

The Ethical Implications of Using Freshman Financial Aid as a Recruitment Tool without Subsequent Inflationary Adjustments

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Abstract

With competition for prospective students increasing among America's private colleges and universities, more and more institutions are turning to financial aid awards as a recruitment tool. Often these awards are proportionately larger for incoming freshman and subsequently capped for the remaining years of schooling with no adjustment for inflation. This paper seeks to determine the ethical implications of this practice utilizing three well established ethical models: Potter's Box, Stakeholder Theory, and Contract Theory. While the institutions defend the practice and meet legal disclosure obligations, ethical conflicts are identified and aspects of the financial aid award policy are found to be unethical.

Key Words: Education Finance, Ethics, Financial Aid, Higher Education, Tuition

JEL Codes: I21, I22

Introduction

Recent literature in the area of ethical finance has focused on the ramifications of the Stakeholder Theory and the global recession's impact on its validity. The focus of this paper will be on Stakeholder Theory as it relates to the non-profit sector, specifically private institutions of higher education and their financial aid policies for incoming freshman. Financial aid will be defined as scholarship and grant monies, as research indicates that only this type of aid demonstrates a significant association with enrollment. (Somers, 1995)

Stakeholder Theory originated in R. Edward Freeman's seminal work Strategic Management: A Stakeholder's Approach, where the author defined organizational stakeholders as, "anyone who can affect, or who are affected by, the activities of a firm." (Bowie, 2002) For Freeman, the view that the role of finance was merely to maximize shareholder wealth was inefficient. Stakeholder theorists did not reject the importance of increasing wealth, but rather argued that an equal duty was also owed to groups outside the organization, impacted by their actions. (Freeman, 1984)

Accepting this definition, students are therefore stakeholders of the private institutions they attend. This paper will consequently consider the question: Is it a violation of the Stakeholder Theory, for private colleges and universities to grant larger financial aid packages to incoming freshman, as a recruitment tool, and not provide subsequent inflationary adjustments to offset known future tuition increases?

The importance of private higher education is undeniable. Representing an estimated 4% of our national \$13.7 trillion dollar gross domestic product (United States Department of Education, 2009); the question takes on a renewed significance in light of the recent global recession. In strong economic times few would argue that a duty to all affected parties is owed. When firms face increased financial difficulties however, the question of whose duty is paramount is considerably harder to answer. The dilemma is the same for non-profit organizations as well as they seek to operate in the black. In fact, one could effectively argue the dilemma is even more urgent for these firms given their limited resources. (Quelch, 2009)

Literature Review

The economic challenges facing private higher education are considerable. With large losses to endowment portfolios stemming from the financial markets collapse, and dim prospects on future giving, endowment driven institutions are joining the ranks of smaller, tuition driven institutions, recruiting potential students with aggressive financial aid awards.

Statistical analysis shows that applicants to private colleges were 23.5% more likely to enroll for each \$1,000 of aid awarded. (Somers, 1995) Michael McPherson, an advocate of equitable financial aid assessed today's climate as follows:

Institutions are increasingly inclined to use financial aid to recruit the most desirable students ... our most prestigious universities have been leapfrogging each other as they modify their aid systems to lure the students they want. The resulting free for all, with institutions competing for students and students trying to play one institution off against another, tends to divert financial support from very needy families toward middle- and upper-income students. (McPherson & Schapiro, 1999, p. 48)

At the heart of a private tuition driven academic institutions' survival are two key variables: recruitment and retention. Large incoming freshman classes are essential to the bottom line, and increasingly freshman financial aid award offers reflect this notion (recruitment). Some institutions have gone so far as to invite their applications to 'seek a response' or 'counteroffer' from their institution, once a competing offer is received. (McPherson & Schapiro, 1999) Proponents of the practice argue that increased competition among institutions leads to greater and more lucrative offers to students, a clear benefit. Critics counter however, that institutions do not fully disclose the aid practices used to freshman students. For example the practice of 'locking in' the first year award and offering no subsequent annual increase in spite of yearly, if not bi-yearly, tuition and cost increases. (St. John & E.P., 1995) In an article entitled Comparing Offers of Aid, David Fischer of U.S. News and World Report warned prospective students of the practice stating:

Some colleges and universities start off with a generous grant for a freshman and in later years dramatically change the deal. They leave the student in the uncomfortable position of having to borrow more than anticipated. (Fischer, 1997)

College financial aid counselors and administrations are quick to defend the practice however, questioning the importance of cost in selecting a college or university at all. Most students are more concerned with tuition expense only as it relates to perceived value of the education received they argue. The stronger the perceived market position of the institution, the less price is a factor. (Ihlantfeldt, 1980) In addition they point to research which indicates that while scholarship monies are useful in recruiting students, they actually have a negative impact on retention. Every \$1,000 received by freshman in scholarship or grant awards resulted in a 24.5% decrease in the probability of that student returning the following year. (Somers, 1995)

Student advocates reject this position however, arguing that the negative relationship observed is strongest with large (full or nearly full tuition awards) scholarships and not with the more common partial award packages. (Somers, 1995) In 2006, Neil Harrison of the University of the West of England comprised a comprehensive, quantitative analysis of factors impacting student retention at the undergraduate level. He found that the third highest complaint among the freshman student body was 'financial difficulty' (23%), with 9% of students leaving after their freshman year citing 'finances' as the sole reason. (Harrison, 2006) This, critics assert, is proof that when private institutions award aid to freshman, and do not fully disclose that the award will not be adjusted for inflation, it forces students to either leave the institution in subsequent years, or pay a higher percentage themselves.

Utilizing a strategy of attractive financial aid awards for prospective freshman students is understandable given its direct impact on recruitment. What is less clear is whether current financial aid administration policies are a violation of the Stakeholder Theory or not. Consider the duties owed stakeholders of academic institutions according to Freeman. For a private academic institution, operating profitably is one duty owed to its faculty, alumni, staff, community, and student body. Profitability, the institutions argue, is the only way to ensure long term operation and service. Securing strong freshman classes, and allowing these classes to become more profitable to the institution in their sophomore, junior, and senior years, is one way of achieving the duty of profitability. Focusing on the duty of profitability alone, critics charge, denies the student the additional, and equal, duty of comparable financial aid year to year.

There is little disagreement between universities and student advocates that a duty is owed to their students with regards to aid. Yet there is strong disagreement on exactly what that duty is and the minimal actions required to meet it.

Research Question

The question posed by this paper can be stated as, “is it ethical for private colleges and universities to award proportionately larger financial aid packages to incoming freshman as a recruitment tool, and not provide subsequent inflationary adjustments to offset known future tuition increases?” The meaning of the phrase ‘proportionately larger’ with regards to financial aid packages refers to awards where new applicants to the institution receive 15% to 20% more than currently enrolled students. (Fischer, 1997) The term ‘financial aid packages’ will be defined as scholarship and grant monies, as research indicates that only this type of aid demonstrates a significant association with enrollment. (Somers, 1995) Lastly, “known future tuition increases” refers to administrators, trustees, and board members of the private institution that are aware of future planned tuition increases at the time the awards are offered.

Several ethical models address the question, albeit from differing perspectives. This paper will focus on three of these models: Potter’s Box (as the main ethical framework), the Stakeholder Model, and Contract Theory. The main ethical model examined is Potter’s Box, developed by Ralph B. Potter, professor of ethics emeritus at Harvard Divinity School. A simple, yet powerful, ethical framework, Potter’s Box utilizes four categories or stages deemed “universal” to all ethical dilemmas. (Christians, Fackler, Rotzoll, & McKee, 2001)

