The Economics and Politics of Scholarships

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Loyalty to alma mater often amounts only to quaint sentimentalism and a useful inducement to philanthropy; but this loyalty also allows elite colleges and universities to mobilize their most influential alumni to protect their economic interests. The sorry ending to the story of the antitrust case against the Ivy League colleges and the Massachusetts Institute of Technology (MIT) for conspiring to limit financial aid to undergraduate students provides an unfortunate illustration of this political clout.

In the face of pressure from leading newspapers and prominent politicians, the Justice Department agreed in December 1993 to a highly favorable settlement for the Ivy colleges and MIT. The colleges, however, were not satisfied. To achieve total victory, they successfully lobbied Congress last year to amend existing laws to override the settlement's only substantial restriction on financial-aid policy. Now, all colleges are legally free to limit financial aid by collusion and, more important, to deny undergraduates the benefits of merit scholarships.

Almost forty years ago, the eight colleges in the Ivy group—Brown, Columbia, Cornell, Dartmouth, Harvard, Pennsylvania, Princeton, and Yale—along with MIT, formed a cartel to limit competition for desirable undergraduate students. The members of the cartel agreed not to award "merit" scholarships to undergraduates and to give undergraduate financial aid only on the basis of "need."

In this context, merit is a shorthand for any characteristic that makes a student especially desirable to a particular college. Colleges are eager to attract students who have exceptional academic, artistic, or athletic talent not only because most faculty prefer to teach students who are smart and interesting, but also because the academic, artistic, and athletic achievements of talented students enhance the reputation of a college and the value of its degrees. In short, exceptional students not only please alumni, but also makes such colleges more attractive to prospective students. In this regard, colleges are like any business: "quality" customers enhance the reputation of the product and attract other customers.

By agreeing to give only need-based undergraduate financial aid and also by adopting a niggardly definition of need, the Ivy colleges and MIT were able to enroll desirable students while not giving them more than the minimum amount of necessary financial aid. Without an agreement about merit scholarships, competition for desirable undergraduates would have led to large increases in financial aid. Moreover, Ivy colleges with the largest endow-

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ments (Harvard, Yale, and Princeton) could easily have become the most aggressive in using merit-based financial aid to compete for highly desirable undergraduates. But Harvard, Yale, and Princeton together attract (without merit scholarships) a major share of those undergraduates who would have been likely to receive merit scholarships. In forming their cartel, the Ivy colleges and MIT apparently recognized that allowing merit scholarships would have depressed their net tuition revenues with little change in the actual composition of their enrollments.

To enforce their agreement to give undergraduate financial aid based only on need (as determined by their formulas), the Ivy colleges and MIT for many years held an annual meeting, called Overlap, at which they decided on the dollar amounts of financial aid to offer to individual prospective students. Over the years, several other private colleges joined the Ivy colleges and MIT as additional participants in Overlap. But all colleges who competed with the Ivies and MIT for desirable students, whether or not they participated in Overlap, benefited from competition restraint instituted by the Ivies and MIT.

The Ivy colleges and MIT not only have given undergraduate financial aid only on the basis of need, but, with the exception of Brown, they also claim to practice need-blind undergraduate admissions and to provide sufficient financial aid to meet the full need of all students.

For decades the Overlap cartel functioned openly and without legal challenge. But, early in 1991, the Justice Department brought an antitrust action against the eight Ivy colleges and MIT for colluding to fix tuition charges to individual students.

The eight Ivy colleges quickly entered into a consent decree with the Justice Department in which they agreed to terminate Overlap. MIT did not join this settlement and the federal District Court in Philadelphia, at the request of the Justice Department, then entered an injunction prohibiting MIT from colluding to restrict financial aid. MIT appealed this District Court ruling.

The higher education establishment, including a dozen organizations listed alphabetically from the American Council on Education to the United Negro College Fund, supported MIT's appeal. The position of the traditionally black colleges is self-serving, but not surprising, in light of a threat made by the president of Harvard after the termination of Overlap to offer merit scholarships to talented African-American undergraduates.

In September 1993, the Appeals Court instructed the District Court to reconsider MIT's defense of Overlap. The Appeals Court's decision, however, was anything but a vindication of the Overlap cartel. The Appeals Court rejected MIT's contention that the antitrust laws do not apply to financial-aid policy. The Appeals Court also ruled that financial aid is not "charity," but rather "part of the commercial process of setting tuition."

