

Report of the Task Force on  
**Student Financial Aid**



**to the Board of Governors  
of the University of North Carolina**

**November 18, 1999**

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## **Executive Summary**

The Task Force on Student Aid has been convened by the University of North Carolina Board of Governors to develop recommendations for the design and structure of a new UNC need-based grant program. The Task Force reviewed how students on UNC campuses finance their education, and how these patterns differ from opportunities that students have in other major state universities. It has also examined the changing face of federal aid, and how best to leverage those resources to support UNC students. It has analyzed statewide grant programs in other major states, and the national research literature on measures of effectiveness for financial aid, to learn what lessons there are about how best to structure aid programs. And the group looked at how the Federal Methodology for measuring financial need might be improved upon, to best design a program that is easy for students and their families to understand as well as relatively easy to administer.

### ***Major Findings***

Low tuition has kept access to a University of North Carolina campus reasonably affordable for many North Carolinians. Nonetheless, the majority of students still face financial barriers in attending college, because tuition and fees comprise only 23% of the total costs that students face in going to college. Over 56% of resident UNC undergraduates apply for need-based aid, and only 5% of them have their need fully met with grant aid. In 1997-98, there were over 33,000 full-time students enrolled with unmet need after grant aid averaging \$4,264 per student. To fully cover unmet need for these students would have cost approximately \$143.5 million annually.

The University of North Carolina lags other major four-year institutions across the country in funding for need-based financial aid: while North Carolina ranks 10<sup>th</sup> in the nation in the 18-to-24-year-old population, it ranks 28<sup>th</sup> in need-based aid for full-time undergraduates, and 36<sup>th</sup> in the percentage of full-time undergraduates receiving need-based grants. When compared to students enrolled in other low-tuition state institutions, UNC students on average have 48% more in unmet need after grant aid, and those who borrow are borrowing close to 43% more than their counterparts. The aid available to UNC students is generally not based on need, and comes from a number of small programs that are funded at very modest levels. As a result, the majority of UNC students are working close to half-time while they are in school, in addition to borrowing.

Financial aid will be an essential component of future strategies to ensure that UNC is able to meet the needs of North Carolina in the future. Enrollment is expected to grow system-wide by over 30% in the next ten years alone. Much of that growth is expected to occur from low-income students who will be the first in their families to go to college. If North Carolina is to increase its college-going rate, attention must be paid to strategies to increase successful college access, retention and graduation, for low-income students.

There is almost no need-based aid for master s-level graduate students, in UNC or in other institutions across the country, and graduate student debt levels are growing at a disturbing rate.

Graduate students are supported quite differently from undergraduates, and so a need-based aid program for the two groups need not be structured identically. Nonetheless, some support for need-based grant aid for graduate students particularly master s-level students in disciplines such as education and social work, who lack fellowship or assistantship support will be necessary if North Carolina is to make graduate school a financial option for low-income students in the future.

A new aid program should leverage other resources in particular the new federal tax credits to ensure that scarce state resources are targeted to the very neediest students. None of the state grant programs that the Task Force reviewed in other states have been restructured to take advantage of these sources of funds. It will also be important to ensure that the UNC program is designed so that it can be fully funded. Most other states, as well as the federal government, build financial aid programs that hold out the promise of higher grants than appropriated funds will support. Students and families are confused about what they can plan on for aid as a result. Also, states frequently resort to across-the-board or grade-point rationing to cut back awards to fit within available appropriations, which also compromises the effectiveness of the programs in serving needy students.

To be most effective in increasing college-going for poor students, the aid program must be easy to understand, and integrated into academic outreach and student information efforts to influence high school students preparation and college-going rates. Too many aid programs fail to meet this test, because they are administratively Byzantine and almost impossible for students and families to understand. Students and their families routinely over-estimate the cost of college, and poor students are the most likely to be deterred from even trying to go to college as a result. One of the most important factors influencing future success in college is the intensity of high school academic preparation. Knowing that college is affordable, and that aid will be available to help the poorest students, will help to encourage students to plan academically as well as financially for college.

### ***Summary of Recommendations for the New Program Design and Funding***

Based on this analysis, the Task Force recommends that a new need-based grant program be created, which is available only to resident students enrolled at a University of North Carolina campus. By confining the program only to UNC, and not to students in independent institutions or community colleges, the program can be focused on the single key goal of ensuring that UNC remains affordable for poor students. The program should reach graduate as well as undergraduate students, because of the critical importance of need-based aid for graduate students. To keep the program costs down, eligibility is be limited to students in degree and credential programs, to students who are attending at least half-time, and to master s-level graduate students. The program has been designed to be easy to understand. Information about it will be made widely available, and integrated into high school recruitment and partnership programs to encourage students to prepare academically as well as financially for college.

The program is designed so that it has a realistic chance of being fully funded, because it targets grants based on need but does not try to fund all unmet need, which would cost \$143 million. By leveraging federal resources from the Pell grant and tax credit programs into the aid award structure, the program ensures that scarce state dollars will go to the very neediest students. Grants for freshmen will be modestly higher than for other students, because the federal tax credit will not be counted against awards for freshmen since they do not receive them until late in their first year. Students and families also share in the responsibility for paying for college, through self-help expectations that will rise as students move through college. The self-help expectation can be met through work, loans, work-study, prior savings, or grants and scholarships offered by institutions and other programs external to institutions. If self-help is maintained at these levels, the increases in student borrowing that have occurred over the last few years will level off, and student debt levels will not become excessive.

A new methodology to measure need has been developed, which improves on federal requirements by eliminating superfluous measures and encouraging families to save for college. Students will not have to fill out any new forms to apply for UNC aid, beyond those required for federal programs. The program will be centrally administered by the North Carolina State Education Assistance Authority, with a minimum of additional administrative burden for campuses. Program integrity is maintained by building on existing controls and audit mechanisms.

The grant formula for the new program described above is:

$$\begin{aligned}
 & \textit{Cost of Education} \text{ (tuition and required fees + \$6750)} \\
 & \textit{Less} \quad \text{Contribution from income (based on family income, dependents, employment)} \\
 & \textit{Less} \quad \text{Student self-help (\$4,000 for freshmen \& sophomores, \$5000 juniors \& seniors,} \\
 & \quad \quad \text{\$7000 graduate students)} \\
 & \textit{Less} \quad \text{Pell grant and estimated tax credits (for all but freshmen)} \\
 & \textit{Equals} \quad \text{UNC GRANT}^1 \text{ (minimum = \$200)}
 \end{aligned}$$

The projected annual cost of the program is shown in Table 1.

**Table 1. Projected Annual Cost of the Program**

<b>Amount</b>	<b>For These Students</b>
\$22.09 million	Undergraduate <i>dependent</i> students (\$9.68M for freshmen, \$6.95M for sophomores, \$2.85M for juniors, and \$2.61M for seniors)
\$7.71 million	Undergraduate <i>independent</i> students (\$2.11M for freshmen; \$2.43M million for sophomores; \$1.38M for juniors; and \$1.79M for seniors)
\$1.71 million	Graduate students
<b>\$31.52 million</b>	<b>All students (\$11.79M for freshmen, \$9.38M for sophomores, \$4.23M for juniors, \$4.41M for seniors, and \$1.71M for graduate students)</b>

<sup>1</sup> Definitions of terms used in this formula are provided in Appendix C.

The Task Force recognizes that resources for the new aid program are competing with other important Board priorities in a very tight budget year. If funding for the full program cannot be found in a single year, the Task Force recommends that the program be phased in over the next four years, beginning with freshmen and extending subsequently to cover all students. Additional adjustments to the program recommended in this document design may be needed once the final budget decisions are made by the legislature and the Board. The Task Force therefore recommends that the Board adopt these recommendations as an initial framework, and be prepared to adjust this as necessary as funding becomes available.

## Introduction

This report from the Task Force on Student Financial Aid Policy is being made to the University of North Carolina Board of Governors. The Board decided to establish the Student Aid Task Force in November 1998 when it adopted the recommendations from the Task Force on Tuition Policy for the institutions of the University of North Carolina. The Board of Governors charged the Task Force on Student Financial Aid to:

1. Analyze the general context for current financial aid policies and programs affecting UNC students, distinguishing between policies and programs for undergraduates and those for graduate and first professional students, and the role of merit and need in determining eligibility for student aid.
2. Evaluate the effect of federal student aid programs and policies on UNC financial aid programs, including the adequacy of federal grant funding in providing a foundation for university-based aid and the efficacy of the Federal Methodology for measuring students financial need.
3. Review the financial aid program and policy models of other states, including the design and administration of aid programs in multi-campus systems, and their applicability to UNC institutions and the North Carolina setting.
4. Analyze available research about the role of financial aid in a) meeting public goals for higher education access, b) influencing enrollment decisions, and c) encouraging student retention and graduation. This includes consideration of student financial aid as an instrument for helping UNC institutions to meet Board-approved enrollment goals.
5. Evaluate the present status of UNC student financial aid policies and programs relative to the level and composition of the financial aid needs of UNC students. This includes assessing the financial aid needs and debt loads of both graduate and undergraduate students, and resident and non-resident students.
6. Identify and develop policy and programmatic recommendations for meeting the financial aid needs of UNC students, including an analysis of the short- and long-term budget implications of possible recommendations and their relationship, if any, to the levels of tuition and fees set by the Board.
7. Consider the appropriate role of early awareness programs in relation to UNC financial aid policies and programs and the University's goal for higher education access and student retention.<sup>2</sup>

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<sup>2</sup> Task Force membership is shown in Appendix A.

