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EDITORS

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Luciana Dar

The Politics of Higher Education Finance: The Role of States and Institutions

EXECUTIVE SUMMARY

The past 40 years have seen growing inequality of access and attainment of college degrees by socioeconomic status and race/ethnicity. As higher education continues to lose status in the policy priorities of most states, a larger share of college costs are being shifted to students and their families. Low- and middle-income students are being priced out of higher education due to a combination of increasing tuition prices, declining purchasing power of student aid programs, and a growing focus by colleges and universities on attracting wealthy, high-achieving students via the strategic use of institutional aid. For example, in California between 1990-91 and 2013-14, tuition and fees have increased more than threefold at the CSUs and more than fourfold at the UCs, whereas state spending per FTE in both sectors is close to its lowest point since 1980-81.

This brief explores two related questions about the roots of this growing inequality in higher education affordability with a view towards potential solutions. First, how do state higher education financing policies affect the pricing strategies of public universities? Second, how do pricing strategies differ across institutions?

The evidence so far indicates that, in the context of decreased state appropriations, public universities have intensified the strategic use of institutional aid resources by favoring wealthier, high-achieving students over their low-income peers as a means to maximize prestige and generate revenues. Attempts by states to mitigate these impacts are only partially successful. Indeed, increases in state student aid spending are associated with increases in both average out-of-pocket costs paid by students in public four-year institutions (i.e., average institutional net price) and tuition levels (i.e., “sticker price”). Finally, increases in state student aid spending are also associated with decreases in average institutional aid awarded to in-state students.

In sum, the research findings presented in this brief suggest that solutions to the college affordability issue demand better coordination between federal, state, and institutional financing policies. In particular, there is a need to develop policies to address the existing misalignment between the priorities of state governments and individual higher education institutions, with effects that vary according to changes in state institutional appropriations to universities and state financial aid to students.

LUCIANA DAR is Assistant Professor of Higher Education at UC Riverside. Her research interests fall into three interconnected areas of inquiry: comparative political economy of higher education, the relationship between higher education and social inequality, and the politics of higher education. She can be reached by email at luciana.dar@ucr.edu or by phone at (951) 827-2751.

Introduction

Who should be paying for public higher education, and how much? This central question—of the proper cost-sharing arrangement between students, institutions, and governments—is one of the biggest policy issues confronting public higher education today. The topic has generated intense debates across the country, as higher education costs continue to increase and states’ share of institutional revenues continues to decrease. For example, in November 2014, the University of California Regents approved a five-year plan that entails a 5% yearly increase in tuition “that could be reduced or eliminated entirely if the state provides sufficient revenue” (Bose, 2014). This plan was approved despite the governor’s announced opposition to the move, and his earlier offer to increase state funding by a more modest amount if the UC were to maintain a tuition freeze (Skelton, 2014). In the meantime, many state legislators set forth their own proposals to increase affordability and encourage college completion. Most of these proposals have failed to consider the need for better coordination and alignment of priorities between the state and higher education institutions in order to achieve those goals. This report summarizes key findings from research on public higher education financing, pointing to ways that state higher education funding strategies can be better aligned with policy goals of increasing the proportion of college graduates in California (Johnson et al., 2014; Parker, 2014)

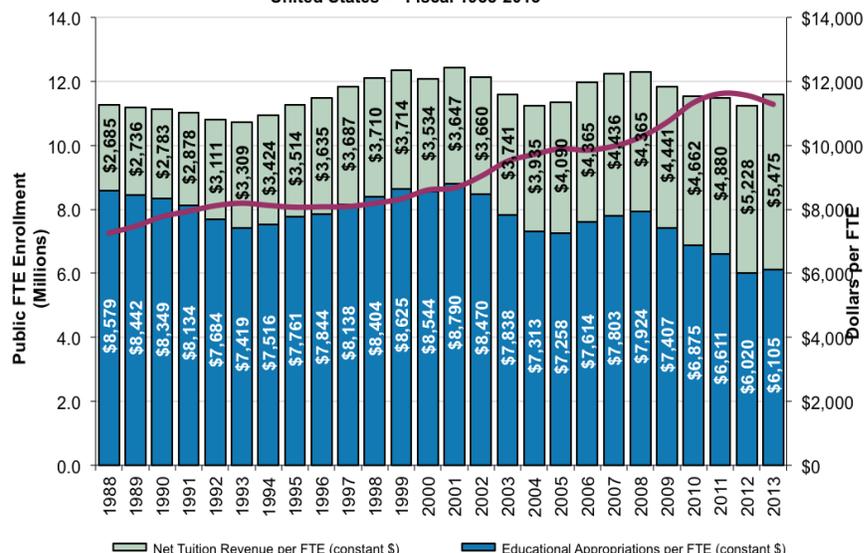
In the last decade, the political and economic importance of higher education has grown dramatically, fueled by several factors: 1) the increasing economic returns of a college degree, 2) the continuing shift in the burden for paying for college away from governments toward students and their families, and 3) the rising