Having decided that antitrust issues are relevant, the Appeals Court fo-

cused on the economic effect of Overlap. The Justice Department and MIT agreed that, without the coordination and discipline provided by Overlap, the participants in Overlap would have offered merit scholarships to undergraduates they were especially eager to enroll without regard for the amount of financial aid these students needed, just as many colleges who did not participate in Overlap have always done and just as all universities do in recruiting graduate students. The Justice Department and MIT also agreed that the *proximate* purpose of Overlap was to prevent the potential erosion of net tuition revenues that would result from the competitive awarding of merit scholarships to undergraduates.

The Appeals Court's decision, however, directed attention to the *ultimate* effect of Overlap. MIT made the claim, which the Justice Department disputed, that without an enforceable agreement to limit undergraduate financial aid to what students need, MIT, and by implication the Ivies as well, could not afford to continue their need-blind undergraduate admissions policies and to provide sufficient financial aid to meet the full need of all students. In ruling on MIT's appeal, the Appeals Court instructed the District Court to consider more carefully whether MIT's claim is likely to be true.

In explaining its position, the Appeals Court took need-blind admissions to be an obviously worthy "social welfare objective." Accordingly, the Appeals Court concluded that, if MIT's claim were true, then the anticompetitive nature of Overlap would have a mitigating "public interest justification." Conversely, on the Appeals Court's reasoning, if a prohibition on merit scholarships were not necessary for MIT and the Ivy colleges to practice need-blind admissions and to provide sufficient financial aid to meet the full need of all students, then it would follow that Overlap was motivated by self interest rather than by public interest objectives and, hence, that its anticompetitive nature would not be mitigated.

Since the termination of Overlap, although the Ivy colleges and MIT still claim to be giving undergraduate financial aid only on the basis of need, they seem in practice to be adjusting financial aid offers according to merit, mainly by stretching their formulas for determining need. The likelihood is that, if an enforceable prohibition on merit scholarships were not reinstated, one or another of the Ivy colleges or MIT would become incrementally more aggressive in using merit-based financial aid to attract the most desirable undergraduates. In response, the other colleges, all of whom also want to attract the most desirable students, would be forced to match the merit-based financial-aid offers of their competitors. Without an enforceable prohibition on merit scholarships, it probably would not be possible for any former participant in Overlap to maintain such a policy indefinitely without suffering a noticeable decrease in the talent and diversity of its undergraduates. Consequently, even without either MIT or any of the Ivies being overtly aggressive in awarding merit scholarships, the competition for desirable undergraduates

over time probably would intensify until eventually all of the Ivies and MIT would be giving a substantial amount of financial aid to undergraduates on the basis of merit and without regard for need.

In one area, merit-based financial aid might be less expensive for the Ivy colleges than need-based financial aid. Unlike MIT, the Ivy colleges heavily recruit athletes. Most of these recruited athletes are admitted as students primarily because of their athletic talents and most of them also receive need-based financial aid. But to maintain the appearance that they are not using financial aid to reward athletic talent, the Ivy colleges do not make financial aid to recruited athletes conditional on their participation on the teams for which they are recruited.

As it turns out, many recruited athletes quit their teams long before they graduate. Consequently, much need-based financial aid is wasted, in the sense that it is given to students who are not delivering the talent for which they were recruited. If the Ivy colleges were to offer merit scholarships to athletes and if these merit scholarships, being in effect standard athletic scholarships, were conditional on participation on a specific team, then the number of recruited athletes and the amount of financial aid given to recruited athletes could be reduced.

This particular source of savings for the Ivy colleges notwithstanding, if merit-based undergraduate financial aid were to become large enough, then the question of whether either need-blind admissions with full need met or even generous financial aid for needy students could continue would turn on whether or not MIT and the Ivies can increase the total undergraduate financial aid that they give. MIT argued in court that it already is budgeting for undergraduate financial aid at the maximum amount it can afford. Based on this argument, MIT claimed that, if competition forced it to give substantial merit-based financial aid to undergraduates, then it would have to decrease financial aid to needy students.

