

SCHOLARSHIPS: NEED OR MERIT?

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The Ivy-MIT Cartel

About 40 years ago the eight colleges in the Ivy group—Brown, Columbia, Cornell, Dartmouth, Harvard, Pennsylvania, Princeton, and Yale—together 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—that is, to offer undergraduates discounts off their full tuition charges—only on the basis of “need.”

In this context, merit is shorthand for any characteristic that makes a student especially desirable to a 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. This effect pleases alumni, who are the main benefactors of private colleges, and also makes a college more attractive to other prospective students. In this regard, colleges are like any business for whom “quality” customers enhance the reputation of the product and attract other customers.

By agreeing to give only need-based undergraduate financial aid and by also 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 necessary amount of financial aid. Without an agreement not to give merit scholarships, competition for desirable undergraduates could have led to large increases in financial aid. Moreover, the Ivy colleges with the largest endowments (Harvard, Yale, and Princeton) probably would have been the most aggressive in using merit-based financial aid to compete for the most desirable

Cato Journal, Vol. 14, No. 3 (Winter 1995). Copyright © Cato Institute. All rights reserved.
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undergraduates. But, much of this competition would have been with each other, because 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 only on the basis of 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 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. In other words, their announced policy has been to make admissions decisions without taking into account whether an applicant needs financial aid and then to give each admitted applicant any financial aid that, according to their formulas, the applicant needs.

Penalizing Prudence

This policy of basing undergraduate financial aid only on need, especially when supplemented by need-blind admissions, 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 for which it qualifies. 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, Martin Feldstein (1995) 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 annually 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 not surprising that the savings of most middle-income families are now inadequate for them to pay to send their children to the Ivy colleges and MIT and that applicants from middle-income families need more and more financial aid.

Need-based financial aid also limits the economic opportunities of women who have left paid employment in order to stay home with their children. Many mothers look forward to resuming their careers when their children go off to college. But, any contribution that mothers of college students make to their 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. Rather, financial aid would be 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.

Not for Profit?

The Ivy colleges and MIT defend their prohibition of merit scholarships by claiming that this policy enhances equality of opportunity. Colleges argue that they cannot afford to increase the total amount of undergraduate financial aid that they already give. Consequently, in order to give substantial merit-based financial aid to undergraduates, they would have to decrease financial aid to needy students.

This argument is hardly convincing. 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 they awarded 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 smaller fraction of their gross revenues from endowment, gifts, and tuition than do many of the poorer colleges. This anomaly is consistent with the view that collusion enabled the richer participants to give less financial aid than they would give under competition. It also suggests that the richest colleges have not been budgeting for undergraduate financial aid the maximum amount that 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 many of the poorer colleges.

In fact, some colleges who did not participate in Overlap and who are not as rich as the richest Ivy colleges seem to be more generous in giving both need-based financial aid and merit scholarships. For example, according to *The Boston Globe* (see Dembner 1995), Brandeis University annually awards \$2.5 million in merit scholarships while also giving \$6 million in need-based financial aid, which is sufficient to meet the full need of all students.

Another 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.

In ruling in an antitrust case against MIT, *U.S. v. Brown University, et al.* (1993), a Federal Appeals Court recognized that financial aid is not "charity," but rather "part of the commercial process of setting tuition." As the Federal 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."¹

Clearly, one such institutional purpose is the generous compensation and perquisites that the faculty and administrators at the Ivy colleges and MIT receive. Those perquisites include light teaching loads, substantial support for research projects and graduate students, and free time to earn consulting income. The costs attributed to

¹In a recent paper, Dennis Carlton, Gustavo Bamberger, and Roy Epstein (1995) claim that the Overlap cartel did *not* result in higher tuition revenues. In my view, their own evidence, especially their finding that tuition revenues were independent of endowments, actually supports the opposite conclusion, which is the common-sense conclusion that the Appeals Court reached.

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, 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 importantly, the prohibition on merit scholarships for undergraduates induced the participants in Overlap to engage in quality competition in order to attract 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, responsive to customer preferences, would have supported.²

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.

²See Crossman (1995) for more discussion of inflated costs at the Ivy colleges, especially with regard to need-based financial aid for recruited athletes.

Educational Opportunity

For decades the Overlap cartel functioned openly and without legal challenge. But, early in 1991, the Justice Department brought an antitrust action (*U.S. v. Brown University, et al.*) 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 initial settlement, but after some litigation MIT and the Justice Department reached a separate settlement.)

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, in order to compete for desirable students. 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 desirable undergraduates. In response, the other colleges, all of whom want to attract the most desirable students, would be forced to match the merit-based financial-aid offers of their competitors. In other words, without an enforceable prohibition on merit scholarships it probably would not be possible for any former participant in Overlap, however committed it is to giving undergraduate financial aid only on the basis of need, 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.

Most importantly, this competition for desirable students undoubtedly would force the Ivy colleges and MIT to increase total financial aid to undergraduates. In a competitive equilibrium, more undergraduates would receive financial aid and financial aid packages would 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.

This outcome, unfortunately, now seems unlikely. In October 1994 the Congress, in the face of intense lobbying by the educational establishment, passed legislation (Public Law 103-382, Section 568) that explicitly permits colleges to agree to give only need-based finan-

cial 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.

This new legislation makes a mockery of the claim that a prohibition of merit scholarships ensures generous financial aid for needy students. Colleges that agree under this legislation to give only need-based financial aid have to practice need-blind admissions, but the legislation does not require them 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. By allowing colleges to deny undergraduates the benefits of merit scholarships, the Congress has opted to protect the economic interests of elite institutions of higher education. In so doing, the Congress has sanctioned a policy that subsidizes imprudence and limits educational opportunity.

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