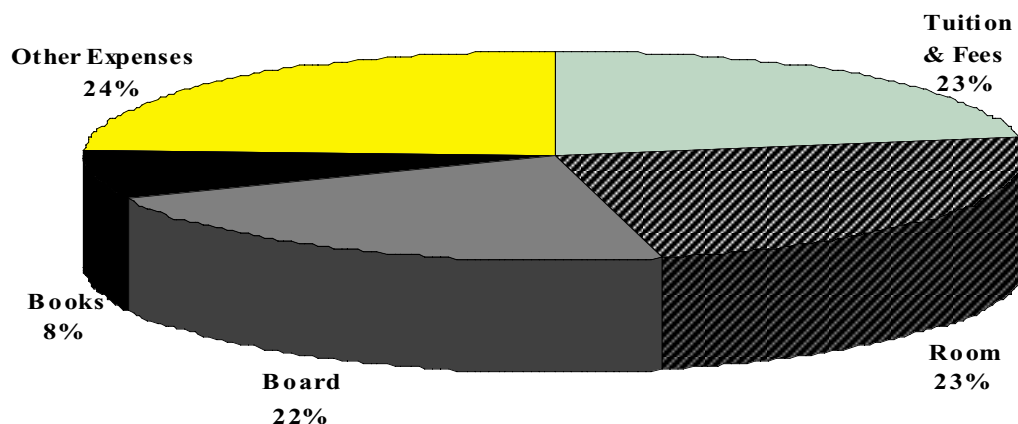
## How UNC Students Pay for College

In the University of North Carolina low tuition has historically been the primary means by which the State has ensured that no student faces economic barriers in going to college. The federal government enhances this core of support aid for poor students,<sup>3</sup> and federal assistance in turn is supplemented with a mix of special purposes financial aid programs that are funded by the State of North Carolina. The majority (57%) of these state programs are not need-based, but are used to encourage students to enroll in targeted professional programs (such as social work, nursing, and public school teaching), or for tuition grants to students in independent institutions, or for graduate student tuition remission.

Need-based aid is aid that is distributed to students based on a measure of personal economic necessity. The most frequently used measure of individual financial need is based on a standard Federal Methodology that has been developed over many years for federal aid programs. The methodology calculates what amount of a family or student's income is available to pay for the costs of college. Of the \$37 million in North Carolina state funding that goes to students based on financial need, the lion's share (\$19.7 million) is made available only to students in independent institutions. A relatively modest \$9.8 million is made available in need-based aid to UNC students, through the state appropriated grants program, and a portion of North Carolina Student Incentive Grants is awarded to UNC students. A complete breakdown of state funding for financial aid is shown in Appendix E.

While low tuitions have kept access to a University of North Carolina campus reasonably affordable for North Carolinians, many students still face financial barriers in attending college, because tuition and fees comprise only around 23% of the total costs that students on UNC campuses face in going to college (Figure 1).

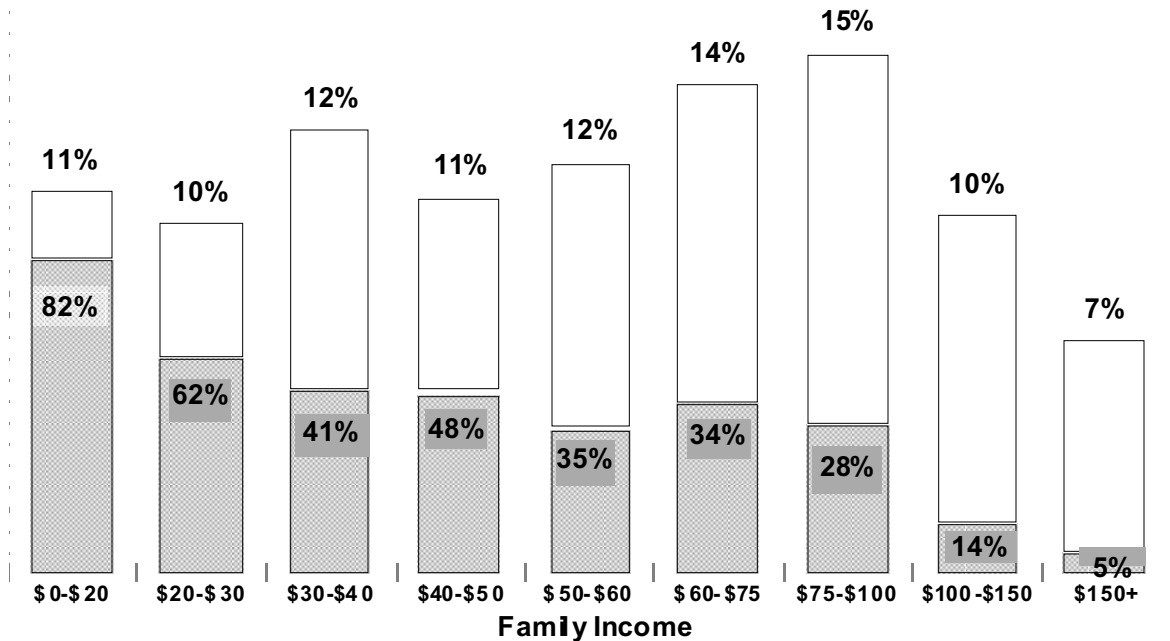
**Figure 1. Tuition and Fees versus Other Costs of Education: UNC Average Annual Costs for Dependent Resident Students**



<sup>3</sup> Appendix B provides a glossary of terms and definitions.

The remaining costs are room and board, books and supplies, and other living expenses. As a result, even with low tuition, UNC students are increasingly seeking financial help to go to college. Figure 2 shows the income distribution of UNC freshmen and the percent of freshmen in each income interval who apply for student financial aid. The graph reveals the heavy dependence of low-income students on financial aid.

**Figure 2. Distribution of Freshmen and Percent Applying for Aid by Family Income**

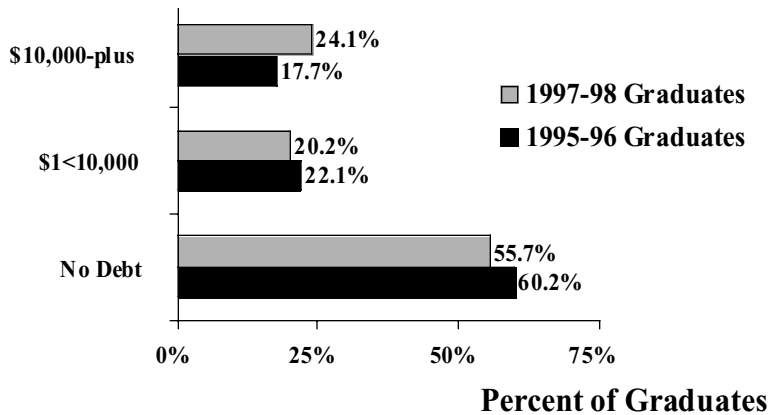


Other data compiled for this study show:

- In 1997-98, 56% (about 58,000) of resident UNC undergraduates applied for need-based financial aid; *of this group, only 5% had their need fully met with a grant or scholarship.*
- One-third of resident freshmen applying for aid in 1997-98 were from families with incomes below \$40,000 annually. Over 33,000 full-time students have unmet need *after* grant aid, averaging \$4,264 per student. *To fully cover all unmet need for these students would cost approximately \$143.5 million.*
- To help pay for the cost of college, students work and take out loans. UNC undergraduates are borrowing an *average* of \$3,829 per year; this average is for all UNC aid recipients, and not just those who borrow. According to a survey of 1997-98 UNC baccalaureate graduates, 44% reported having college debts to repay, and their median debt load was \$11,600. The number of student reporting loans in excess of \$10,000 increased from around 18% to 24% between 1995-96 and 1997-98. *In 1997-98, loans accounted for 62% of all aid given to students in the University (Figure 3).*
- Nearly 75% of UNC seniors report working during their last year of college; of those who worked, two-thirds did so for more than twenty hours per week. Forty-three percent of

entering freshmen report plans to work in their first year of college. While some national research shows that on-campus work can actually help students get through college, work that exceeds 20 hours per week and that is off-campus undoubtedly extends time to degree and contributes to student attrition; by how much cannot be measured precisely.

**Figure 3. Change in UNC Baccalaureate Debt Burden**



The picture for graduate students in the University is murkier than that for undergraduates, because almost all financial aid programs separate eligibility for graduates from undergraduates, and need-based financial aid has traditionally been a lower priority for graduate students than for undergraduates. There are many reasons for that: graduate students are older, economically self-reliant and independent from their families, and sometimes supported through combinations of teaching and research assistantships, fellowships, and traineeships. Graduate assistants frequently receive a tuition remission or waiver as part of their assistantships. Despite the assistantships some graduate students receive, it is important to recognize that there is no need-based grant aid for graduate students and many of these students do not receive assistantships. The only federal aid that is available to graduate students based on need is loans. As a result, graduate students are borrowing even more heavily than undergraduates. Because graduate assistantships and fellowships are most frequently available to students at the doctoral level and in health- and science-related disciplines, master s-level students particularly those in disciplines such as education and social work are often forced to resort to borrowing to meet their financial needs. A need-based aid program such as this would benefit these students most directly of all graduate students.

