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Educational opportunity and income inequality

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Abstract

Affordable higher education is, and has been, a key element of social policy in the United States with broad bipartisan support. Financial aid has substantially increased the number of people who complete university—generally thought to be a good thing. We show, however, that making education more affordable can increase income inequality. The mechanism that drives our results is a combination of credit constraints and the 'signaling' role of education first explored by Spence [Spence, A. Michael, 1973. Job Market Signalling, Quarterly Journal of Economics, 87(3) Aug., 355–374]. When borrowing for education is difficult, lack of a college education could mean that one is *either* of low ability *or* of high ability but with low financial resources. When government programs make borrowing or lower tuition more affordable, high-ability persons become educated and leave the uneducated pool, driving down the wage for unskilled workers and raising the skill premium.
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[With the G.I. Bill,] for the first time, the link between income and educational opportunity was broken. —Diane Ravitch in The Troubled Crusade: American Education 1945–1980 (1983)

1. Introduction

Governments at both the national and the state level in the United States spend large sums of money to make education affordable for the average American. Although subsidized state universities date to the 19th century, a focus on making college affordable for all dates to the Second World War. Starting with the GI Bill in 1944, the federal government has provided an ever-expanding package of grants, subsidized loans, subsidized 'work-study' jobs and other financial devices to college-going Americans. The results speak for themselves: between 1947 and 1999, the percentage of people 25 years old and over who had completed 4 or more years of college increased from 5.4% to 23.6%. By 2001, direct appropriations and grants at the state and federal levels had grown to $86 billion a year.[1] Nevertheless, many policy makers still think that college tuition remains a substantial and possibly insurmountable financial burden for American families. Ten bills directly addressing financial assistance for postsecondary education were proposed in Congress during 2003.[2] Both main candidates in the 2004 U.S. presidential election advocate making college more affordable. Bush touts his plan for "Strengthening Access to Post-Secondary Education and Job Training".[3] The Kerry campaign website says, "...every young person who works hard and wants to go to college should be able to afford it".[4]

Why does everyone think that making higher education affordable is a worthy goal for public policy? Many argue that education has positive social externalities. But others make the case that broader access to education promotes equality. For example, Harvard University President Larry Summers said in a Wall Street Journal interview, "No doubt, without this progress in promoting access to higher education, inequality would be even higher".[5]

In this paper, however, we argue that making education more affordable can lead to higher income inequality. We look at a world in which education acts as a signal of ability and households are credit-constrained, and we show that improved educational opportunity can increase wage inequality. The mechanism that drives our results is the 'signaling' role of education first explored by Spence (1973). Following his model, we make education costly in terms of tuition and effort, and the effort required is greater for low-ability persons. When households face credit constraints, lack of education could mean one of two things: low ability; or high ability and low financial resources. In other words, in contrast to Spence's model where differences in educational attainment can arise

[1] See Section 4 for details.
[2] See http://www.senate.gov.
[3] See http://www.georgebush.com/Education/Brief.aspx.
[4] See http://www.johnkerry.com/education.
[5] "Bush, Kerry Duel, Differ on College Costs", by David Wessel, *The Wall Street Journal*, July 29, 2004.

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