inequality in postsecondary educational achievement and opportunity across income and racial/ethnic groups (Bailey and Dynarski, 2011; Carnevale and Strohl, 2013; Hout, 2012; Quintero, 2012). In the United States, these trends have been occurring for at least 40 years but have intensified sharply after the Great Recession, with steep decreases in the amount of state government subsidies spent per full-time equivalent (FTE) student (Barr and Turner, 2013). Figure 1 shows that, between 1988 and 2013, total state appropriations per FTE went down from \$8,579 to \$6,105 in constant 2013 dollars, whereas students’ average dollar share of costs went up from \$2,685 to \$5,445 (State Higher Education Executive Officers, 2014).

Figure 2 shows the same data for California, where we can observe greater volatility in state support per FTE over time, compared to the U.S. average, and most importantly, a significant increase in enrollment without accompanying increases in state funding per FTE. Finally, average state fiscal support for higher education per \$1,000 of state personal income dropped 46.8 percent between FY1980 and FY2014 (and 53.7 percent in California), indicating a decreasing ability or willingness by states to commit resources to the postsecondary sector (Postsecondary Education Opportunity, 2014).

Higher education financing policies that have worked well in the past remain unchanged, or have been marginally adjusted with short-term solutions, which has resulted in a system that increases group inequality, threatens affordability, and fails to respond to increasing demand (Carey, 2013; Carnevale and Strohl, 2010). In a recent book, Suzanne Mettler (2014) claims that this lack of policy responsiveness to socioeconomic and higher education changes (e.g., rising college costs, stagnant family incomes, federal

Figure 1. Public FTE Enrollment, Educational Appropriations and Total Educational Revenue per FTE, United States -- Fiscal 1988-2013



Note: Constant 2013 dollars adjusted by SHEEO Higher Education Cost Adjustment. Educational Appropriations include ARRA funds. (HECA)

SOURCE: SHEEO (2014)

and state budget challenges) is the result of “a political failure, a breakdown of representative government so that it no longer provides effective mechanisms by which Americans can pursue a better life” (p. 5). In particular, as the American political system became more responsive to the needs of wealthy and powerful interest groups, in combination with growing political polarization, higher education financing policies have become dysfunctional and unable to maintain the earlier successful cost-sharing partnership among multiple stakeholders (Gilens, 2012; Hurley et al., 2014; Mettler, 2014).

The Centrality of State Financing

At the center of this growing lack of coordination in higher education policy are the American states. Indeed, state disinvestment in public higher education has been the main reason for the rising average published tuition price and net tuition price (after financial aid) at public four-year institutions. Between 2003 and 2013, these have increased by 50 percent and 62 percent respectively (College Board, 2013a; Desrochers and Wellman, 2011). However, there is great variability across states in how much state fiscal support has decreased. The same variability is true for other indicators of state support, such as, state higher education spending as a share of states’ general fund budgets, state appropriations per FTE student, and states’ share of institutional revenues.

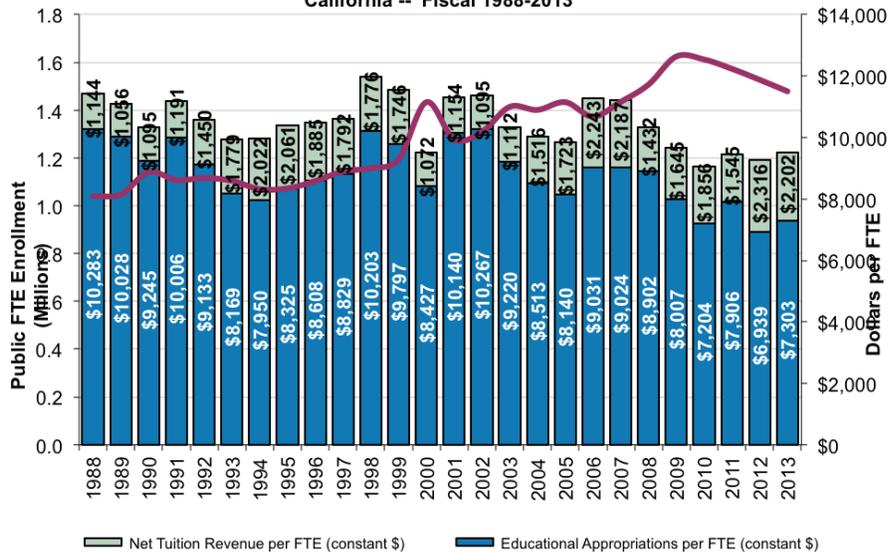
What explains inequalities across states in public financing strategies and priorities for higher education? Whereas state economic conditions have been shown to play a significant role, recent scholarship also shows that states’ political contexts and the nature of higher education as a policy area matter a great