## **The Changing Role of Federal Aid**

The federal government has been, and continues to be, the dominant force in student aid, both in terms of funding and program administration. In 1998, nearly \$60 billion was spent nationally on all forms of student aid; of this amount, almost \$44 billion was from federal sources. If the approximately \$12—15 billion expected to be expended annually on the new Hope Tax credit (and Lifelong Learning credit) is also taken into account, the federal role will have grown even larger.

In addition, the federal aid delivery system (the administrative apparatus for evaluating need, for distributing resources, and for accounting for aid) has become the coin of the realm for financial aid programs not just for federal aid, but for state and institutional aid as well. Not surprisingly, virtually all state and many institutional aid programs are designed to build on top of federal programs both to take advantage of federal aid before spending other precious resources, and to avoid duplicative administrative systems. But federal aid programs have changed significantly over time, and in many respects may no longer serve as the foundation for need-based grant aid. Three major trends are influencing the changing role of federal aid:

- the erosion of aid in relation to students' college expenses,
- the shifting balance between grants and loans, and
- the growth of funding for non-need-based aid.

### ***The Erosion of Aid in Relation to Students' College Expenses***

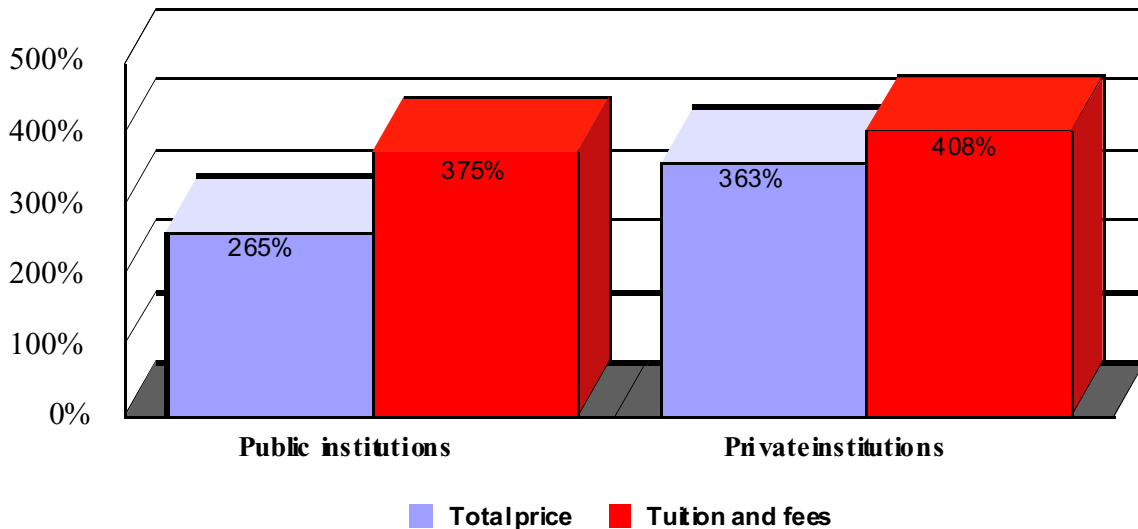
One of the biggest forces affecting the capacity of federal aid programs to meet the needs of poor students has been the rapid increases in college costs (Figure 4), which have not been matched with increased federal need-based aid. Nationally, tuition charges in four-year public institutions for resident students have almost doubled since 1988, from an average of \$1,218 annually to \$2,365 in 1998. Private tuition charges have increased at a slightly lower rate of 86% during that period, but by a much larger dollar amount from an average of \$6,990 annually to slightly over \$13,000. UNC in-state tuition and fees have increased from an average of \$868 annually to just under \$1,800 in 1998 still low by national standards, but closer in 1998 to the norm for four-year public institutions at the end of the decade than at the beginning.

During this same decade of rapid tuition increases, financial aid grew, but more slowly: federal Pell grants grew by only 19%, and subsidized federal loans by 37%. The percentage of college costs that were covered by the maximum Pell grant in public four-year institutions went from 60% in the early 1980s to less than 40% currently. As federal aid has diminished and emphasized loans over grants, responsibility for grant funding has begun to shift to institutions and states. State grant programs have increased by 60% over this ten-year period, and institutional grant aid by 111%. The only source of funding for grant aid that has grown faster than tuition is institutional aid, but these increases have occurred largely in private institutions.<sup>4</sup>

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<sup>4</sup> See The College Board, *Trends in Student Aid*, New York, NY, October 1999.

**Figure 4. Increase in Prices between 1976-77 and 1996-97 in Constant 1996-97 Dollars**



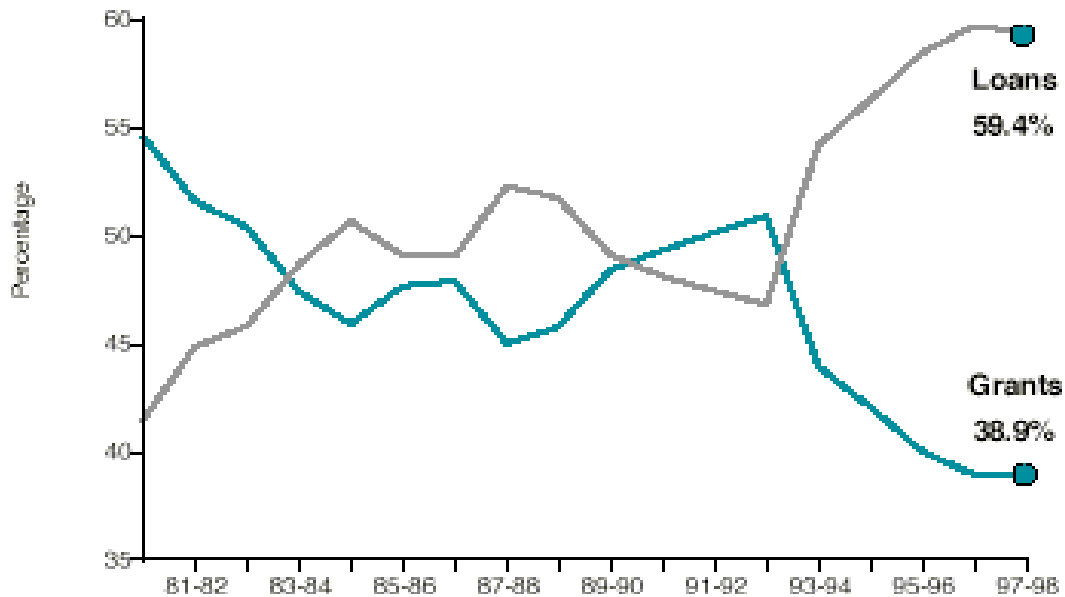
Note: Private institutions include both non-profit and for-profit.  
Total price includes tuition, fees, room, and board. 1996-97 data are preliminary.  
Source: US Department of Education, 1997.

### ***The Shifting Balance between Grants and Loans***

As grant aid has dwindled relative to college expenses, students have increasingly resorted to borrowing to pay for college. In 1987, loans comprised roughly half of all expenditures for student aid, a figure that has grown to close to 60% ten years later (Figure 5). Students have always borrowed to pay for a portion of their college costs, and borrowing remains a legitimate and appropriate means of financing a college education given the high individual pay-off in lifetime earnings to students with a college education. Loans are also a relatively inexpensive way for governments to leverage resources to help pay for college, since the direct taxpayer costs for the program go to pay for loan subsidies in the form of lower interest costs and deferments on payments while students are in college. But debt financing becomes a public policy problem when student borrowing becomes excessive because increasing numbers of college graduates enter the labor force with high accumulated debts from college. National estimates of the average indebtedness levels of 1995-96 graduates showed that 52% of college graduates had debts, averaging almost \$12,000.<sup>5</sup> Debts for professional students in medicine, law, and dentistry averaged close to \$50,000. Not surprisingly, these same data reveal that the students most likely to borrow are from low-income families. Although UNC graduates show lower reliance on loans than their counterparts nationally, their rising debt levels reflect national trends.

<sup>5</sup> From Jacqueline E. King, *Student Borrowing: Is There a Crisis?* In *Student Loan Debt: Problems and Prospects*, Washington, DC, December 1997.

**Figure 5. Declining Need-based Grant Aid, Increasing Loan Dependence: Percent Share of Grants versus Loans Nationally, 1980-81 to 1997-98**



***The Growth of Funding for Non-Need-based Aid***

The most dramatic change in financial aid funding in the last ten years has not been the transition from grants to loans, but the shift away from need-based aid to other forms of student finance. The basic purposes of financial aid programs have shifted incrementally away from access for poor students to expanded support for middle- and upper-income students, as a tool to reward merit, and as an enrollment-management incentive. The fastest growing programs nationally are unsubsidized federal loan programs, federal Hope Tax Credits, and state Hope Scholarship programs, all three of which make awards without regard to need. These three programs alone now comprise an estimated \$23-\$26 billion annually for the nation almost four times the federal Pell grant program, eight times more than all state grant programs combined, and twice as much as all institutional aid.

### ***Focus on the Hope Tax Credit***

The year 1998 marked the largest increase in federal student aid funding in more than two decades both because of the increase in the maximum Pell grant and because of the introduction of the Hope Tax Credit and the Lifelong Learning Tax Credit. These credits are not grants or scholarships in a traditional sense, but they do provide students and families with additional resources to meet tuition and required fees. Hope credits are available to freshmen and sophomores, while Lifelong Learning credits are available to upper division or graduate students.

