



# Focus

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## The coming debate on postsecondary student aid policy

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The legislation authorizing the Stafford Loans and Pell Grants, the major federal programs subsidizing postsecondary schooling by lower- and middle-income students, expires at the end of 1991.<sup>1</sup> It is already apparent that reauthorization of these programs will not be routine. A sharp debate on the form and magnitude of federal student aid policy is taking shape.

Numerous proposals for replacing or complementing the present programs are being floated for consideration by the 101st Congress. Among them are the following:

- **Graduation-Contingent Aid:** Writing in the magazine *Change*, Frederick Fischer of the Office of Management and Budget proposed replacement of the existing programs by a “graduation-contingent” aid program. This would give “unsubsidized loans while the student is in school, with subsidies provided in the form of partial loan cancellation only after degree attainment.”<sup>2</sup>
- **National-Service-Contingent Aid:** Representative David McCurdy (Oklahoma) and Senator Sam Nunn (Georgia) have announced that they will cosponsor

legislation that would replace existing programs by one awarding grants to youth who complete specified military or other national service. According to Nunn, the new program would “take the step of converting the student loan programs from an entitlement to an earned benefit by tying federal assistance to the performance of national service.”<sup>3</sup>

- **STARS:** During the recent presidential campaign, Governor Michael Dukakis proposed that the existing programs be complemented by a new “Student Tuition and Repayment System.” Under the STARS proposal, each dollar of aid that a student receives would obligate him to return a fixed fraction of his future income rather than a fixed dollar amount, as is now the case for Stafford Loans.<sup>4</sup>
- **Personal Capital Accounts:** In his recent book *Starting Even*, Robert Haveman of the University of Wisconsin–Madison proposed that, upon reaching age eighteen, every American youth receive a “personal capital account.” This would replace the existing aid programs at least in part. According to Haveman, “The account would be interest earning and could be drawn upon for approved purchases of education and training as well as for health care services.”<sup>5</sup>
- **Elimination of Postsecondary Aid:** A recent article in the *Chronicle of Higher Education* reported a proposal by Robert Zemsky, director of the Institute for Research on Higher Education at the University of Pennsylvania, to eliminate all federal postsecondary aid and direct the funds saved to elementary and secondary education. According to the *Chronicle*, Zemsky asserts that “despite nearly two decades of massive investment in student aid programs . . . college participation rates have not substantially changed.”<sup>6</sup>

These proposals clearly embody a wide range of views. It is the task of the research community to inform the policy-making process through objective analysis of the effects of alternative aid programs.

Unfortunately, we are not well prepared to evaluate the new proposals. Research to date has focused on a narrow question: What effect do straightforward subsidies to students such as the Pell Grants have on the postsecondary enrollment rates of high school graduates?<sup>7</sup> The approaches used to answer this question were not designed to—and therefore cannot—compare the diverse forms postsecondary aid might take after 1991. Moreover, these approaches address only some of the effects of the subsidies being evaluated.

This article calls attention to some of the features of the schooling process which must be better understood if the research community is to play a constructive role in the coming debate on postsecondary aid policy. Where possible,

I discuss how these features interact with specific proposals. I do not attempt, however, to thoroughly assess any proposal.

## Understanding postsecondary school dropout

I begin with the widely misunderstood phenomenon of dropout from college or technical school. Such dropout is widely considered a social problem, and reducing it is often cited as an objective of student financial aid. For example, introducing a recent special issue of the *Economics of Education Review* dealing with student aid, Estelle James wrote: “And, does this aid accomplish one of its major purposes, reducing the above-average attrition rates of low socio-economic status students, so that more of them complete college?”<sup>8</sup> Frederick Fischer motivated his proposal for graduation-contingent aid by writing: “All knowledgeable observers bemoan current dropout levels and believe society would be better off if these levels were lower.”<sup>9</sup>

In fact, reducing postsecondary dropout would not necessarily make society better off. Student aid policy should not be evaluated by its effect on dropout but rather by its joint effects on enrollment and completion rates. These are the conclusions of my recent analysis of the process of postsecondary enrollment and completion.<sup>10</sup>

The key observation is that students contemplating enrollment do not know whether completion will be feasible or desirable. Hence enrollment is a decision to initiate an experiment, one of whose possible outcomes is dropout. Experiments should be evaluated by their ex ante expected return, not by their ex post success rate. It follows that, told only the completion rate of enrolled students, one cannot judge whether the right enrollment decisions have been made.

