Estimate

*We are unable to provide an estimate for this proposal. ❖*

## Conclusion

Sometimes a crisis presents an opportunity. With a “funding cliff” looming for years to come, the Pell Grant program is clearly on an unsustainable path. So far, policy-makers, in the midst of high-stakes budget negotiations, have responded with a series of short-term solutions to shore up the program on a year to year basis. Some of these solutions – such as eliminating the year-round Pell Grant and ending financial aid eligibility for students without a high school diploma or GED – were not well thought out



and are counterproductive.

The need to find a permanent solution to the Pell Grant program's budget problems should spur policymakers to reexamine a federal student aid system that was created for a different era and that has evolved haphazardly over the decades. At a time of skyrocketing college costs, crushing student debts, abysmal college completion rates, and growing disparities in student outcomes, we should use the Pell crisis as an opportunity for a top-to-bottom overhaul to make the system simpler, more understandable, more outcomes oriented, and fairer.

This paper provides a comprehensive set of policy proposals that are designed to achieve these goals—at no additional cost to taxpayers. They show what kind of student aid system is possible if policymakers are willing to rethink the way they use the resources they have already committed. ■

## Appendix I: Pell Grant Funding Sources

Funding Cliff (Appropriation necessary to sustain current policy)

Enacted and Projected Current Policy, Fiscal Year, \$ billions

YEAR	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Regular Annual Appropriation*	14.215	17.288	17.495	22.956	22.824	23.072	28.579	31.476	31.761	30.494	31.026	31.399	31.854	32.582	32.973
Prior Years' Surplus**	-	-	-	-	-	-	2.087	-	-	-	-	-	-	-	-
Recovery and Reinvestment Act	-	13.518	4.239	-	-	-	-	-	-	-	-	-	-	-	-
2010 Student Loan Savings	-	-	10.726	3.862	-	-	-	-	-	-	-	-	-	-	-
Year-Round Grant Ended	-	-	-	3.183	-	-	-	-	-	1.060	1.125	1.125	1.140	1.145	1.145
Budget Control Act	-	-	-	0.194	9.806	7.000	-	-	-	-	-	-	-	-	-
FY12 Loan/Pell Grant Savings	-	-	-	-	0.612	0.587	0.588	-	-	0.514	0.257	0.284	0.290	-	-
Entitlement formula	2.031	2.090	4.469	5.315	4.998	5.776	6.509	7.255	8.144	9.204	9.296	9.404	9.527	9.645	9.759
<b>TOTAL</b>	<b>16.246</b>	<b>32.896</b>	<b>36.929</b>	<b>35.510</b>	<b>38.240</b>	<b>36.435</b>	<b>37.763</b>	<b>38.731</b>	<b>39.905</b>	<b>41.272</b>	<b>41.704</b>	<b>42.212</b>	<b>42.811</b>	<b>43.372</b>	<b>43.877</b>
<b>Pell Grant Maximum Award</b>															
Enacted and Projected Current Policy, Fiscal Year, \$ actual															
YEAR	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Appropriation & Supplemental	4,241	4,860	4,860	4,860	4,860	4,860	4,860	4,860	4,860	4,860	4,860	4,860	4,860	4,860	4,860
Entitlement	490	490	690	690	690	785	865	950	1,050	1,170	1,170	1,170	1,170	1,170	1,170
<b>TOTAL</b>	<b>4731</b>	<b>5350</b>	<b>5550</b>	<b>5550</b>	<b>5550</b>	<b>5645</b>	<b>5725</b>	<b>5810</b>	<b>5910</b>	<b>6030</b>	<b>6030</b>	<b>6030</b>	<b>6030</b>	<b>6030</b>	<b>6030</b>

\*Appropriations prior to 2013 are law; figures for years thereafter reflect appropriation needed to fund the grant level under current policy shown at the bottom.

\*\*Assumes Congress applies the surplus to fiscal year 2014 funding; Congress could apply it to fiscal year 2013 funding.

Source: New America Foundation, based on Congressional Budget Office estimates

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53. 34 CFR 685.221(d)(i)-(ii) (2009). “Changes in the payment amount. (i) If a borrower no longer has a partial financial hardship, the borrower may continue to make payments under the Income-Based Repayment plan, but the Secretary recalculates the borrower’s monthly payment. The Secretary also recalculates the monthly payment for a borrower who chooses to stop making income-based payments. In either case, as result of the recalculation—The maximum monthly amount that the Secretary requires the borrower to repay is the amount the borrower would have paid under the standard repayment plan based on the amount of the borrower’s eligible loans that were outstanding at the time the borrower began repayment on the loans under the Income-Based Repayment plan; and the borrower’s repayment period based on the recalculated payment amount may exceed 10 years.”

54. It is likely that policymakers included this provision to make the program more generous or to encourage enrollment among more borrowers who are eligible but might earn higher incomes later in their repayment terms. Another possible explanation is that, because borrowers can leave IBR for another repayment plan at any point, they would have an incentive to leave IBR if their incomes reached a level such that their payments under IBR were actually higher than under the standard 10-year repayment plan. In response, drafters may have included the cap so that borrowers do not need to leave IBR to pay at the 10-year rate once their incomes rise. Moreover, borrowers who leave IBR but continue to make payments as high as those under the standard 10-year repayment plan (based on the calculation on their original loan balance) may count those payments toward the minimum needed to qualify for loan forgiveness. Lastly, the provision also prevents a borrower from having to make payments that are higher than those on the 10-year standard repayment plan if he no longer qualifies for IBR and his loan balance increased while in IBR. However, that situation should occur extremely rarely, if ever, because a borrower can almost always opt to repay through consolidation and make payments that are less than those on a standard 10-year repayment plan.

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