Under Hope Tax Credit rules, a family may claim a credit of up to a maximum of \$1,500 per tax year for each eligible dependent. A family may claim up to 100% of the first \$1,000 of eligible expenses and 50% of the next \$1,000 in remaining allowable expenses for a minimum credit of \$1,500. Allowable expenses include tuition and required fees *minus* all untaxed income used to pay the tuition and fees, including untaxed grants and scholarships. To receive the benefit, taxpayers must owe taxes and file tax returns. The credit phases out for single taxpayers with incomes between \$40,000 and \$50,000 for single taxpayers, and for married taxpayers with incomes between \$80,000 and \$100,000. Middle-income families are generally regarded as the intended beneficiaries of the program. This is because such families are the most likely to show sufficient tax liability to receive a full credit and are also the most likely to face a net tuition (tuition minus scholarships and grants) that will exceed \$2,000. At the same time, it is anticipated that comparatively few lower-income families will benefit from the credit, either because they have little or no tax liability or because their net tuition after receipt of untaxed grants is too small. Also, because the financial benefits of Hope Tax Credits occur at the end of the academic year after tuition has been paid the family must find the resources to pay for the costs of attendance before they actually have the credit in hand.

An analysis by the National Policy Center for Higher Education<sup>6</sup> based on US Department of Education analysis suggests that approximately \$241 million will be claimed by North Carolina taxpayers in tax credits, with an average credit per family of \$694 annually. This figure is slightly less than national averages, because of the low public tuitions in North Carolina and the State's relatively large number of low-income families whose tax liabilities are too low to claim the credit.<sup>7</sup>

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<sup>6</sup> *Federal Tuition Tax Credits and State Higher Education Policy*, The National Center for Public Policy and Higher Education, San Jose, California, December 1998.

<sup>7</sup> See The Institute for Higher Education Policy, *Diffusion of Purpose*, Washington, DC, September 1999.

## How North Carolina Compares with Other States

To get a sense of how other low-tuition states address grant aid for needy students, the task force constructed a sample of the major low-tuition states, and used national data on student financial aid to see how students in those states pay for college. Low-tuition states are those that are in the bottom third nationally in terms of resident undergraduate tuition. The analysis required some apples-and-oranges comparisons, because the national data for other states is only available through 1995-96, in comparison to more 1997-98 data for UNC. Nonetheless, the analysis showed that, even after making allowance for changes over these two years, UNC is well behind these other states in addressing students unmet need after grant aid, and considerably ahead in terms of students average annual amounts borrowed. Data for these comparisons are shown in Table 2.

**Table 2. Comparative Measures<sup>8</sup>**

Measures	UNC	Other Low-Tuition States*
Unmet need after grants	\$4,264	\$2,865
Average amount borrowed	\$3,829	\$2,666
* States whose resident tuition and fees rank in the bottom third.		

In comparing North Carolina to other states in the availability of aid relative to the size of the undergraduate population, the analysis in Table 3 reveals the relatively low percentage of full-time undergraduates receiving need-based aid in North Carolina. The data cover all students at the postsecondary level public, private, two-year, and four-year.

**Table 3. Comparisons of State Spending on Student Financial Aid in 1997-98<sup>9</sup>**

Population of 18- to 24-year-olds	Rank = 10
Need-based aid for undergraduates	Rank = 17
State grant aid per full-time undergraduate (\$386)	Rank = 15
Need-based grant per full-time undergraduate (\$171)	Rank = 28
Percent of full-time undergraduates receiving aid (18.2%)	Rank = 25
Percent of full-time undergraduates receiving need-based grants (5.9%)	Rank = 36

### **State Grant Aid Programs**

The task force reviewed information on the major state grant programs, to learn how they are constructed in terms of funding and methodology, and to see what information is available about

<sup>8</sup> National Postsecondary Student Aid Survey (NPSAS), U.S. Department of Education.

<sup>9</sup> The NASPPG Report, 1997-98.

the students served by them. The data (Table 4) showed considerable variation among the states on the following kinds of variables:

- **Year started:** With the exception of the Georgia Hope Scholarship program, which was started in 1993, all the other major state grant programs were started some time ago well before the major tuition increases of the 1980 s and 1990 s, and before the changes in federal aid. Among the major grant programs, the youngest is the New Jersey Tuition Assistance Program, which began in 1978. The oldest program is the New York program, which dates back to 1962. Although many of the programs have been revised slightly, none of them have been fundamentally restructured to take account of changed price structures and the new shape of federal aid.
- **Size in terms of funding:** The programs range widely in funding, as measured by the percentage of state higher-education appropriations allocated to them. The New York program now accounts for close to one-quarter of all funding for higher education in the state, by far the largest among the states.

**Table 4. Comparisons of Major Statewide Need-based Grant Programs<sup>10</sup>**

State/Year Started	1) Total 97 Appropriations/% of HE Appropriations	2) # of Recipients	3) Average NBA/UG/ National Rank	4) % UG/NBA/ Rank	5) Public Sector Share
New York/TAP, 1962	\$619,786,000/23%	279,813	\$1,086/ 1	46.8%/ 2	56%
Illinois MAP, 1958	\$263,261,987/14%	127,607	\$ 869/ 3	37.1%/ 5	52%
Pennsylvania, 1966	\$235,865,512/15%	140,609	\$ 700/ 4	39.2%/ 4	49%
California, CGA, 1956	\$ 177,358,000/ 4%	55,106	\$ 349/11	13.2%/28	54%
New Jersey TAG, 1978	\$132,260,198/12%	51,599	\$ 963/ 2	41.2%/ 3	65%
Minnesota State Grant, 1967	\$ 89,298,269/ 9%	61,397	\$ 642/ 5	18.5%/22	48%
Ohio Inst. Grant, 1969	\$ 74,549,639/ 7%	84,443	\$ 291/17	27.6%/ 9	57%
Michigan, Comp. Schol., 1964	\$ 51,159,669/ 5%	31,537	\$ 354/10	21.7%/17	0%
Washington, Need Grant, 1970	\$ 57,053,859/ 6%	43,456	\$ 366/ 9	20.4%/18	88%
Florida, Student Asst. Grant, 1972	\$ 34,356,621/ 5%	41,839	\$ 124/30	12.7%/30	77%
Georgia, SSIG, 1974	\$ 2,165,362/%NA	5,106	\$ 12/48	2.8%/45	77%
Georgia, Hope, 1993	\$183,702,000/%NA	138,573	NA	NA	NA
<b>Notes:</b>	1) Total 1997-98 state funding appropriated, and as a percentage of the total state funding for higher education. State funding for institutionally-based programs is <i>excluded</i> , as are other sources of institutional aid.	2) Number of students receiving aid from the program.	3) Average need-based aid award per undergraduate, and national rank.	4) Percent of under-graduates receiving need-based aid from this program and national rank.	5) The public sector share of funding from the program. The Georgia total also includes SSIG in state totals.

<sup>10</sup> The NASPPG Report, *op. cit.*

- **Sectors covered:** With the exception of Michigan, where the Comprehensive Scholarship program is exclusively targeted to students in independent institutions, all the major programs are designed to meet the needs of students in both public and independent institutions. Those states where students in private institutions participate most in the aid programs are also those with the most costly aid programs.
  - **Award formulae and rationing schemes:** The differences in student awards between the states are caused by the different financial aid formulae more than by differences in income levels for students in the states. The formulae vary widely in how costs are measured, and in the relative weight given to tuition costs as compared to living expenses. States which weight living expenses more than tuition favor students in low-priced institutions, whereas those that do not limit tuition costs favor students in private institutions.

Except for Georgia, where the Hope program is not need-based, all the other state programs are designed to reduce or even eliminate unmet need. Since funding all unmet need is impossible because of budget constraints, the states use different mechanisms to cut or distribute the aid among eligible applicants to fit within the amounts appropriated. These mechanisms undermine the basic purposes of the programs, because they are added as afterthoughts to the budget process rather than built into the basic program design. They also make it hard for students and families to predict what award levels will be, because the possible award level is always so much higher than what is funded. As an example, in California, the Cal Grant program is designed to fund all measured student need, yet resources that are appropriated fall close to \$1 billion below the amount needed to meet need. As a result, California rations the aid by establishing a grade-point average cut-off, with the higher awards going to the students with the highest grade-point averages. The effect of this is to reward students in institutions with selective admissions, because they have better grades.

- **Award structure:** Although the state programs are designed to build on top of federal aid, none of them has been restructured to recognize the changing picture of federal aid. In particular, the Hope Tax Credit has not been factored into how States evaluate need for aid. The result is that the low/middle-income students who are eligible for a tax credit and also may receive state grant aid are receiving more aid than if the programs adequately accounted for the tax credit. The programs have also not been revised to recognize the changed tuition structures at the state levels, and the increasing disparity in prices between private colleges, research universities, and comprehensive institutions and community colleges. If the programs aim to reach students from all sectors in a single structure, unless great care is taken, the political pressures on the program over time will cause them to be transformed to become instruments for funding institutions, rather than determined by student demand and financial need.

## Research on Purpose and Effectiveness of Aid

Research on the effectiveness of need-based financial aid generally documents the assertion that a student's decision about college attendance, and which college to attend, are inversely related to price i.e., tuition, fees, and other costs minus grants and scholarships and positively related to family income. Evidence about the relationship with income is pervasive and is best illustrated by survey data from the U.S. Department of Education and from the Bureau of the Census.