The first step is the ‘definition/fact’ stage. As the name implies, this is the point where the basic facts of the situation are established. No information is withheld and no judgments are made. The question at hand is simply clarified and defined. The second stage is the ‘values’ stage. Potter correctly noted that our personal values influence our definitions of right and wrong, but also that it is important to consider the value perspectives of others involved in the dilemma. A complete understanding of all competing and complimenting value perspectives is essential to making a correct ethical decision. (Christians et al., 2001) The third stage is the ‘principles stage.’ In this stage, several ethical philosophies and viewpoints are examined and applied to the situation. No philosophies are excluded, and while Potter focused on five well known models (Aristotle’s Golden Mean, Kant’s Categorical Imperative, Mill’s Principle of Utility, Rawl’s Veil of Ignorance, and Agape Principle in his personal decision making, this paper will instead utilize the established philosophies of the Stakeholder and Contract Theories for stage three (principles stage). The final stage in Potter’s Box is ‘loyalties.’ Here the decision maker must determine where their allegiances and loyalties ultimately lie. Duties may be owed to several parties, but Potter argues that a hierarchy of importance establishes which value perspective and principle should govern the decision.

Referring back to the principles stage, the first model utilized is Freeman’s Stakeholder Model. In his seminal work *Strategic Management: A Stakeholder’s Approach*, the author defined organizational stakeholders as, “anyone who can affect, or who are affected by, the activities of a firm.” (Bowie, 2002) For Freeman, the view that the role of organizations was merely to maximize shareholder wealth was inefficient. Stakeholder theorists did not reject the importance of increasing wealth, but rather argued that an equal duty was also owed to groups outside the organization, impacted by their actions. (Freeman, 1984) Accepting this definition, students are therefore stakeholders of the private institutions they attend, and these institutions subsequently have ethical obligations to them. There are several problems with the Stakeholder Theory in this context however. While many scholars contend that the theory is equally appropriate for non-profit organizations, by definition it is clearly most applicable to firms seeking to maximize shareholder wealth while considering everyone involved with the enterprise. Additionally, in his 1991 article entitled, “Business Ethics and Stakeholder Analysis”, Kenneth Goodpaster noted a distinction between what he referred to as “fiduciary” and “non-fiduciary” obligations. Stakeholders, he held, were owed non-fiduciary duties, while stockholders were owed both non-fiduciary as well as fiduciary considerations. (Goodpaster, 1991)

Contract Theory is the next ethical model used as part of stage three; not to be confused with the larger class of models known as ‘social contract theories’. According to the contract theory, the relationship between an organization (i.e. private institution) and its customers (i.e. freshman students) is essentially a contractual one. The terms of the agreement are entered into freely and these terms establish any and all ethical duties owed.

There are four main ethical duties established by this ‘contract’ between the two parties. First, both sides agree to comply with the terms of the contract as established. Secondly, the nature of the product or service must be clearly disclosed.

Thirdly, any misrepresentation must be avoided, with emphasis placed on open and direct communication. Lastly, duress or any other undue influence upon the customer must be avoided. (De George, 1993). The development of Potter’s Box model now provides a strong basis to examine the question, “is it ethical for private colleges and universities to award proportionately larger financial aid packages to incoming freshman, as a recruitment tool, and not provide subsequent inflationary adjustments to offset known future tuition increases?” and determine an answer. Figure one illustrates the ethical framework of Potter’s Box.

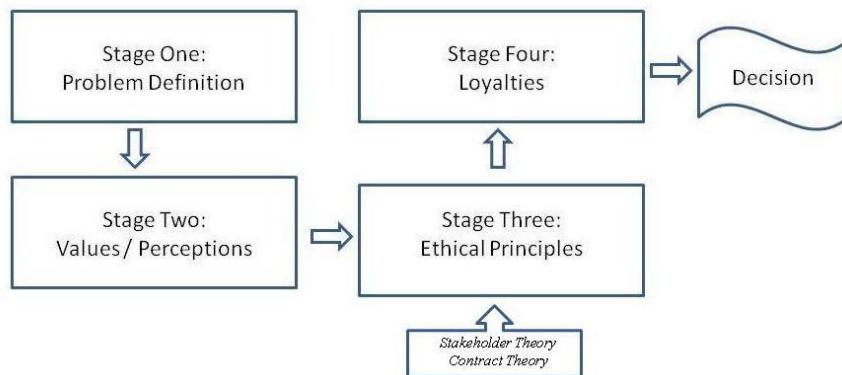


Figure 1

Results

Based upon the ethical model established in chapter three, the practice of private colleges and universities utilizing proportionately larger financial aid as a freshman recruitment tool, with no subsequent inflationary adjustment over the rest of their collegiate career, is unethical. In order to understand this conclusion, and support its validity, consider each stage of the established Potter’s Box Model.

