

Loans for Educational Opportunity: Making Borrowing Work for Today's Students

Susan Dynarski and Daniel Kreisman



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Loans for Educational Opportunity: Making Borrowing Work for Today's Students

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NOTE: This discussion paper is a proposal from the authors. As emphasized in The Hamilton Project's original strategy paper, the Project was designed in part to provide a forum for leading thinkers across the nation to put forward innovative and potentially important economic policy ideas that share the Project's broad goals of promoting economic growth, broad-based participation in growth, and economic security. The authors are invited to express their own ideas in discussion papers, whether or not the Project's staff or advisory council agrees with the specific proposals. This discussion paper is offered in that spirit.

BROOKINGS

Abstract

Borrowing for college has risen for decades, and today 7 million of these student loans are in default. Yet the cost of borrowing is far lower than the lifetime payoff to college, which is estimated to be hundreds of thousands of dollars. Moreover, 69 percent of students borrow less than \$10,000 and 98 percent borrow \$50,000 or less. In addition, distressed borrowers do not have larger loans than other borrowers, though they do tend to be younger. These facts—moderate debt, a high payoff to college, high rates of default on typical loans, and high default among young workers—suggest we do not have a *debt* crisis but rather a *repayment* crisis. The current system turns reasonable levels of *debt* into crippling *payment* burdens that can prevent young workers from attaining financial independence and stability.

In this paper we propose a better model of loan repayment. A single, simple, income-based repayment system called Loans for Educational Opportunity (LEO) will replace the current, bewildering array of repayment options. Student-loan payments will automatically rise and fall with a borrower's earnings, just as contributions to Social Security rise and fall. A fraction of earnings will be deducted from each paycheck, with a larger fraction taken when incomes are high and a smaller fraction when incomes are low. A borrower who wants to pay off the loan more aggressively can file a W-4 that indicates the higher payment. If a borrower loses her job or suffers a pay cut, she will not need to file paperwork to adjust her payments since her withholding will automatically adjust. Payments will continue until the loan is paid off, for a maximum of twenty-five years.

This is a system of loan repayment designed for the 98 percent of students who borrow a manageable amount. For the other 2 percent, we propose stronger consumer protection: private student loans will not survive bankruptcy, loans that need a credit check will not be marketed as “student loans,” and individuals will exhaust all federal student loans before being allowed to take out any private loans.

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Chapter 1: Introduction

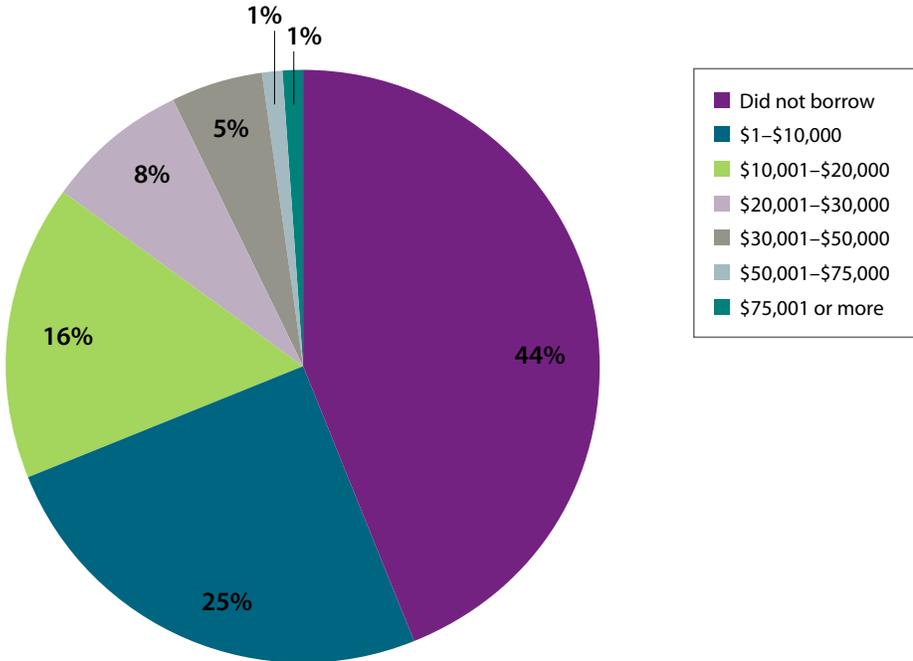
Borrowing for college has risen steadily for decades. Student-loan debt has mounted to \$1 trillion, now surpassing credit cards as the third-largest form of consumer debt.¹ With 7 million student loans in default and rising tuition prices, it is reasonable to wonder, “Is there a student-debt crisis?” At the heart of this question is a suspicion that borrowing is out of line with the value of college, just as mortgages were out of line with home values during the real-estate bubble. Are students underwater, with the carrying costs of their student-loan debt exceeding the value of their college educations?