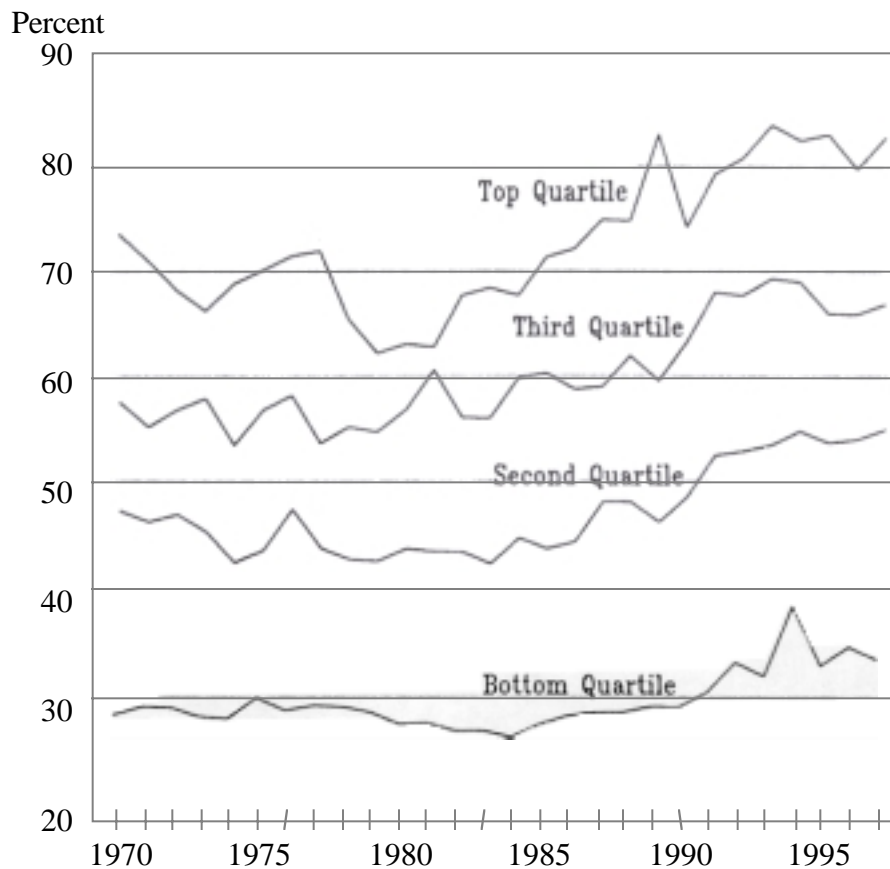
In 1980, and again in 1992, the U.S. Department of Education conducted longitudinal surveys of high school graduates in order to study their experiences after graduation. Table 5 shows the pattern of post-secondary enrollment 20 months after graduation experienced by each cohort of graduates. Graduates in the highest-income quartile were two to three times more likely than graduates in the lowest-income quartile to enroll in a postsecondary institution. The gap in likelihood was greater for the 1992 graduates than it was for the 1980 graduates. The data also show that the 4-year college enrollment rate of graduates in the highest-income quartile had increased by 11 percentage points over these twelve years, while the 4-year college enrollment rate for graduates in the lowest-income quartile had increased by only one percentage point. The latter finding is consistent with evidence that incomes of those in the lowest quartile have not increased as much as those in the upper quartile(s) while college tuition has increased faster than family incomes generally. The fact that aid programs nationwide have, on balance, shifted toward those that promote college choice over college access has very likely also contributed to the gap.

**Table 5. Percentage of Students from Families in Each Income Quartile Who Enroll in Postsecondary Schools within 20 Months of Graduation**

Parental Income Quartile	No PSE Enrollment	Total with Some Postsecondary	Vocational, Technical	2-Year College	4-Year College
<b>1980/82 High School Graduates</b>					
<b>Top</b>	20	80	6	19	55
<b>Second</b>	29	71	10	22	39
<b>Third</b>	37	63	11	19	33
<b>Bottom</b>	43	57	12	16	29
<b>1992 High School Graduates</b>					
<b>Top</b>	10	90	5	19	66
<b>Second</b>	21	79	6	25	48
<b>Third</b>	30	70	7	25	38
<b>Bottom</b>	30	60	10	22	28

A second study by Tom Mortenson calculated the chance for college of 18- to 24-year-olds (who graduate from college by age 24) using annual survey data on educational attainment collected by the U.S. Bureau of the Census. The chance for college is broken down in his analysis into three components: the chance for high school graduation; the chance for college attendance following high school graduation, and the chance for graduation from college all three of which are shown to vary predictably with levels of family income. Figure 6 displays the trends since 1970 in the chance for college series, in which students have been grouped by income quartile. Even though the data show upward trends for all quartiles, the gains appear to be greatest for those in the high-income quartiles, and the gap between high- and low-income quartiles appears to have widened in the 90 s.

**Figure 6. Chance for College for Dependent 18- to 24-year-olds by Family Income Quartiles in the United States 1970 to 1997<sup>11</sup>**



What neither study shows is the effect that the availability of need-based grants may have played in reducing or widening the gaps between students in different income groups. Some studies have sought to determine the effect of need-based grants on college-going patterns by controlling for other variables, such as family income, educational attainment, academic achievement, college

<sup>11</sup> Tom Mortenson: *Postsecondary Education OPPORTUNITY*, Number 86, August 1999, p. 1.

admission test scores, and the price of college, where price has been calculated net of grants and scholarships. Such studies have tended to show that in their college attendance decisions, low-income students are more responsive to changes in the price of college than are high- and middle-income families. This suggests that need-based financial aid will be an effective policy tool in promoting access, but past studies have been too narrowly focused to provide evidence concerning the most effective way in which to structure a program of need-based grants for this purpose.

In past studies of the college-going decision, there is, for example, little information about the role of timing (when students need to know that grants are available); predictability (how much they will receive); availability of other resources, such as loans, jobs, and past savings; and the impact of counselor intervention in middle and secondary grades. It seems reasonable that college prices that are known as early as possible in a student's pre-college years will have a more positive impact on their choice of curriculum and their willingness to work than will college prices that are not known until the spring of the senior year in high school. It seems reasonable to expect that larger grants will be more effective than smaller grants, and that more counselor intervention will be more effective than less counselor intervention, but precise evidence for these effects are largely absent from the research literature on college attendance decisions.

Several recent studies suggest partial answers to questions about some of these factors. Concerning predictability of aid awards, Thomas Kane<sup>12</sup> has found evidence that the complexity of the current financial aid system turns off the very students it is designed to attract. He suggests that the Federal Methodology has sacrificed clarity for undue precision, particularly in the way that student assets are counted. He further argues that aid should be restructured to take advantage of the new resources in Hope Tax Credits, and to front-load grant aid to increase grant funding for freshmen. Finally, he suggests that program simplification should include steps to make college prices with aid included more predictable for students and their families.

Another study that underscores the need for better predictability about college costs was undertaken by the American Council on Education<sup>13</sup>. It sought to measure the extent to which students and their families knew how much college actually costs. When asked about their estimate of tuition at different types of colleges in their state, interviewees tended to overstate it significantly, particularly when asked about tuition at public institutions. Table 6 shows the result of their study.

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<sup>12</sup> Thomas Kane, *Rethinking the Way Americans Pay for College: More Bang for a Buck*, Santa Monica, California: The Milken Institute, 1999.

<sup>13</sup> American Council on Education, *Research on Public Perceptions of College Costs and Student Aid*. Washington, DC: ACE, 1998.

**Table 6. Estimated Price and Actual Tuition**

<b>Institution Type</b>	<b>Estimated Price<sup>14</sup></b>	<b>Actual Tuition</b>
Public Community College	\$6,295	\$1,194
Public University	\$9,599	\$2,982
Private Liberal Arts College	\$13,824	\$10,698
Private Research University	\$20,410	\$14,510

Another study by the Institute for Higher Education Policy<sup>15</sup> relates to the increased levels of spending on merit-based aid and tax-expenditure aid relative to need-based aid. The study is critical of the increases, noting that such spending has a greater effect on *where* students will go to college rather than *whether* they will go to college. In other words, these resources end up enhancing subsidies for students who would likely have gone to college without them.

Taken together, these findings suggest that the precise structure of a successful need-based grant program is therefore more art than science. Research evidence supports the importance of need-based grants in promoting the college attendance of under-represented low-income students, but it does not provide detailed information about all of the variables that determine a program, nor does it provide much evidence about the indirect beneficial effects of a program.

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<sup>14</sup> Based on surveys done by ACE in July of 1996, based on tuition data for 1994-95.

<sup>15</sup> The Institute for Higher Education Policy, *Taxing Matters*, Washington, DC: The Institute, 1998.

## **Recommendations**

The Task Force on Student Aid convened by the University of North Carolina Board of Governors recommends that the Board authorize the creation of a new UNC need-based grant program, and seek funding for that program from the State of North Carolina to allow the program to begin in 2000-2001.

The program recommended by the Task Force is structured as follows:

### ***Eligibility for a Grant***

The task force recommends that the program be available only to in-state students, undergraduate and master s-level graduate, who attend a UNC institution at least half-time in a degree or certificate program and who meet the needs test established by the program.