MIT's analysis of the budgeting problem is surely too mechanical and simplistic. In fact, MIT and each of the Ivies have budget options that would enable them to avoid reductions in need-based financial aid even if competition made it necessary to offer merit scholarships to many undergraduates.

The richest Ivy colleges (Harvard, Yale, and Princeton) have substantially larger incomes from endowments and annual gifts than the other Ivy colleges and MIT. The richest colleges, however, devote to financial aid for undergraduates a much smaller fraction of their gross revenues from endowment, gifts, and tuition than do many of the relatively poorer colleges. This anomaly is consistent with the view that collusion enabled the richer participants to give less financial aid than they would be forced to give under competition. It also suggests that the richest colleges have not been budgeting for undergraduate financial aid at the maximum amount they can afford. The richest colleges could increase significantly the amount of financial aid that they give

to undergraduates simply by devoting to undergraduate financial aid the same fraction of their gross revenues as do colleges less well off.

An even more important issue is the nature of the so-called "costs" of providing an undergraduate education at MIT and the Ivy colleges. MIT and the Ivy colleges want us to believe that these costs cannot be reduced in order to free up funds for additional financial aid. One reason to doubt this claim is that, because the tax laws allow private colleges to designate themselves to be not-for-profit enterprises, the costs that colleges calculate are artificially inflated. The not-for-profit designation is one of the methods by which the taxpayers subsidize education. It allows colleges to keep their books in such a way that they report no profits for tax purposes. But this bookkeeping contrivance does not mean that colleges do not earn what an economist would properly call "profits." Rather, the not-for-profit designation allows private colleges, and other not-for-profit enterprises, to include in what they call their costs some amounts that are really profits.

As the Appeals Court put it, "The higher than competitive tuition prices which MIT and the other Overlap members were able to charge, absent competition, enhances 'revenues,' if not 'profits,' which can be allocated to any conceivable internal institutional purpose." Clearly, one such institutional purpose is the generous compensation and perquisites that the faculty and administrators at the Ivy colleges and MIT receive. These perquisites include light teaching loads, substantial support for research projects and graduate students, and free time to earn consulting income. The costs attributed to generous compensation and perquisites for faculty and administrators are to some extent really profits.

The correct economic view of private colleges would seem to be that they function similarly to producer cooperatives or partnerships and that the partners, who in this case are the faculty and administrators, share the profits, which consist of any excess of revenues over true costs. That private colleges attempt to maximize profits is not itself a problem. In fact, the profit motive has made the elite American colleges into great educational institutions. All studies show that, despite collusive restrictions on financial aid, an education at an elite private college is a good investment. But as the antitrust laws recognize, consumers get maximum value only if the profit motive encounters unrestricted price competition.

Another reason to doubt the claim that the costs of providing an undergraduate education at the Ivy colleges and MIT cannot be reduced is that at least part of the steep increase in costs in recent years probably reflects nonprice competition for desirable students. Overlap precluded the use of merit scholarships to attract desirable undergraduates, but it did not prevent costly recruiting efforts such as visits by admissions officers and athletic coaches to the high schools and homes of prospective students and paid visits to campus by prospective students. Even more important, the prohibition on

merit scholarships for undergraduates induced the participants in Overlap to engage in quality competition by way of attracting desirable students. This quality competition included the provision of extensive counseling and psychological support systems and the building of lavish facilities for artistic and athletic activities, all of which are peripheral to academic functions. Like any restriction on price competition, the prohibition on merit scholarships caused costs to increase and probably forced students to pay for more expensive services than a competitive market would have supported.

In sum, it seems clear that the Ivy colleges and MIT could continue generous need-based financial aid, including need-blind admissions with full need met, even if they also were offering merit scholarships. Of course, they might not do so. Instead, they might reduce need-based financial aid as competition for desirable students intensified and merit scholarships depressed net tuition revenue. But, this outcome, were it to occur, would not be forced on either the Ivies or MIT. Rather, it would result from their choice to reduce need-based financial aid rather than to make alternative budget cuts, including adjustments in the compensation and perquisites of faculty and administrators.