As figure 1 shows, the facts do not support the popular narrative of crippling debt. In 2009, among those who had started college six years earlier, 69 percent had borrowed \$10,000 or less and 98 percent had borrowed \$50,000 or less.²

How do these data compare to the payoff to college? Over a lifetime, the typical holder of a bachelor’s degree (BA) earns several hundred thousand dollars more than a high school graduate. Even those who try college, but do not graduate, experience lifetime gains of about \$100,000 on average (Greenstone and Looney 2013). These facts indicate that most students have not borrowed more than their education is worth and are not underwater on their student loans.

The recent spike in defaults on student loans is worrisome. Surprisingly, defaults are not driven by the small fraction of borrowers with large loans. Rather, borrowers with typical levels of student debt struggle with their payments. Undergraduate borrowers who default have loans no larger than those who pay without incident.³ Overall, borrowers who default have borrowed less than those who pay without incident: the average loan in default is \$14,000 while the average

FIGURE 1.
The Real Numbers Behind Student Borrowing



Source: College Board 2012b.

Note: Data come from the 2009 Beginning Postsecondary Students Longitudinal Study for students first enrolling in fall 2003.

loan in good standing is \$22,000.⁴ To slice the data slightly differently, whereas 16 percent of borrowers are currently in default, just 11 percent of loan dollars are in default.⁵

Although the size of the loan does not predict default, the age of the borrower does. Younger borrowers are at far greater risk of default and delinquency. Among those under twenty-one, 28 percent have defaulted on their loans. This drops to 18 percent of borrowers between the ages of thirty and forty-four and 12 percent of those forty-five and older (Cunningham and Kienzl 2011).

These four facts—moderate debt for the typical student borrower, the high payoff to college, high rates of default on typical loans, and higher rates of default among young borrowers—suggest we do not have a *debt* crisis but rather a *repayment* crisis.

These four facts—moderate debt for the typical student borrower, the high payoff to college, high rates of default on typical loans, and higher rates of default among young borrowers—suggest we do not have a debt crisis but rather a repayment crisis.

We have a repayment crisis because student loans are due when borrowers have the least capacity to pay. Student borrowing is not excessive given the lifetime payoff to a college education, but current practice is for loans to be repaid during the first ten years after college. It often takes years for college graduates to settle into a steady, higher-paying job that reflects the value of their education. Yet payments on their student debt are due early in their careers, when incomes are relatively low and variable. As a result, loan payments consume a high proportion of borrowers' pay, especially during periods of unemployment or underemployment.

There are provisions that allow borrowers to suspend loan payments during hardship (forbearance, deferment), but many borrowers in distress do not use them (Cunningham and Kienzl 2011). Borrowers have many repayment options to choose from, including several income-based plans, yet only 14 percent are enrolled in anything other than the ten-year, flat payment schedule.⁶ Why? Applying for forbearance,

deferment, or an income-based payment plan is a confusing process whose demands overwhelm borrowers, especially those in distress.

The current system turns reasonable levels of *debt* into crippling *payment* burdens that can prevent young workers from attaining financial independence and stability. The mismatch in the timing of the benefits of college attendance (a steady, well-paying job) and the *costs* of college attendance (loan payments) produces financial distress and damaged credit records. As penalties and fees accrue, a few missed payments can lead to rapidly rising balances.⁷ The damaged credit record that results from even a few missed payments increases the costs of borrowing for a home, a car, and on credit cards. It can also lead to lost employment opportunities.

In this paper, we propose a better model of loan repayment. Under our proposal, student-loan payments will automatically

rise and fall with a borrower's earnings, similar to contributions to Social Security. Payments will be automatically deducted from borrowers' paychecks, similar to Social Security contributions. We call this system Loans for Educational Opportunity (LEO). Instead of paying off loans during a fixed, ten-year period, borrowers will have up to twenty-five years to repay. We expect most borrowers will repay in about ten years, as is true now. Those with low earnings, however, will take more time and those with high earnings will take less time, as borrowers' payments rise and

fall with earnings. Any borrower can opt to pay down the loan more quickly than the automatic, default payment would imply. Payments will continue until the loan (principal plus interest) is paid off, for a maximum of twenty-five years.