I have made the point in earlier work that postsecondary schooling is an experiment. In *College Choice in America*, David Wise and I noted:

Like trial and error in the job market, postsecondary education may for many young people be part of the search process that leads to discovery of what they like and don't like and of which occupations are compatible with their interests and abilities. To this extent, students may derive informational value from attendance, even if they drop out.<sup>11</sup>

In his article in *Change*, Fischer wrote: “There are so many college dropouts for the same reason there are so many small business failures—start-up costs are not exorbitant and the risk is rationally worth taking.”<sup>12</sup>

Despite occasional remarks such as these, the implications of thinking of schooling as experimentation have not been appreciated.<sup>13</sup> In an attempt to shed light on the interaction between dropout probabilities, enrollments, and realized dropouts, I developed a model of postsecondary enrollment

and completion. Working through the implications of this model makes it clear that dropout reductions should not be the objective of student aid.

Perhaps the most striking finding is this: if one wants to reduce postsecondary dropout, then one should eliminate aid entirely. The reason is that eliminating aid would make enrollment less attractive relative to working. Lowering the attractiveness of enrollment would reduce the number of students who choose to enroll. The students who choose to work rather than enroll would be those with the lowest school completion probabilities. Hence, eliminating aid would shift the composition of enrollment toward those students with the highest completion probabilities.

## Postsecondary aid and high school dropout

The foregoing discussion concerns postsecondary dropout only. High school dropout is a fundamentally different phenomenon. Whereas postsecondary enrollment is voluntary, high school enrollment is compulsory. A student entering college recognizes that dropout may be the outcome and willingly accepts this risk. A student entering high school does not thereby signal his acceptance of the risk of dropout. Some high school students are people who, in the absence of compulsory attendance laws, would have chosen not to enroll.

Postsecondary student aid programs should increase the rate of high school completion by low-income students. This is because aid affects the "option value" of high school completion.

To illustrate the point, suppose that the prevailing wage for a person with postsecondary training is substantially higher than that for a person with a high school diploma. Suppose that someone with a high school diploma earns only marginally more than does a person with ten years of schooling. In this setting, a tenth grader who expects to be able to finance postsecondary enrollment has an incentive to complete high school. Otherwise, completing high school makes no sense. Hence the availability of postsecondary aid should encourage students to persist in high school.

The option value of schooling has long been recognized in the theoretical literature on investment in human capital. Perhaps the earliest discussion is in Burton Weisbrod's article "Education and Investment in Human Capital."<sup>14</sup> Y. Comay, A. Melnik, and M. A. Pollatschek gave a clear statement of the idea in their article "The Option Value of Education and the Optimal Path for Investment in Human Capital."<sup>15</sup> These authors considered an individual who has completed a number of years of schooling and who must decide between enrolling for another year and entering the labor force. They noted that, contrary to the assumption of many studies on the returns to schooling, the investment value of the anticipated year of schooling *does not* equal the income stream obtainable with the additional year minus that obtainable without it. The return to the additional year

of schooling properly includes the value of the option of pursuing further schooling. In the extreme, an additional year of schooling "may be undertaken solely because it offers the option of continuation to a desired rung in the educational ladder" (p. 425).

The above notwithstanding, empirical research evaluating postsecondary aid policy has ignored the potential relationship between the availability of aid and the rate of high school completion. The practice has been to examine the impact of aid on the postsecondary enrollment rate of high school graduates, as if the latter group is not determined to some extent by the availability of aid. Thus we do not at present have estimates of the magnitude of the effect of postsecondary aid on high school completion.<sup>16</sup>

## Student aid and career choice

Schooling behavior is intimately bound up with the process of career choice. The present policy of postsecondary aid makes no overt attempt to influence career choices. The Pell Grant and Stafford Loan programs define postsecondary education very broadly. Students can use these awards to

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attend universities or vocational schools. Within these institutions, they may study subjects of their choosing.

Federal aid policy has not always sought to be career-neutral and may not be so in the future. The National Defense Education Act of 1958, which provided loans for general college enrollment, contained a loan cancellation provision for students who subsequently entered teaching. The McCurdy-Nunn proposal making aid contingent on national service seeks to induce youth to perform such service.

It is important to understand that aid programs imposing no explicit career restrictions may nevertheless influence career choices. Two illustrations will suffice to make the point.