### ***Structure of the UNC Grant Program***

1. Aid is targeted to low-income students.
2. The program s grant formula is progressive, to provide the maximum grant aid to the lowest-income students.
3. Funding of student financial need is recognized as a shared responsibility, between the state and federal government, students, and families:
  - Federal resources Pell, Hope, and Lifelong Learning should be used first to address student financial need.
  - Student self-help expectations can be met from work, borrowing, savings, campus work-study funds, or grants or scholarships from outside the new program. Under these self-help expectations, borrowing can be maintained at reasonable levels.
4. The award process is simple, efficient, and applicant-friendly.
5. Grant aid amounts under the new program are predictable for students and families.
6. The program ensures that gift aid from all sources does not exceed the cost of attendance.
7. By assuring that UNC is kept affordable, the new grant program will encourage students to continue their academic progress, from K-12 through graduate school.
8. Through PATHWAYS, early information about college affordability is provided to students, along with information about career options and academic preparation for college and career.
9. Program integrity is ensured to maintain public and legislative support for student aid.
10. The administrative structure builds upon existing federal and institutional audit and program review processes, and uses existing application and data collection procedures.
11. Funding for university grants should increase as needs and tuition and fees increase.
12. The recommended program addresses about 20 percent of undergraduate unmet need, as measured by the Federal Methodology for determining financial need.

## The Grant Formula

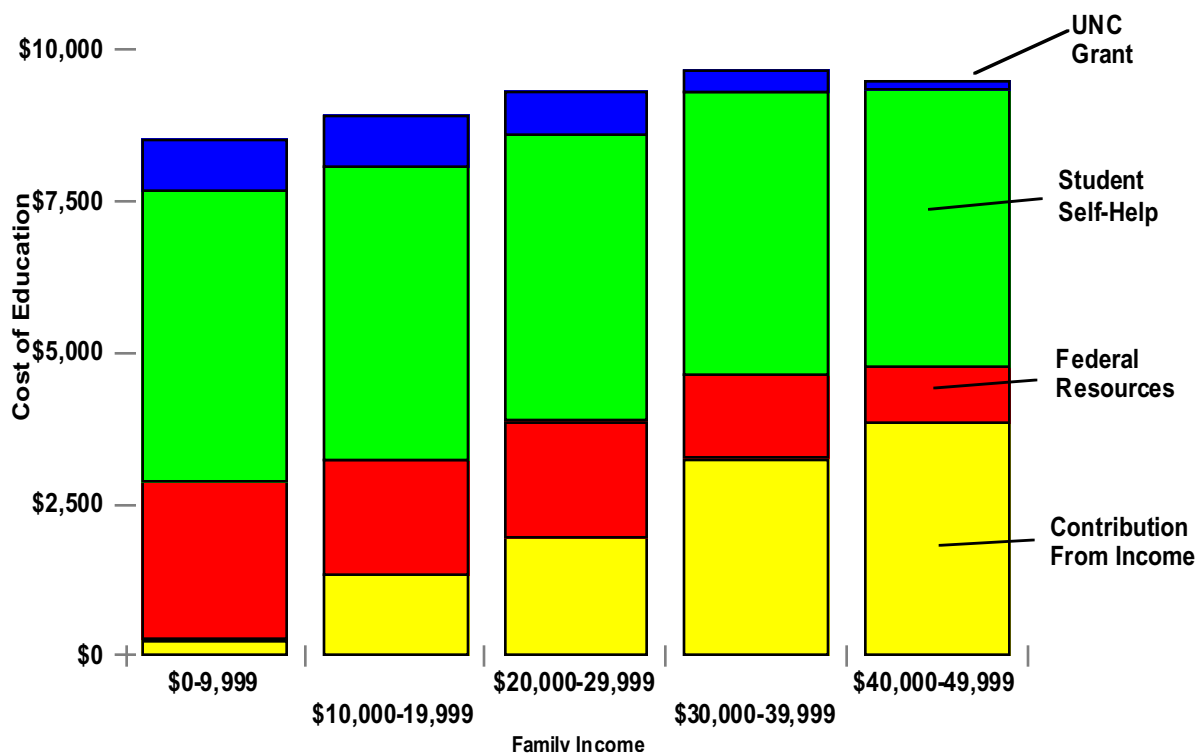
The grant formula for the new program is:

$$\begin{array}{l}
 \text{Cost of Education (tuition and required fees + \$6750)} \\
 \text{Less Contribution from income (based on family income, dependents, employment)} \\
 \text{Less Student self-help (\$4,000 for freshmen \& sophomores, \$5000 juniors \& seniors,} \\
 \quad \text{\$7000 graduate students)} \\
 \text{Less Pell grant and estimated tax credits (for all but freshmen)} \\
 \hline
 \text{Equals UNC GRANT (minimum = \$200)}
 \end{array}$$

Appendix C provides definitions of measures used in this formula.

The UNC Grant will be part of an aid package that could include a Pell grant, other grants (such as from institutional sources), scholarships, loans, and work-study funding. The estimated distribution of grant resources to families at income levels below \$50,000 is displayed graphically in Figure 7. Each bar shows the way in which the new grant will be combined with other resources to meet the cost of education experienced by students in each income interval.

**Figure 7. Resources for College for Dependent Students by Family Income**



## Estimated Cost of the Program

The projected annual cost of the program is \$31.52 million, as shown in Table 7, which also shows the proportion of program expenditures that each class of students is expected to receive.

**Table 7. Projected Annual Cost of UNC Grants by Class Level and Dependency Status**

Class Level	Dependents	% of total	Independents	% of total	Both Dependents & Independents	% of total
Freshmen	\$9.68	30.7%	\$2.11	6.7%	\$11.79	37.4%
Sophomores	6.95	22.1%	2.43	7.7%	9.38	29.8%
Juniors	2.85	9.0%	1.38	4.4%	4.23	13.4%
Seniors	2.61	8.3%	1.79	5.7%	4.41	14.0%
Undergraduates	\$22.09	70.1%	\$7.71	24.5%	\$29.81	94.6%
Graduates	0	0.0%	\$1.71	5.4%	\$1.71	5.4%
<b>TOTAL</b>	<b>\$22.09</b>	<b>70.1%</b>	<b>\$9.42</b>	<b>29.9%</b>	<b>\$31.52</b>	<b>100.0%</b>

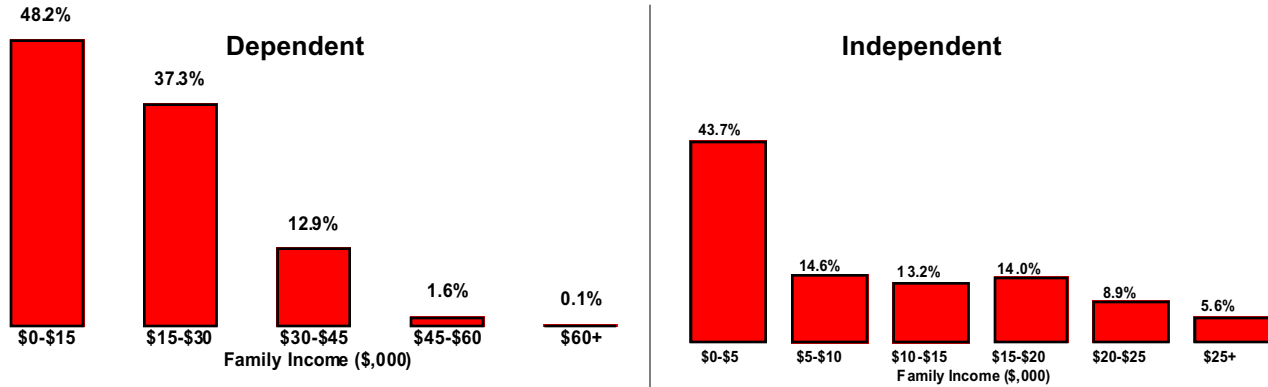
Data on the number of grant recipients, the percent of aid applicants that will receive a grant, the dollars awarded, and the average grant amount are shown for dependent and independent undergraduates in Table 8.

**Table 8. Distribution of Grants to Undergraduates by Level of Family Income**

Income Level	Number of Grants	Percent Receiving Grants	Dollar Amount (in millions)	Average Grant
<b>Undergraduate Dependents</b>				
\$0-14,999	8,136	85%	\$10.64	\$1,308
\$15,000-29,999	5,552	66%	8.24	1,484
\$30,000-44,999	2,477	32%	2.85	1,151
\$45,000-59,999	368	6%	0.34	930
\$60,000-74,999	13	0%	0.01	1,017
\$75,000-plus	5	0%	0.00	1,472
<b>All Undergraduate Dependents</b>	<b>16,551</b>	<b>39%</b>	<b>\$22.08</b>	<b>\$1,335</b>
<b>Undergraduate Independents</b>				
\$0-4,999	3,640	73%	\$3.37	\$925
\$5,000-9,999	1,215	44%	1.13	928
\$10,000-14,999	854	41%	1.02	1,189
\$15,000-19,999	829	47%	1.08	1,305
\$20,000-24,999	624	44%	0.68	1,098
\$25,000-plus	513	16%	0.43	848
<b>All Undergraduate Independents</b>	<b>7,676</b>	<b>47%</b>	<b>\$7.71</b>	<b>\$1,005</b>

The distribution of UNC Grant dollars by level of family income is shown graphically for dependent and independent undergraduates in Figure 8.