Students will still repay their loans, but on a schedule that adjusts flexibly with their incomes. As a result, LEO need not cost taxpayers any more money than the current system. In fact, our approach could be less expensive because it will reduce defaults and cut the cost of loan servicing, which is currently contracted out to private loan servicers. Further savings will come from eliminating what will become redundant policies, such as the student-loan interest deduction and the in-school interest subsidy.

A number of other countries rely on similar, income-contingent repayment plans to help their borrowers manage their student debt. Australia, New Zealand, and the United Kingdom, for example, have implemented successful systems

that provide clear lessons for the United States (see Barr 2011). Closer to home, the debate over an income-based repayment system in the State of Oregon has gained national attention.

In our proposal, employers withhold loan payments from paychecks just as they withhold deductions for Social Security and income taxes. To start repayment, employees will check off a box on their W-4 form, which is already used to manage tax withholding. Self-employed workers will make their loan payments on a quarterly basis, just as they handle their federal income and payroll taxes. Any underpayments or overpayments will be reconciled on the annual federal tax return.

Any borrower who wants to pay off the loan more aggressively than the default plan can file a W-4 that specifies the higher payment, just as taxpayers can adjust their tax withholding. A borrower will pay a fraction of earnings with each paycheck; the fraction is larger when incomes are high and smaller when incomes are low, just as with income-tax withholding. If a borrower loses her job or suffers a pay cut, she will not need to file paperwork or even make a phone call in order to adjust her payments. Instead, the payments will automatically be reduced (or stopped altogether) to reflect this setback. The payment plan can be calibrated so most students will repay their loans in about ten years, as they do now. Those with periods of low

earnings will have more time to repay. Designed appropriately, the vast majority of students will repay the entirety of their loans, but those undergoing persistent hardship will have their remaining balance forgiven after twenty-five years. Borrowers will not owe any taxes on the forgiven amounts.

Borrowers will pay an interest rate that varies over the life of the loan. Importantly, payments will not vary as interest rates rise and fall. A drop in the interest rate will shorten the time it takes to pay off the loan, and an increase will lengthen it. The interest rate will reflect the cost to taxpayers of borrowing the capital for the loans, the riskiness of the loans, and administrative costs.

This is a system of loan repayment designed for the vast majority of former students—the 98 percent who borrow a manageable amount (\$50,000 or less). For the other 2 percent, the problem is very high levels of debt. For this group, we need better consumer protection. We propose tighter regulation of the private lenders who own most of these very large loans and better protection for borrowers in bankruptcy. Student loans made by private lenders currently survive bankruptcy, an unprecedented protection for private lenders making unsecured loans. This special protection of private lenders should be eliminated.

Chapter 2: Why We Need a New Student-Loan System

Why does the government offer student loans?

Education is an investment—students incur costs now, but get the benefits later. To pay the current costs of their education, students need cash. In a business deal, a borrower puts up collateral in order to fund a potentially profitable investment. The collateral would typically include any capital goods used in the fledging enterprise, such as a building or machinery. Similarly, homeowners put up their home as collateral when they take out a mortgage.

Students cannot put themselves up for collateral; they cannot contractually commit to hand over their future labor to a lender in exchange for upfront cash (after all, indentured servitude is illegal). This is a market failure—there are good investments to be made, but private lenders are reluctant to make these loans, just as they are reluctant to make (and demand higher interest rates for) other unsecured loans.⁸ This failure in the student-loan market is an opportunity for governments to intervene to improve the lives of their citizens. Indeed, the public sectors of most developed countries and many developing countries provide loans to students.

College is one of the best investments a young person can make (Greenstone, Looney, Patashnik, and Yu 2013). College graduates earn more than workers without college degrees, are more likely to have health insurance, and are less likely to be unemployed during tough economic times. Student aid—in the form of both grants and loans—makes this investment possible for millions of students each year. Making loans work for today’s students, both when they are in college and after they enter the labor market, is the challenge we address in this proposal.