deal (Dar, 2012; Dar and Lee, 2014; Delaney and Doyle, 2011; Tandberg and Griffith, 2013). To find a satisfactory answer, we must sort out the mechanisms that link state representatives’ and voters’ political preferences, political-economic institutions, state higher education systems characteristics, educational institutions’ behavior, and higher education financing policy decisions (Gift and Wibbels, 2014; McLendon et al., 2014).

To briefly summarize on the political roots of the rising inequality in higher education affordability across states: I pose and address several questions, such as, how do state governments’ preferences and priorities over redistribution shape their spending on higher education? In a recent co-authored article, we explored the relationship between partisanship and states’ higher education expenditure patterns for a sample of 44 states from 1977 to 2004 (Dar and Lee, 2014). We found that partisanship matters: more Democrats in the state legislature are associated with higher levels of higher education spending. The effects diminish significantly, however, as partisan polarization and unemployment rates increase. In other words, as ideological disagreements among legislators increase and economic conditions worsen, having more supportive of higher education spending, i.e., Democrats, who, historically, have been more supportive of higher education spending, is not enough to protect this policy area from lower funding levels.

Whereas some scholars have found a similar direct relationship between partisanship and higher education spending (e.g., McLendon et al., 2009), we were able to show that the strength of this relationship is dependent on political and economic conditions (i.e., political polarization and business cycles). Thus, policymakers and higher education advocates should be more familiar with the political-economic environment and how it shapes

Figure 2. Public FTE Enrollment, Educational Appropriations and Total Educational Revenue per FTE, California -- Fiscal 1988-2013



Note: Constant 2013 dollars adjusted by SHEEO Higher Education Cost Adjustment (HECA). Educational Appropriations include ARRA funds.

SOURCE: SHEEO (2014)

states' support for higher education, especially in light of growing political polarization, volatility in states' budgets, and disagreements among stakeholders over the role and public benefits of higher education (Zumeta et al., 2012). All three of these issues have been connected to shifts in states' spending priorities across different policy areas and, as a result, decreases in financial support for higher education.

State Funding for Higher Education and Institutional Pricing Responses

While it is important to ask what accounts for variation in financing across states, it is also important to look at how college affordability is affected by interactions within each state, between state financing and responses from higher education institutions. Affordability—which can be thought of as the average net price paid by students—depends to a great extent on the interactions between government/institutional aid programs and college pricing strategies. Indeed, the effects of financial aid policies on institutional behavior have received significant scholarly attention over the past 30 years. Researchers have focused on the so-called “Bennett Hypothesis,” which posits that institutions will raise tuition to capture the increased generosity of federal student aid (Bennett, 1987; Gillen, 2012). The empirical evidence with regard to the validity of this claim is mixed. In part, results are contradictory because scholars often use different data sets, sample selection, and/or methodological strategies, making comparisons difficult. Moreover, there are significant challenges involved in modeling the complexity of the tuition-setting process (Heller, 2013).

More recent scholarly work on this issue indicates that, even when institutions may not be able to raise tuition prices, they often capture part of federal student aid resources through price discrimination (i.e., charging different prices for similar students), by decreasing institutional grant aid and effectively making the net price higher for students than it would have been otherwise (Turner, 2014). Institutional price responses to increases in federal student aid vary across higher education sectors. However, the more robust findings in support of the “Bennett Hypothesis” have been found in the for-profit-sector and among selective non-profit institutions (Cellini and Golden, 2012; Turner, 2013). Most importantly, all studies in this area of inquiry highlight the potential misalignment of interests between governments and universities and the fact that both college tuition prices and Federal government financial aid expenditures have risen continuously in recent decades (College Board, 2013a, 2013b).

As state support for higher education has continued to decrease and tuition and fees at public institutions have continued to increase, there also has been a shift in state financing policies from direct support for institutions toward direct support for students via state financial aid programs (Dynarski and Scott-Clayton, 2013). Between 1971 and 2011, total average state grants per FTE undergraduate student rose from \$240 to \$670 in the United

States, with state averages ranging between \$0 and \$1,730 in 2011 (College Board, 2013b).