**Figure 8. Distribution of UNC Grant Payout to Undergraduate Students by Family Income**



The Task Force recognizes that resources for the new aid program are competing with other important Board priorities in a very tight budget year. If funding for the full program cannot be found in a single year, the Task Force recommends that the program be phased in over the next four years, beginning with freshmen and extending subsequently to cover all students. Additional adjustments to the program recommended in this document design may be needed once the final budget decisions are made by the legislature and the Board. The Task Force therefore recommends that the Board adopt these recommendations as an initial framework, and be prepared to adjust this as necessary as funding becomes available.

## **Appendix A: Task Force Membership**

- Gary Barnes**, Task Force Chairman  
Vice President for Program Assessment and Public Service  
University of North Carolina General Administration
- George Antonelli**, Associate Vice President for Student Affairs and Special Programs  
University of North Carolina General Administration
- Sherri Avent**, Director of Financial Aid  
North Carolina Agricultural & Technical State University
- James C. Black, Jr.**, Associate Provost for Enrollment Services  
University of North Carolina at Greensboro
- Steve Brooks**, Executive Director  
North Carolina State Education Assistance Authority
- Clementine Cone**, Vice Chancellor for Finance & Administration  
Winston-Salem State University
- C. Lee Conner**, President  
UNC-Chapel Hill Graduate and Professional Student Federation
- Julie Rice Mallette**, Director of Financial Aid  
North Carolina State University
- Carolyn McElrath**, Director of Financial Aid  
University of North Carolina at Asheville
- Ernest Murphrey**, Vice Chancellor for Business & Finance  
Elizabeth City State University
- Jeffrey L. Nieman**, President  
University of North Carolina Association of Student Governments
- Shirley Ort**, Associate Vice Chancellor and Director, Student Aid  
University of North Carolina at Chapel Hill
- Thomas Stafford**, Vice Chancellor for Student Affairs  
North Carolina State University
- Rose Mary Stelma**, Director of Financial Aid  
East Carolina University
- Joe Watts**, Associate Vice Chancellor for Enrollment Services and Director of Admissions  
Appalachian State University
- Curtis Whalen**, Director of Financial Aid  
University of North Carolina at Charlotte

### ***Consultants to the Task Force:***

- Jane Wellman**, Senior Associate  
The Institute for Higher Education Policy  
Washington, DC
- Brian Zucker**, President  
Human Capital Research Corporation  
Chicago, IL

## **Appendix B: Dictionary of Terms**

Each year the funds available for most student aid come from three sources: the federal government, foundation or privately funded programs that are generally managed by individual UNC campuses, and state funds. Financial aid is typically provided either as a grant or scholarship, a loan, a fellowship, or a work opportunity, Key definitions follow:

### **Financial Need**

The calculated difference between a student's cost of attending college and his or her ability to pay these costs, most commonly determined by the Federal Methodology, which is used to determine eligibility for Pell grants, subsidized loans, and other federal aid programs.

### **Unmet Need (after grant aid)**

The amount of financial need remaining after a student receives all of the grants and scholarships (other than the UNC Grant) from existing sources.

### **Grants or Scholarships**

Grants, such as federal Supplemental Educational Opportunity Grants, and scholarships are aid funds that require no subsequent action on the part of the student. Grants and scholarships often require the recipient to belong to a special population before receiving the award, such as financially needy or academically gifted. These funds are often referred to as gift aid, because the student has no further responsibilities for service or repayment.

### **Work Aid**

Work aid, such as the Federal Work-Study Program, requires the students to work for their aid funds. Most often the required jobs are on-campus with flexible schedules to accommodate the student's class schedule. The promise of payment is made at the beginning of the semester with funds disbursed after the job is accomplished or hours are worked, usually monthly. Funding for work aid that is classified as such for student aid purposes is only a small proportion of the resources that students receive from employment.

### **Fellowships**

Fellowship aid is a kind of combination of scholarship and work, awarded to students on the basis of merit or performance and often tied to research or scholarly work. Most fellowships are awarded to students at the graduate level.

### **Loans**

Loan aid, such as Federal Perkins Loan and Federal Family Education Loans, must be repaid. Student loans vary widely in their terms and conditions for repayment. However, most student loans do not require the student to begin repayment of principal or interest until they have left school. Some loans are repayable through service, and are frequently referred to as scholarship/loans.

### **Federal Pell Grants**

The foundation of the Title IV aid programs and largest federal grant program since 1980, Pell Grants provide aid to undergraduate students solely on the basis of financial need. During 1996-

97, \$41.6 million in Pell grants was awarded to in-state UNC undergraduates. In 1998, Congress increased the maximum Pell award to the neediest students from \$2,700 in 1997-98 to \$3,125 in 1999-2000.

### **Federal Perkins Loans**

Formerly known as the National Direct or National Defense Student Loan program, Perkins Loans are low interest loans with eligibility based on financial need, as determined by the campus financial aid office using the Federal Methodology. Current annual loan limits allow undergraduates to borrow a maximum of \$3,000 per year.

### **Federal Family Education Loan Program (FFELP)**

North Carolina's Federal Family Education Loan Program, also known as the North Carolina Insured Student Loan Program, offers low interest loans to students and parents. Loan capital is provided by the North Carolina State Education Assistance Authority, North Carolina banks, and other investors. The FFELP includes Subsidized Stafford, Unsubsidized Stafford, and Parent Loans to Undergraduate Students.

### **Federal Direct Loan Program (FDLP)**

In 1993, Congress authorized a competing federal loan program to the FFELP. Under this direct lending system, capital for student loans is obtained by direct U.S. government borrowing by the Department of the Treasury and participating colleges and universities acting as agents of the Department of Education in making loans to students. The FDLP includes Subsidized Stafford, Unsubsidized Stafford, and Parents Loans to Undergraduate Students.

### **Institutional and Private Sources of Student Aid**

Campus-based institutional aid program constitutes the second biggest source of aid funds to UNC students. Institutional aid includes all aid from local campus sources including foundations and private donors. These funds include not only need-based aid, but also aid based on criteria such as academic merit, athletic ability, or musical or artistic talent. Although they collectively constitute the second largest group of aid to federal resources, they do not constitute a general source of aid funds, as most of the programs are available only to target populations. Some of the scholarships are: the American Chemical Society for Minority Scholars Program; the Aubrey Lee Brooks Scholarships; the Jagannathan Scholarships; and the Glaxo-Wellcome Opportunity Scholarships.

### **State Student Aid**

State resources account for the third largest source of student financial aid to UNC students; state aid consists mostly of grants, scholarships, and scholarship/loans. Notable programs include the North Carolina Teaching Fellows Program, the North Carolina Student Incentive Grant Program, Appropriated Grants, the Nurse Scholars Program, and a number of special-purpose programs for targeted groups.

## Appendix C: Definitions and Measures for the UNC Award Structure

All UNC students who are residents of the State of North Carolina are eligible to apply for aid. Undergraduates and graduate students who attend at least half-time are eligible for the program. Students will receive grant aid if they demonstrate financial need, as defined by the grant formula below.

### **Grant Formula**

**Grant award** = (Cost of Education) — (Contribution from Income + Federal Resources + Student Self-Help)

### **Definitions and Measures**

**Cost of Education** = Tuition + mandatory fees + a standard living allowance of \$6,750.<sup>16</sup>

**CI** = the Contribution from Income, which is a measure of the ability of the family to pay for college based on a measure of family income, adjusted by an assessment that differs between independent students and dependent students.

**Adjusted Income** = [(Total income)<sup>17</sup> — (federal, state, and local taxes paid) — (allowance for state taxes ) — (FICA taxes paid) — (income protection/maintenance allowance) — (employment allowance)].

**Allowance for State Taxes:** Dependent students and independent students with children receive an 8.5% allowance of total income; independent students without dependents receive a 1.5% allowance.

**Student Self-Help:** Each student is expected to contribute annually to the cost of his or her education through self-help, which is a combination of work, savings, student loans, and grants from sources other than the UNC Grant program. The maximum self-help expectations will differ by level of instruction: \$4,000 annually for freshmen and sophomores; \$5,000 annually for juniors and seniors; and \$7,000 annually for graduate students.

**Federal Resources:** The grant maximum will be reduced by the value of the Pell grant or the federal Hope tax credit or Lifelong Learning credit. Freshmen will not have grants reduced by the value of a Hope Tax credit, because it is received at the end of the school year. Students and families will be advised to include the value of grant aid as income for tax

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<sup>16</sup> Tuition and mandatory fees paid at UNC, adjusted annually with changes in tuition and fees, and capped at the maximum for UNC campuses. Tuition and fees will vary by campus, depending on the tuition and fee structure of each UNC campus. Student expense measures are standard for all campuses, and set at \$6,750.

<sup>17</sup> Total taxed and untaxable income, derived from the FAFSA or the NC tax form. Measures of federal, state, and local taxes and FICA are from the Institutional Methodology. All other measures are based on existing measures which are reported on the College Scholarship Profile, which is based on the Institutional Methodology (IM).

purposes as needed to receive the full tax credit for which they are eligible. The advice to the task force on this issue from the Internal Revenue Service is included as Appendix D.

***Part-Time Awards:*** Students attending at least half-time but less than full-time will receive one-half of the award they would have received if attending full-time.