TRENDS IN BORROWING, COLLEGE ENROLLMENT, AND COLLEGE COSTS

As context for our critique of the current loan system and proposed reforms, we describe trends and patterns in student borrowing and debt. Student borrowing doubled between 2001 and 2011, from \$56 billion to \$113 billion a year (constant 2011 dollars; College Board 2012b, fig. 6). However, borrowing has increased, in part, because there are more students. College enrollment rose 32 percent in the decade between 2001 and 2011 (National Center for Education Statistics [NCES] 2013, tbl. 221).⁹ But this 32 percent jump in the number of college

students cannot explain all of the increase in borrowing for college. Over the same period, annual borrowing per student rose from \$3,500 to \$5,400.

In just ten years, then, borrowing per student has risen by 54 percent. This is not nearly as scary a statistic as the doubling of student borrowing over the same period, or the headline of \$1 trillion dollars in student-loan debt. Furthermore, annual borrowing of \$5,400 does not sound nearly as scary as the \$100,000 loan debts that are spotlighted in the news. But an increase of 54 percent is still a sobering, attention-grabbing statistic that demonstrates that families and students increasingly rely on student loans to pay for college.

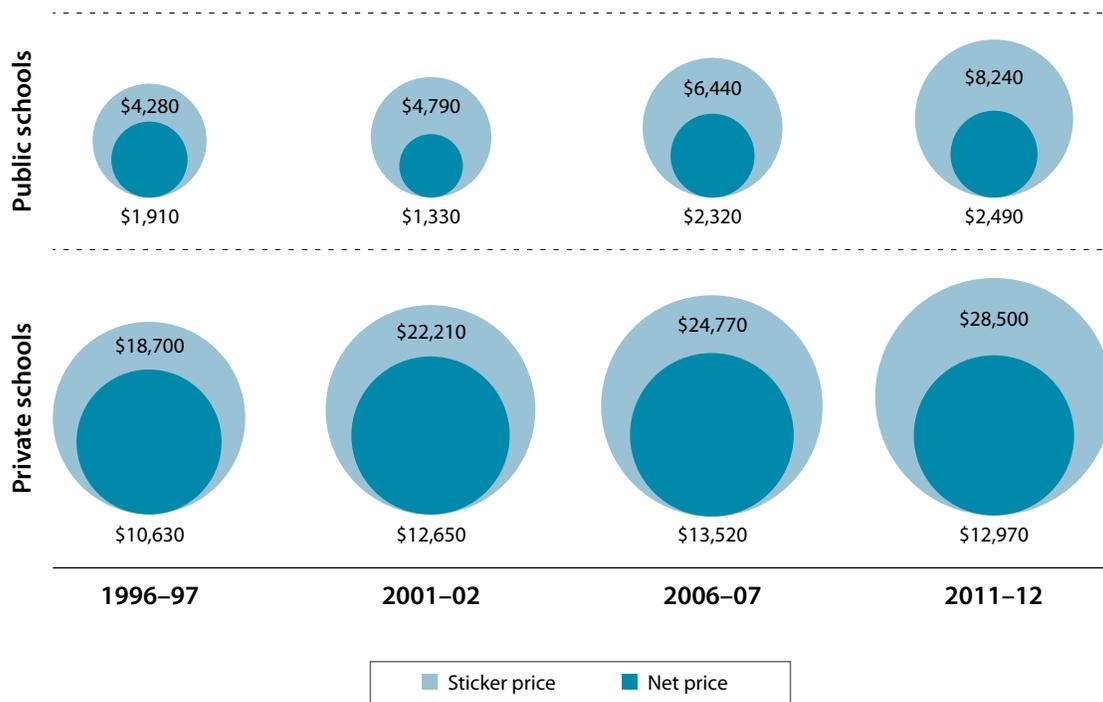
An increase in average student borrowing can be driven by one or both of two factors: an increase in the share of students taking out loans, and/or an increase in the size of the loans they take out. Both of these factors appear to be at work today. Federal Stafford loans are the largest loan program, accounting for 75 percent of student-loan volume. In 2001, 34 percent of college students took out a Stafford loan; by 2011, that number had risen to 50 percent.¹⁰ The average loan taken out by borrowers went up by less than 8 percent, by contrast—from \$7,600 to \$8,200, in constant 2011 dollars.

These statistics paint a fairly consistent picture of more widespread borrowing and, among those who borrow, of higher balances.

While we know that students now borrow more, it is not clear why. Rising college costs are a natural suspect. But while the sticker price of college has risen for years, so too has aid (see figure 2). At public colleges, where 80 percent of students are enrolled, the sticker price of college increased by \$3,450 in real terms from 2001–02 to 2011–12. But after netting out increases in grants and tax credits, the out-of-pocket cost of college rose by just \$1,160. At private schools, which frequently offer grants to students, net prices rose even less, by \$320. These increases in net price cannot explain the \$1,900 increase in average borrowing.