Given this growing role of student financial aid in the states, a related question emerges: *Do institutions of higher education alter their pricing behaviors in response to state financial aid policy?* Bridget Long (2004) found little evidence that public institutions in Georgia increased tuition in response to the implementation of the HOPE (Helping Outstanding Pupils Educationally) Program, but did find that this new merit-based student financial aid program was related to increases in non-tuition prices such as room-and-board. Conversely, William Doyle et al. (2009) found that institutions generally follow state policy goals with their own financial aid programs, which contradicts the notion that institutions capture some of the state financial aid resources through increases in tuition.

In a recent co-authored study, we sought to contribute to the literature on the “Bennett Hypothesis” by exploring whether public and private four-year higher education institutions alter their pricing strategies based on changes in state financial aid generosity (Curs and Dar, 2015). Using an institutional-level dataset for 2000 to 2012, we estimated whether institutions adjust net tuition and fees, list tuition and fees, and average institutional financial aid awards as their home states alter their state-based financial aid.

In the case of public four-year institutions, our results indicate that a one percent increase in the average state financial aid award is associated with a 0.28 percent increase in average net-price paid by students (i.e., tuition plus fees minus institutional grants). Expressed in dollars, for every \$100 increase in the average state grant awarded within an institution, our model predicts that the net-price within the same institution would increase about \$11. When the components of net-price are estimated separately, we find that a one percent increase in state grants leads to a 0.09 percent increase in list in-state tuition (i.e., “sticker price”) and a 0.15 percent decrease in institutional grants. In the case of private four-year institutions, our results indicate that a one percent increase in the average state financial aid award is associated with a 0.01 percent decrease in average net-price. In other words, for every \$100 the average state grant increases within an institution, our model predicts that the net-price within the same institution would decrease about \$12.

Our findings indicate that both public and private non-profit institutions adjust their pricing strategies in response to changes in state student aid expenditures, which affects affordability, especially for low-income students. As the share of net tuition increases as a percentage of institutional revenues (see Figure 3 for the U.S trends), higher education institutions' discretionary power over the distribution of institutional aid also increases, making it possible for institutions to change the allocation of public subsidies intended by state (and federal) governments through tuition discounting practices where students at the same institution can pay very different net prices. For example, the University of Cali-

ifornia has a plan that, through a combination of federal, state and institutional aid support, students coming from families making up to \$80,000 per year do not pay any tuition/fees (Jackson, 2014). Funds allocated to institutional aid come mainly from tuition revenues generated from full-paying students. While net price paid by low-income students has remained stable between 2008 and 2011, the majority of students do not receive enough aid to offset the steep increases in tuition, despite increases in both federal and state student aid programs (Johnson et al., 2014).

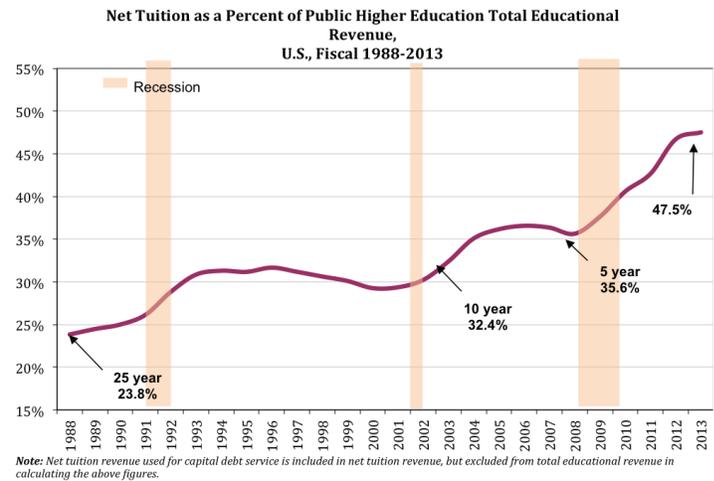
As we continue to explore the relationship between government financial aid policies and institutional pricing strategies, there are many questions that remain unanswered. Are there any differences in institutional responses to different types of state student aid (merit or need-based aid)? Does the level of market competition that institutions face in a particular state affect the out-of-pocket amount paid by students? Are institutions diverting resources from other essential functions to fund institutional aid as they compete for students? If yes, which are they? How do states' political and regulatory environments shape and/or constrain institutional pricing strategies? These are some of the questions that we will pursue as we seek to advance our theoretical and empirical understanding of how government and higher education institutions interact to determine average net price paid by students and, ultimately, to identify some of the coordination challenges that the American higher education financing system currently faces (Doyle, 2013).