***Award Caps :*** Grants will be based on need, as defined by the grant formula, and there is no system-wide cap for the program other than the total cost of attendance (net of gift and from all other program sources). Campus aid officers are to adjust awards to reflect the value of other campus resources that are made available to the student if total gift aid without adjustment would exceed the cost of education.

***Annual Changes:*** There will be annual adjustments to the cost of education to reflect any increases in tuition, mandatory fees, and living costs. Income protection and employment allowance calculations from the IM are also adjusted annually for inflation

**Appendix D: Opinion Letter from the Internal Revenue Service on  
Deductibility of Grants in Relation to the Hope Tax Credit**

**Internal Revenue Service**

**Department of the Treasury**

Washington, DC 20224

Human Capital Research Corporation  
1735 North Paulina, Loft 401  
Chicago, IL 60622

Person to Contact:  
M.F. Schmit; #50-06448

Telephone Number:  
(202) 622-4960

Refer Reply to:  
CC:DOM:IT&A06/COR-114578-99

Date:

OCT 14 1999

Attn: Brian Zucker, President

Dear Mr. Zucker:

This is in response to your inquiry of September 1, 1999, concerning the proper federal income tax treatment of amounts received as scholarships or fellowship grants. You are particularly concerned about the availability of the Hope Scholarship and Lifetime Learning Credits (education tax credits) in the case of excludable scholarship receipts that have been included in recipients' gross incomes for federal income tax purposes. We are pleased to provide the following general information and comments in response to your inquiry.

The federal income tax treatment of scholarships and fellowship grants is addressed in section 117 of the Internal Revenue Code (the Code). Section 117(a) provides that gross income does not include any amount received as a qualified scholarship or fellowship grant by an individual who is a candidate for a degree at an educational organization described in section 170(b)(1)(A)(ii) (describing, generally, a school).

Generally, a scholarship or fellowship grant is any amount paid or allowed to, or for the benefit of, an individual to aid such individual in the pursuit of study or research, whether at the undergraduate or graduate level. To be considered a scholarship or fellowship grant, an amount need not be formally designated as such; similarly, the mere designation of a payment as a scholarship will not govern tax treatment.

Only qualified scholarships may be excluded from gross income under section 117 of the Code. A qualified scholarship is defined as an amount received as a scholarship, and expended for qualified tuition and related expenses. Qualified tuition and related expenses are tuition and fees required for the enrollment or attendance of a student at an educational institution, and fees, books, supplies, and equipment required for courses of instruction at such an educational organization. Amounts expended for room, board, travel, and incidental living expenses are not

related expenses. Thus, scholarship receipts that exceed the amount of qualified tuition and related expenses are not excludable from a recipient's gross income under section 117. For example, stipend payments in excess of tuition and related expenses made to students for general living expenses are not excludable from gross income under section 117.

Generally, the statutory scheme of section 117 does not impose any direct tracing requirement on scholarship receipts and expenditures: Scholarship receipts are excludable to the extent of the recipient's qualified tuition and related expenses. To the extent that the terms of a grant specify that any portion of a scholarship grant *cannot* be used for tuition and related expenses, or designate any portion of a scholarship grant for purposes other than tuition and related expenses, such amounts are not amounts received as a qualified scholarship, and hence are not excludable from gross income.

Section 25A of the Code provides that, if certain requirements are met, a taxpayer may claim an education tax credit for the qualified tuition and related expenses paid to an eligible educational institution. Section 25A(g)(2) provides that the amount of qualified expenses that a taxpayer may use in claiming an education tax credit must be reduced by a qualified scholarship excludable from gross income under section 117.

On January 6, 1999, the Department of Treasury and the Service issued proposed regulations under section 25A of the Code. *See* 64 Fed. Reg. 794 (1999). The proposed regulations provide rules for reducing the amount of qualified expenses by scholarships excludable from gross income under section 117. Section 1.25A-5(c)(3) of the proposed regulations provides that a scholarship or grant will be treated as a qualified scholarship or grant excludable under section 117, unless: (1) the student reports the grant as income on the student's federal income tax return; or (2) the terms of the grant require it to be used for expenses other than qualified tuition and related expenses (a restricted grant). The following examples illustrate these rules:

Example 1. During 1999, Student attends an eligible educational institution. During the year, she pays \$2,500 for qualified tuition and related expenses and \$2,500 for room and board. She receives a \$2,500 unrestricted scholarship that may be applied against any of her costs of attendance. Under section 117(a) of the Code, Student may properly exclude the scholarship from gross income. If Student excludes the scholarship, she may not claim an education tax credit for the qualified expenses covered by the scholarship. Alternatively, Student may include the scholarship in gross income and may claim an education tax credit for the qualified expenses.

Example 2. The facts are the same as in Example 1, except that Student receives a \$5,000 unrestricted scholarship. Under section 117(a) of the Code, she may properly exclude \$2,500 as a qualified scholarship and should include \$2,500 in her gross income. If Student excludes \$2,500 as a qualified scholarship, she may not claim an education tax credit for the qualified expenses covered by the scholarship. Alternatively, Student may include the entire scholarship in gross income and may claim an education tax credit for the qualified expenses.

As you may be aware, the Internal Revenue Service issues both private letter rulings and general information letters to assist taxpayers in the preparation of their returns. As indicated, this is a general information letter; the procedures for requesting private letter rulings are set out in Rev. Proc. 99-1, 1999-1 I.R.B. 6.

We thank you for your interest and concern in this matter, and hope that the general information and comments provided are helpful. If we may be of further assistance, please do not hesitate to contact Michael Schmit of this office at (202) 622-4960 (not a toll-free call).

Sincerely yours,

Assistant Chief Counsel  
(Income Tax & Accounting)



William A. Jackson  
Chief, Branch 6

Enclosures:

- Copy of this letter
- Copy of your correspondence

# HCRC

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**HUMAN CAPITAL RESEARCH CORPORATION**  
Education Policy, Research and Evaluation

Michael Schmidt  
CC: DOM IT&A Branch 06  
Room 5026  
1110 Constitution Avenue N. W.  
Washington DC 20224

September 1, 1999

Dear Mr. Schmidt:

This letter concerns the interpretation of regulations relating to the Hope Scholarship Credit and the Lifetime Learning Credit under Section 25A-5 C and Section 117-6.

In general terms, I understand that only tuition paid out-of-pocket may be claimed as tax credits under the Taxpayer Relief Act of 1997. That is, tuition paid with scholarships and/or grants may not be claimed. This is stated in 1.25A-5 [c] (1) which says that scholarships and grants that are excludable from gross income must be used as an adjustment to qualified tuition.

However, because 1.25A-5 [c] (1) says that the grant is treated as qualified unless the student reports the grant as income on student's federal tax return, it suggests that a student can choose to report a scholarship or grant as income, even though IRS laws on scholarship/grant taxation would not require the student to do so.

Simply put, can a family choose to report any scholarship on the student's federal tax return as income, and thereby enable the parent to claim the tax credit on the parent's return under the Hope or Lifetime Learning credit, and, which, if any, scholarships and grants must be treated as non-excludable? Specifically, can a family choose to pay taxes on the Federal Pell, SEOG, State Grants or Institutional Grants that have not been explicitly ear-marked for tuition only?

Please be aware that the information you provide may have bearing on the formula for a newly designed need-based financial aid program for students who attend the University of North Carolina. As one of the project's consultants, I am seeking this information on behalf of the university's office of general administration. Because we are now in the final stages of the project and will hold our last taskforce meeting on September 15 to deliberate the components of the proposed design, your timely response would be greatly appreciated.

Thank you again for your time and consideration of this issue.

Brian Zucker  
  
President

P.S. Naturally, if you have any questions, please do not hesitate to call (773) 342-0440, fax (773) 342-0498 or e-mail [brian@humancapital.com](mailto:brian@humancapital.com)

cc: Gary Bames, VP Program Assessment and Public Service, University of North Carolina

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**Appendix E: State-funded Student Aid Programs for Undergraduates, 1997-98<sup>18</sup>**

<b>Program</b>	<b>Sectors</b>	<b>Expenditure</b>
<b>Need-based Programs</b>		
1. Appropriated Grants	UNC	\$9.8 million
2. Community College Scholarship	NCCCS	\$0.3 million
3. ECSU Incentive Scholars	UNC	\$1.4 million
4. Incentive Scholars (HBUs & UNCP)	UNC	\$1.6 million
5. Incentive Scholarship & Grant Program for Native Americans	UNC	\$0.4 million
6. Minority Presence Scholarships	UNC	\$1.3 million
7. NC Student Incentive Grants	All	\$2.5 million
8. State Contractual Scholarship Fund/SCSF	Private	\$19.7 million
<b>Total of need-based programs</b>		<b>\$37.0 million</b>
<b>Non-Need-based Programs</b>		
9. NC Legislative Tuition Grants (LTG)	Private	\$33.6 million
10. NC Veterans Scholarships	All	\$4.1 million
11. Tuition remission	UNC	\$0.7 million
12. Vocational Rehabilitation	All	\$9.0 million
13. NC Teaching Fellows	UNC/Private	\$7.3 million
14. Other vocational scholarship programs (students in nursing, teacher education, social work, health, science, and mathematics)	All	\$6.6 million
<b>Total of non-need-based programs</b>		<b>\$61.3 million</b>
<b>TOTAL OF ALL PROGRAMS</b>		<b>\$98.3 million</b>

<sup>18</sup> 1997-98 UNC-GA file on financial aid recipients.