Why borrowing is rising faster than the net price of college is not a settled question. The family-income distribution has become much more unequal over the past several decades, with incomes dropping among the lowest-earning

FIGURE 2.
The Net Cost of College



Source: College Board 2012a.
Note: Prices are in constant 2011 dollars.

households, stagnating in the middle, and rising only at the very top (Piketty and Saez 2003). For the majority of families, flat college costs represent a mounting share of family income. These shifts in the income distribution may explain at least part of the increasing reliance on loans to cover college costs.

FACTORS TO CONSIDER IN DESIGNING A NEW LOAN SYSTEM

For the purposes of this paper, we take it as a given that students borrow to pay a substantial part of their college costs. Also for the purposes of this paper, we are neutral on whether the shift to an increased reliance on student loans is good or bad. Rather, we point out that the current system of borrowing and repaying student loans was built when students did not borrow as much as they do now. While the standard repayment system was manageable for the few students who borrowed, and the small amounts they borrowed, it does not work well for today’s borrowers, particularly in today’s tough labor market. Our proposed reform of loan repayment does not preclude any shift back toward a model where students borrow less. Our proposed system is flexible and compatible with a world in which students borrow small or moderate amounts.

Most students borrow small or moderate amounts.

For the vast majority of students, loan debt is lower than is widely perceived. Consider students who first enrolled in college in 2003–04. Six years later, in 2009, 44 percent had no student debt and another 25 percent had borrowed \$10,000 or less (figure 1). That is, 69 percent of undergraduates had borrowed \$10,000 or less, another 29 percent had borrowed between \$10,001 and \$50,000, and only 2 percent had borrowed \$50,001 or more (College Board 2012b). Based on limited data, today’s entering college students appear to be on a similar path. While attention is focused on extreme cases, only a very small share of undergraduate borrowers hold the \$100,000 loans that grab the headlines.

Policymakers urgently need to address the problems of the 2 percent of college students who take out very large loans, and we discuss proposed reforms below. However, our repayment proposal is designed with the typical student borrower in mind, not the rare outliers. The overwhelming majority of borrowers need a sensible model for repaying their loans.

Most defaults occur on modest balances.

While attention is focused on borrowers with high loan balances, most defaults occur on much smaller loans. In fact,

on average, the loan balance of those who default is *smaller* than among those who pay without adverse event: \$6,625 versus \$8,500 (Cunningham and Kienzl 2011, tbl. A-6).¹¹ The average loan in default is about \$14,000, while the average loan *not* in default is \$22,000.¹² Furthermore, the data indicate that there are more students who experience temporary rough patches but do not default than there are students who default: the delinquency rate (being behind on payments for 60 to 120 days) is much higher than the default rate (Cunningham and Kienzl 2011). Most of these delinquent borrowers eventually manage to repay, but with damaged credit histories.

There are programs to help borrowers in distress. But applying for forbearance or deferment involves bureaucratic hurdles

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and detailed paperwork, real obstacles for borrowers who are in financial distress. The simple fact that many delinquent borrowers do not make use of forbearance, deferment, or income-based repayment suggests that the current system is not addressing their problems.

The current loan system puts pressure on incomes when they are lowest.

Education is an investment that pays off over a working life. For most loans, the repayment period matches the life of the investment. No banks offer a twenty-five-year loan for a car, but they do for a house: the car will probably be worthless after fifteen years, whereas the house can provide shelter for decades. Furthermore, few families could afford to own a home if they had to pay off the mortgage in just a few years. The same logic applies to student loans. The maximum life of an education loan should reflect the decades of increased earnings that education produces. A longer repayment period also allows more students to afford college, since some cannot pay off their loans in ten years without severe financial stress

even if the lifetime payoff to college makes it worthwhile. Ten years was manageable when loans were smaller, but as students take on more debt, a ten-year repayment period has become burdensome.