First compare the Pell Grant program with Fischer's graduation-contingent aid. These two policies differ with respect to who pays for schooling should a student drop out. The Pell Grant is not contingent on the student's subsequent success or failure; graduation-contingent aid is awarded only should the student graduate. The probability that a student does graduate varies with the nature of the postsecondary program he chooses. It should therefore be expected that moving from Pell Grants to graduation-contingent aid would influence career choices by inducing more students to choose "safe" programs with high completion rates.

Next compare the Stafford Loan program with the STARS proposal. The former program imposes on the student a fixed repayment obligation; the latter makes repayment an increasing function of the student's income. It should therefore be expected that moving from Stafford Loans to STARS would reduce the incentive students now have to choose high-wage occupations.

## General equilibrium effects

As complex as it is to forecast the effects federal postsecondary aid may have on student decision-making, this forecasting problem is not the only one that policy analysts face. The magnitude and form of federal aid presumably affect the behavior of other actors who play roles in the determination of schooling outcomes: the colleges and technical schools that supply postsecondary education, the states and other sources that administer their own aid programs, the firms that hire educated labor, etc.

Policy evaluation should examine the "general equilibrium" effect of aid policy, that is, the effect when all the impacts on all the relevant actors are jointly accounted for. The literature evaluating aid policy has, however, concerned itself only with the direct effect of aid on student decision-making. As Michael McPherson pointed out in a recent article: "The implicit assumption is that other aspects of state and institutional behavior, such as pricing, levels of state budgetary support, offers of institution-based aid, and so on, are unaffected by federal policy change."<sup>17</sup>

In the absence of research, one can only speculate as to the general equilibrium effect of aid policy. Three examples indicate the types of questions in need of study.

First, what are the displacement effects of aid programs? That is, to what extent are increases in federal aid followed by decreases in aid from other sources or by increases in tuition levels?

Second, how does the form of federal aid affect the nature of the programs offered by postsecondary institutions? Suppose, for example, that Pell Grants were replaced by graduation-contingent aid. Universities might respond by relaxing their graduation requirements. Vocational schools might divide their programs into shorter subprograms, each yielding a certificate of some kind.

Third, how do the returns to schooling depend on the supply of educated labor? Research evaluating aid policy has assumed that the returns to schooling do not depend on the distribution of schooling levels in the population.<sup>18</sup> Unfortunately we do not know how well this assumption approximates reality. If the demand for educated labor is actually fixed, then any attempt to use aid to increase the number of workers with postsecondary training will fail. An increase in postsecondary aid will generate a compensating fall in the wage paid to labor with postsecondary training. The result will be that the provision of aid will not induce more students to enroll.<sup>19</sup>

## Postsecondary aid and antipoverty policy

Federal programs of postsecondary aid are among a complex of instruments that society uses in its attempt to reduce poverty. In recent years, the poverty research community has been only marginally concerned with postsecondary aid policy. Greater concern is warranted, for three reasons.

First, it is misplaced to think that students from poverty backgrounds who graduate from high school are "success stories," requiring no further attention. It may once have been the case that a high school diploma adequately qualified a person for entry into the mainstream of the labor market. As the composition of jobs in the American economy changes, however, it becomes increasingly questionable whether a high school education suffices to ensure an escape from poverty.

Second, programs of financial aid for enrollment in postsecondary education should increase the rate of high school completion by low-income students. As pointed out earlier, the availability of aid affects the option value of persisting in high school.

Third, the recently enacted Family Support Act of 1988 creates a potentially strong interaction between postsecondary aid and Aid to Families with Dependent Children (AFDC). Among other purposes, the new act is intended to

“assist needy children and parents . . . to obtain the education, training, and employment needed to avoid long-term welfare dependence.”<sup>20</sup> For those AFDC recipients possessing a high school diploma, this means postsecondary aid.

It may be thought that few AFDC recipients do possess a high school diploma. That is not the case. Data from the March 1988 Current Population Survey indicate that of all the female heads of households with no husband present and with incomes below the poverty line, 51.8 percent are high school graduates.<sup>21</sup> That statistic well illustrates the need to be concerned about our policies for providing aid to students beyond the high school level. ■

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<sup>1</sup>Stafford Loans, formerly Guaranteed Student Loans, were initiated by the Higher Education Act of 1965. The Pell Grants, formerly known as Basic Educational Opportunity Grants, were begun in 1972. Both programs have subsequently been reauthorized several times, with fluctuating eligibility criteria and funding levels. The most recent authorization, by the Higher Education Amendments of 1986 (Public Law 99-498, October 17, 1986), expires at the end of 1991. In academic year 1986-87, the Pell Grant program disbursed \$3.5 billion to 2.6 million students. The Stafford Loan program guaranteed \$8.3 billion in new loans to 3.5 million students. (Estimates made by the College Board, reported in the *Chronicle of Higher Education*, December 2, 1987, p. A36.)