Definition of the problem, stage one, has already been established and is again stated precisely at the start of Chapter Four. In stage two of Potter’s Box, the values/perception stage, two sets of values are considered; those of the institution and those of the student body. The party making the decision on student aid, the college or university administration, values things like financial stability, longevity, enrollment, and faculty morale. The student body perception is somewhat different as they value academic quality, tuition affordability, and personal stability.

Jumping to Potter’s third universal stage, the model requires the question to be viewed from the perspective of established and accepted ethical principles. Stakeholder theory clearly establishes that potential freshman students are owed a duty by the private colleges and universities they apply to and receive aid offers from. By definition, they are individuals who are ‘affected by the actions of a firm’ and therefore are stakeholders. It can be debated as to whether or not the duty is a fiduciary one or not, but a duty is owed. Moving to Contract Theory, the question of ‘what duty is owed’ is established. Four duties are owed to the individual parties according to the theory – first, compliance with the established terms of the contract (repayment, interest, etc). Secondly, full disclosure of the nature of the product or service must be provided. Private institutions do provide, in writing, an explanation of the offer including language that it will not include inflationary adjustments. This disclosure does meet the requirement of the theory, albeit at a minimum.

The third required duty, the avoidance of any misrepresentation between the contracting parties, is debatable however, and on this point an ethical challenge is raised. Professor of Law and International Business, Dr. Walter Hutchens of Whitworth University, noted that contract law recognizes and distinguishes between, material statements and material omissions. Stating in the contract that no adjustments for inflation will be provided is a ‘material statement.’

Failing to disclose that the institution will raise, *or expects to raise* (based on historical trends) tuition could be argued legally as a ‘material omission.’ (W. Hutchens, personal communication, March 2, 2010) Failure to provide this information is a misrepresentation, and therefore a violation of the Contract Theory ethical model. The final universal stage is ‘loyalties.’ Here the decision maker must determine where their primary loyalties and allegiances lie.

In the case of a non-profit, such as a private college or university, the primary obligation is owed to those the institution serves; the students. Considering each universal stage of the Potter’s Box model, the final decision is that the present financial aid practice is unethical as currently implemented.

Conclusions and Recommendations

The financial aid award procedure examined in this paper is widely accepted within the higher education community, and utilized by most private colleges and universities. While student protests and frustrations are voiced, they go largely ignored. The common response from administrators is that ‘the terms are disclosed at the time of the offer to the potential student, and therefore there is not an ethical issue’. This paper would propose a different approach; one that fundamentally achieves the same end results for the institution while rectifying the moral ambiguity. The current practice, as the posed question clearly states, is done to improve recruitment of new students. With the global financial crisis and shrinking state budgets, private schools are forced to compete even harder for the tuitions dollars required to keep their institutions operating. Given these resource limitations, inflationary adjustments may not be possible.

Awards may remain flat after the freshman year, however by disclosing not only this, but also the additional fact that ‘based on historical data, and expected inflationary challenges, tuition will most likely rise’ students have the whole picture. This accomplishes the required duty under the Contract Theory that any misrepresentation be avoided. One might argue that the awarding institutions would then be at a disadvantage, since competing institutions do not disclose likely tuition increases. However, given that nearly all institutions record yearly tuition increases, awarding institutions should not only educate prospective students up front to this reality, but also challenge them to question the awards from other colleges and universities.

This decision provides two key benefits. First, future student frustrations and feelings of misrepresentation are avoided. Student retention in subsequent years would increase, as well as alumni support after graduation, as both are tied directly to student perception and attitude about their educational experience. (Kealy & Rockel, 1987) Secondly, students are better equipped to make an educated decision on the right college or university for themselves.

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