The mismatch between the timing of the costs and benefits of education is especially salient among young borrowers, who are most likely to default. Of borrowers under twenty-one, 28 percent default. The default rate drops sharply with age, to 18 percent of those aged thirty to forty-four and 12 percent among those forty-five and older (Cunningham and Kienzl 2011). This pattern makes sense when you look at the time path of earnings. Earnings are lowest and most unstable in the years right after college, yet it is in these most uncertain years

that workers pay their loans. Among those with at least a BA, median earnings are \$32,000 for those aged twenty-four to thirty, \$48,000 for those thirty-one to forty, and \$50,000 among those forty-one through forty-eight.¹³ It is a lot easier to make loan payments on an income of \$48,000 than on one of \$32,000.

Charge an interest rate that holds taxpayers harmless.

It is our premise that the government should seek neither to make nor to lose money from student loans. Student loans correct a capital market failure: the private sector will not provide loans that are secured

only by a borrower's future earnings. Federal student loans therefore solve a liquidity problem, not a pricing problem. Student loans are appropriate neither for raising revenue nor for subsidizing college.

The first point, we suspect, is not controversial: the system for funding education is not where we should be looking for revenue to drive down the deficit. Taxpayers should be compensated for the costs of providing the loan, including administrative costs, default risk, and the cost of borrowing, but that is all. Loans should not be viewed as a revenue source.

The second point—that government should not charge below its cost of lending—bears more explanation, because many students, parents, politicians, and journalists argue that low interest rates help students. While an interest subsidy certainly drives down payments (which begin *after students leave college*), it is a poor tool for increasing schooling and reducing loan defaults. As we have discussed, the evidence suggests that defaults are driven by an ill-timed, rigid payment system that

stresses young borrowers. Many of these distressed borrowers, once they settle into their careers, will earn comfortable salaries. An across-the-board interest subsidy benefits every borrower, including those whose educational investment pays off handsomely. An interest subsidy is a poorly targeted, inefficient, and costly tool for reducing loan default. (See Barr and Johnston 2010 for a full discussion.)

Subsidized interest rates are also a poor tool to encourage educational investments. By definition, these subsidies do not arrive until long after students have decided to attend college.

Only after college is complete do the former students receive the benefits of an interest subsidy—and even then those benefits are hidden within the loan payment. The evidence from behavioral economics suggests that tangible and salient incentives at the moment of decision-making are most effective in changing behavior. Evidence further suggests that grants, counseling, and targeted information are all more effective than an interest subsidy at promoting college attendance and completion. Funds spent on interest subsidies would be better spent on these more-effective programs.

Chapter 3: Detailed Proposal

We propose two major reforms to the student-loan program to address the challenges described above. Both these reforms are discussed in detail in box 1.

1. Replace the current student-loan system with an income-based repayment system.

A single, simple, income-based repayment system called Loans for Educational Opportunity (LEO) will replace the current, bewildering array of repayment options. (See table A.1 in the appendix for an overview of current loan options.) Payments will be spread out beyond the low-earning early years so that young workers are not hit with large payments when they can least handle them.

2. Eliminate private servicing of loans and regulate private loans more tightly.

To protect students and their families from taking on too much debt, and to ensure that individuals are properly informed of their options in repaying their loans, we propose a number of changes to how private lenders operate: private student loans should not survive bankruptcy, loans that need a credit check will not be marketed as student loans, and individuals will exhaust all federal student loans before being allowed to take out any private loans.

INCOME-BASED REPAYMENT WITH LOANS FOR EDUCATIONAL OPPORTUNITY

Social Security allows workers to transfer funds from their productive working years to their older, retired years. LEO will allow workers to transfer funds from their productive working years to their younger, student years. Just as workers contribute a percentage of their earnings to their Social Security fund, working borrowers will contribute a percentage of their earnings to LEO.

Employers will deduct contributions in the same way that they deduct payroll taxes. First, the W-4 will be modified to include a checkbox that asks whether a worker has a LEO. Borrowers can also indicate a higher repayment amount than the one that would otherwise be automatically deducted by filing a W-4 that specifies additional withholding. Self-employment and multiple jobs will be handled in the same way as they are for Social Security and income taxes, with quarterly payments

and an annual reconciliation in April to correct any over- or underpayment.

Contributions will stop when the loan is repaid. This distinguishes our proposal from a new program under consideration in Oregon, where some borrowers would continue to pay even after they have paid off what they had borrowed, with interest. The Oregon approach is known as a graduate tax. With a graduate tax, the student's obligation is not denominated in dollars but as a percentage of income and number of years. In such a scheme, students with high earnings pay back much more than they borrowed.¹⁴ We think of our proposal as a friendly amendment to the Oregon initiative, which also seeks to create a system of flexible loan payments that reduces the stress on young workers.