Institutions and Higher Education Affordability

Public and private institutions of higher education compete for students with desirable characteristics while attempting to maximize revenues. The practice of "tuition discounting" or price discrimination, i.e., charging different prices for similar students, has been part of revenue and enrollment management strategies in private institutions for a long time but is now also a part of public institutions' strategies (Burd, 2013). Institutions use discounting to attract high-achieving and skilled students (merit component), maximize revenues, given a specific level of capacity, and to ensure that needy students can attend (need component), or redistribute available resources in line with other institutional priorities.

As public colleges have been spending more resources on institutional grant aid (beyond state and federal grants), there has been a growing shift in the use of these funds from supporting low-income students toward the strategic use of these resources to recruit more high-achieving students and to maximize revenues (Burd, 2013). Indeed, scholars have produced a robust research literature that finds that higher education institutions have a fundamental role in determining which individuals will benefit from public subsidies and, before they are admitted, the composition (fund sources and type) and total amount of subsidy that they receive. Moreover, recent empirical analyses by scholars show that

Figure 3.



SOURCE: SHEEO (2014)

redistribution through institutional aid tends to favor students other than low-income and/or underrepresented minorities, the intended beneficiaries of almost all federal and state financial aid programs (Hillman, 2010). Finally, beyond this distributive effect, it follows that, by financing a decreasing share of the average cost to educate a student in higher education, federal and state governments have a diminished ability to influence institutional choices over the allocation of resources and to successfully reach particular policy goals.

Institutions redistribute resources by putting together individual-level packages for students that include federal and state sources of student aid and, most importantly, institutional discounts. Institutions fund discounts by giving up revenues, by using funds from other sources (including state appropriations when allowed), or by transferring part of tuition revenues obtained from full-paying students to those they wish to support. How do these discounting strategies differ across institutions? Preliminary results of our multilevel analysis indicate significant differences in tuition discounting policies between institutions (Dar and Yoshikawa, 2013). After we controlled for state priorities and incentives, research and doctoral institutions tended to offer larger tuition discounts, a strategy used to maximize institutional prestige. Our results also support the argument that institutions offer greater tuition discounts, measured as a proportion of full tuition price, to attract certain types of students, with larger discounts taking place at more selective institutions and institutions with larger minority enrollments.

Moreover, our preliminary analysis highlights the need to further explore the incentives that these packages create for enrollment decisions across different institutional types as well as their implications for student persistence and final graduation rates. Institutions not only have the ability to decide whom to admit but, by discriminating on price, also influence who is likely to persist. As we move forward in this research, we will expand our analyses

to include more years of data, breaking down the information on the types of student aid disbursed by states and institutions (need, merit, or a combination of the two) and attempting to look at the distribution of discounts across different groups of students. We also plan to explore the interactions between states' political variables, states' revealed preferences for the subsidization of students through spending patterns, and institutional-level variables that capture institutions' priorities—the maximization of their three main competing goals of prestige/quality, revenue generation, and crafting a class—and how the distribution of institutional funds benefits students differently within institutions and across institutions.

Conclusion

Jacob Hacker and Paul Pierson (2010) argue that, in order to understand redistribution and inequality trends, we need a more robust analysis of the role of public policy. In particular, they note that policy change also takes place through “drift.” That is, public policy effects can change when the economic, social, or political contexts change and there is little will or ability by policy-makers to adapt. The increasing use of discounting practices by public institutions of higher education is the result of decreasing public subsidy and the realities of competitive higher education markets. While state governments have actively tried to incentivize institutions to contain costs and increase productivity and student graduation rates, very little effort has been directed at addressing the coordination problems now pervasive in higher education finance policy (Fethke and Policano, 2012; Zumeta et al., 2012). This is particularly troubling, as decreases in state appropriations are leading universities to shift resources toward financial aid provided by the institution that favors wealthier, high-achieving students over their low-income peers as a means to maximize prestige and generate revenues.

As policymakers attempt to increase postsecondary graduation rates and to minimize inequalities in access and achievement, solutions to the college affordability issue demand better coordination between federal, state, and institutional financing policies. In particular, there is a need to develop solutions to address the existing misalignment between state governmental and institutional priorities. Without such an integrated approach, attempts to improve college affordability will remain partial solutions that fail to address the needs of students, families, and taxpayers alike.

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Luciana Dar

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CONTACT THE EDITORS:

Karthick Ramakrishnan - karthick@ucr.edu

Mindy Marks - mindy.marks@ucr.edu