<sup>2</sup>Fischer, “Graduation-Contingent Student Aid,” *Change*, November/December 1987, pp. 40-47.

<sup>3</sup>“Bill Links Education Aid, Service,” *Washington Post*, January 6, 1989, p. A8.

<sup>4</sup>“Dukakis Asks College Loans to Be Repaid on Job,” *New York Times*, September 8, 1988, p. 1. A similar proposal for “income-contingent loans” was earlier made by the Reagan administration; see “Reagan Seeks Big Increase for Program That Links Loan Repayments to Income,” *Chronicle of Higher Education*, January 7, 1987, p. 17. In fact, funds for a small demonstration were authorized by the Higher Education Amendments of 1986.

<sup>5</sup>Haveeman, *Starting Even* (New York: Simon and Schuster, 1988), p. 155.

<sup>6</sup>“Revamping of Financial Aid Called Vital for Low-Income and Minority Students,” *Chronicle of Higher Education*, November 9, 1988, p. A1.

<sup>7</sup>My work on this subject is described in Manski and David Wise, *College Choice in America* (Cambridge: Harvard University Press, 1983), Chap. 7. A good review of the literature is provided in Richard Freeman, “Demand for Education,” in Orley Ashenfelter and Richard Layard, eds., *Handbook of Labor Economics* (Amsterdam: Elsevier, 1986). A number of new studies and critiques of the literature are collected in a recent issue of *Economics of Education Review*, 7, no. 1 (1988). See also “Financial Aid for College Students: Have the Barriers to Opportunity Been Lowered?” *Focus*, 10, no. 3 (Fall 1987), 6-9.

<sup>8</sup>James, “Student Aid and College Attendance: Where Are We Now and Where Do We Go from Here?” *Economics of Education Review*, 7, no. 1 (1988), 1-13. (Quote from p. 3.)

<sup>9</sup>Fischer, “Graduation-Contingent Student Aid,” p. 42.

<sup>10</sup>“Schooling as Experimentation: A Reappraisal of the Postsecondary Dropout Phenomenon,” IRP Discussion Paper no. 865-88, University of Wisconsin-Madison, 1988.

<sup>11</sup>Manski and Wise, *College Choice in America*, p. 10.

<sup>12</sup>Fischer, “Graduation-Contingent Student Aid,” p. 44.

<sup>13</sup>Much of the literature on the economics of education ignores dropout entirely by treating schooling as an investment which, when undertaken, will definitely be completed. Recent survey articles by Mark Blaug and Richard Freeman make no mention of the dropout phenomenon: Blaug, “Where Are We Now in the Economics of Education?” *Economics of Education Review*, 4, no. 1 (1985), 17-28; and Freeman, “Demand for Education.”

<sup>14</sup>*Journal of Political Economy*, 70, no. 5, part 2 (1962), S106-S123.

<sup>15</sup>*International Economic Review*, 14 (1973), 421-435.

<sup>16</sup>Empirical research to date has not recognized the fact that students make sequences of related schooling decisions. The failure of the literature to examine the dynamics of schooling behavior can be traced largely to the absence of tractable approaches for the empirical analysis of dynamic choice. This situation is now changing. Recent work has demonstrated the feasibility of empirical analysis of some dynamic choice problems. Among the new approaches is one I developed in “Path Utility Analysis of Dynamic Choice,” Social Systems Research Institute Paper no. 8805, University of Wisconsin-Madison, February 1988. This approach is being applied to the analysis of schooling behavior in an ongoing IRP project.

<sup>17</sup>McPherson, “On Assessing the Impact of Federal Student Aid,” *Economics of Education Review*, 7, no. 1 (1988), 77-84. (Quote from p. 78.)

<sup>18</sup>This assumption is not peculiar to studies evaluating aid policy. It is maintained in almost all the empirical literature on education and labor.

<sup>19</sup>Aid may still have distributional effects, shifting the composition of enrollments toward students from low-income backgrounds.

<sup>20</sup>Public Law 100-485, October 13, 1988, 102 STAT. 2343. An article in this issue of *Focus* describes the provisions of the act.

<sup>21</sup>See U.S. Bureau of the Census, Current Population Reports, Series P-60, no. 161, *Money Income and Poverty Status in the United States* (Washington, D.C.: U.S. GPO, 1988) Table 19, p. 37.