The key principle of our proposal is that the repayment of loans will be *automatic* and *simple*. The existing withholding system for income and payroll taxes is the ideal payment mechanism. The withholding system allows for regular and automatic payments that adjust with earnings, is backstopped by an infrastructure of reporting and enforcement, and provides a periodic mechanism for reconciling payments and liabilities.

We see the Social Security Administration (SSA) as a good model for the agency that will administer LEO, since SSA serves a similar function in collecting and tabulating Social Security contributions. SSA manages the Social Security system at very low cost, tracks contributions made through the payroll system, receives payments from employers, shares data with the IRS to monitor compliance, and provides timely and helpful communication with workers and beneficiaries. The SSA has in-house expertise for analyzing data on earnings, contributions, and benefits; the SSA also pulls in outside academic analysts in order to keep the program ticking. Whoever runs the LEO system will need to collaborate with the IRS.¹⁵

An agency analogous to SSA can administer LEO. One option is to establish an independent agency in the spirit of the SSA. This is the approach used in the United Kingdom, where an independent government agency, the Student Loans Company, tallies and reconciles payments based on data transmitted from the tax authorities. A second option is to house the agency in the U.S. Department of Education (ED).

BOX 1.

Overview of Proposal

- The current loan repayment system will be replaced by an income-based repayment schedule called Loans for Educational Opportunity (LEO).
- After leaving college, individuals will repay student loans through their paychecks; employers will automatically deduct a fraction of their income according to the following specifications:
 - The W-4 form will be modified to include a checkbox that asks a worker whether she has a student loan. Employers will withhold contributions from individuals' paychecks, just as they withhold payroll taxes and personal income taxes.
 - Borrowers will contribute a fixed percentage of their earnings to repay their loans. The rate will be 3 percent on the first \$10,000 earned and will rise with earnings, topping out at 10 percent.
 - A borrower who wants to pay off the loan more aggressively can file a W-4 that indicates the higher payment.
 - Reports will inform the borrower of her total payments at the end of each tax year. This information will be transmitted to the IRS. On a quarterly or annual basis, the IRS will transmit information about the amount collected from each borrower to the agency running the loan program. The agency running LEO will then reconcile the borrower's account, notifying the IRS when the loan has been repaid.
 - Contributions will stop when the loan is repaid or after twenty-five years, whichever comes first. Balances remaining after twenty-five years will be forgiven, with no tax consequences.
- A board analogous to the Social Security Advisory Board will be created to administer LEO. This board will call on outside academic expertise in order to undertake the analyses and projections needed to keep the program running efficiently.
- The U.S. Department of Education will purchase federal loans now held by private loan companies in order to allow existing borrowers to shift to the new system.
- Student loan rates will be pegged to a variable interest rate that adjusts during the life of the loan. Monthly payments will not be affected by the interest rate.
- The federal government will increase regulation of private loans:
 - Protections for private lenders that allow private student loans to survive bankruptcy will be repealed.
 - Loans that require a credit check or cosigner will no longer be labeled as student loans.
 - Financial aid offices will certify a student's need before she can take out a private loan in order to prevent students from taking out a private loan when federal loans are still available.
- To offset the costs associated with the proposal, the federal government can take the following steps:
 - Stop paying loan servicers to collect loans, thereby reducing government expenditure by about \$360 million a year.
 - Eliminate the federal deduction for student-loan interest, which will save another \$1 billion annually.
 - Eliminate the in-school interest subsidy. The billions used on this subsidy will instead be used as grant aid.

We do not favor this approach, since it could easily distract ED from its mission of improving and encouraging education.

The new agency will receive loan payments through the same channels that feed the Social Security trust funds. Information reports will detail for the borrower her total payments in a year and will be transmitted to IRS in the same way that information about earnings is delivered. On a quarterly or annual basis, IRS will transmit to the administrator

information about the amount collected from each borrower.¹⁶ The administrator will reconcile the borrower's account, notifying the new agency and IRS when the loan has been repaid. Any overpayments caused by lags in reporting will be reconciled via annual income tax returns.

What about nonworkers?

The proposed withholding system collects loan payments from borrowers who work. Some will not work for pay after

college, including those who step out of the labor force to raise children. Lacking earnings, these borrowers fall outside the traditional withholding system.