This analysis seems sufficiently persuasive that MIT's lawyers probably expected the District Court, if it were to reconsider MIT's case on the basis of the Appeals Court's criteria, to reaffirm its ruling that Overlap was illegal. In any event, rather than returning to the District Court, MIT, together with the Ivies and the rest of the higher education establishment, mobilized its powerful alumni to pressure the Justice Department to drop the case. Within months, the Justice Department retreated.

The December 1993 settlement between the Justice Department and MIT allowed colleges to participate in "cooperative financial aid arrangements." The participating colleges could agree to prohibit merit scholarships and could exchange information to coordinate their need-based financial-aid policies. The president of MIT described this settlement as authorizing a more modern system to replace the "Overlap processes." The Justice Department also committed itself to supporting an amendment to the 1991 Ivy consent decree to include the terms of the MIT settlement.

The settlement's only substantial restriction was that the participating colleges must practice need-blind admissions and provide sufficient financial aid to meet the full need of all students. Even though they already claim to satisfy this condition, the presidents of Harvard and Yale objected because this restriction would limit the number of participating colleges. Clearly, the Ivies wanted to maximize the number of colluders.

Not being content with the Justice Department's settlement with MIT, the Ivy colleges adopted a legislative strategy. They exerted additional political pressure to induce Congress to override the courts and to exempt financial-aid policy from the anti-trust laws. These lobbying efforts were successful.

In October 1994, the Congress passed legislation that explicitly permits colleges to agree to give only need-based financial aid, to adopt a common definition of need, and to exchange any information about the income and assets of prospective students and their families that is necessary to make such an agreement work. Most important, this new legislation does not incorporate the only substantial restriction on financial-aid policy in the Justice Department's settlement with MIT. Colleges that agree under this legislation to give only need-based financial aid do not have to provide sufficient financial aid to meet the full need of all students. In effect, all colleges, including the Ivies and MIT, are now legally free to collude to limit financial aid in any way that they choose.

This case raises not only educational and antitrust issues but also a fundamental issue of social policy. In defending its settlement with MIT, the Justice Department stressed the value of need-based financial aid and need-blind admissions in enhancing equality of opportunity.

Unfortunately, a policy of basing undergraduate financial aid only on need, especially if supplemented by need-blind admissions, also has the undesirable effect of reducing the incentive for families to make their own provisions for paying college tuition. The larger a family's income and savings and the fewer children it has, the smaller the amount of need-based financial aid it qualifies for.

In this way, need-based financial aid penalizes families who have accumulated sufficient savings to be able to pay to send their children to college. Need-blind admissions goes further and denies such families any advantage in being able to get their children admitted to the college of their choice.

Many economists would argue that, because it penalizes prudence, need-based financial aid encourages sensible families to be imprudent. In a recent study for the National Bureau of Economic Research, Martin Feldstein explains how need-based financial-aid formulas act like a tax on the savings of middle-income families. Using data from the 1986 Survey of Consumer Finances, Feldstein estimates that this implicit tax actually causes the typical middle-income family with two precollege children to reduce the amount it saves by about 50 percent.

According to this analysis, it is hardly surprising that the savings of most middle-income families are now inadequate to pay for the Ivy colleges and MIT and that applicants from middle-income families need more and more financial aid. Responding to the incentives created by need-based financial aid, perhaps middle-income families have steadily come to regard saving to send children to college as both pointless and foolish.

Need-based financial aid also limits the economic opportunities of women who have left paid employment to stay home with their children. Many mothers look forward to resuming their careers when their children go off to college. But the rub here is that any contribution that mothers of college

students make to family income causes a reduction in need-based financial aid.

If talented undergraduates were able to receive merit scholarships, then the implicit tax on savings and family income would be mitigated. With some undergraduate financial-aid awards based on merit, financial aid would be more than a reward for being poor, as it is now at colleges that give only need-based financial aid; instead, financial aid would become a prize available to any talented applicant who, on the basis of ability, industry, and any other relevant characteristics, ranks at the top of the applicant pool.

Most important, if colleges were not allowed to collude to prohibit merit scholarships, then competition for desirable students undoubtedly would force the Ivy colleges and MIT to increase total financial aid to undergraduates. Without a cartel, more undergraduates will receive financial aid and financial-aid packages will be larger. Merit-based financial aid not only would help talented students from middle-income families who do not qualify for need-based financial aid but also would mean more generous financial aid for talented applicants from poor families.