We propose a number of solutions. For borrowers with a nonworking spouse who also borrowed for college, the W-4 form will allow for withholding for both the worker and the spouse. This allows couples to have their payments withheld automatically, without additional paperwork. The same percentage of earnings will be withheld as would be for a single borrower, but payments will continue until both loans are repaid.

In the case of borrowers with no labor earnings and no working spouse and therefore no W-4 form or withholding, the administrator will send bills based on the current, standard, ten-year payment. Borrowers can either pay the bill or file for deferment (reduction in payments) by demonstrating financial distress. When requesting deferment, the borrower would authorize the administrator to periodically verify income with data retrieved from the IRS. Any underpayments will be reconciled via annual income tax returns.

Contribution rates should rise with earnings.

We propose a progressive system of loan payments that rise with earnings. Like Social Security, they will vary over the course of the year, with a higher contribution rate triggered when borrowers pass an earnings threshold. Alternatively, the contribution for each pay period can be calculated by assuming that the worker will receive paychecks of the same size for the remainder of the tax year; this is how withholding for income taxes is calculated.

A flat contribution rate of 6 to 9 percent of earnings will pay off typical loans in ten to fifteen years, with some loans paid much more quickly. A lower contribution leads to a lower payment, a longer payment horizon, more interest paid by the borrower, and more loans forgiven after twenty-five years. Higher contribution rates have the opposite effects.

In our proposal, we focus on a progressive schedule of contributions in which the rate is 3 percent on the first \$10,000 earned and rises with earnings, topping out at 10 percent.¹⁷ From both equity and efficiency standpoints, we consider this preferable to a flat contribution rate (of 6 to 9 percent) that would produce similar repayment ratios. A contribution rate of 9 percent would nearly double taxes on the lowest earners, who pay payroll tax but no federal income tax. This could have negative impacts on the labor supply of this group as well as create financial hardship, which this proposal is intended to ameliorate.

While we provide the above contribution rates as an illustration, the specific parameters can be changed to achieve alternative goals. There are many contribution schedules that will work, with the choices affecting the length of payment, the level of payments, and the share of loans forgiven. Box 2 explains the

relationship between contribution rate, repayment period, and interest rate.

Set interest rates such that loans neither cost nor make money for government.

Interest rates should be set to hold taxpayers harmless for the costs of making student loans. These costs consist of the cost of borrowing, credit risk from unpaid loans, and administrative overhead. To keep loan rates closely tied to borrowing costs (which vary over the business cycle), we propose an interest rate that adjusts annually over the life of the loan and is not nominally capped. We propose using a loan rate pegged to Treasury rates, plus a fixed markup to compensate for credit risk and the costs of administration.

However, a variable rate means that interest accrues more quickly if rates rise. This highlights an advantage of the current, fixed-rate, level-payment system: payments are predictable. The downside of this predictability is rigidity: payments do not flex as earnings rise and fall. In an income-based repayment plan, the contribution is just as predictable as Social Security contributions: *payments are a percentage of earnings and do not vary with the interest rate.*

In an income-based plan, contributions do not rise when interest rates do. Instead, if rates rise, contributions are extended later into the working life. Conversely, lower interest rates do nothing to help young workers since they do not affect the level of their contributions. Instead, a lower interest rate allows a middle-aged worker to stop making loan payments earlier. Lower interest rates do not help those whose lifetime earnings are too low to pay off their loans, since they will see their remaining balances (including interest) forgiven after twenty-five years of payments.

We recommend charging interest during college. The in-school subsidy (which distinguishes the subsidized Stafford loan from the unsubsidized Stafford loan) costs billions of dollars per year, money that could instead be directed to grants. As discussed above, interest subsidies are costly but cannot increase college attendance since they do not arrive in time to affect students' schooling decisions. Funds that are now spent on in-school interest subsidies can be rolled into grants, which can influence students' decisions.

Why extend the repayment period as long as twenty-five years?

Education is an investment that pays off over decades; the repayment period should be commensurate with the investment. Theoretically, the contribution schedule could continue until someone retires, and so could be set at an even lower rate than we have proposed. Over forty years, the median person with a BA earns about \$1.85 million; the forty-year contribution rate required to pay off a \$25,000 loan is

BOX 2.

Key Parameters for Loans for Educational Opportunity

- Contribution rate. A higher rate
 - decreases the likelihood a borrower will have a balance to be forgiven at the end of the repayment period;
 - decreases the repayment period;
 - decreases interest paid by the borrower;
 - increases distortions to labor supply;
 - decreases the risk of negative amortization;
 - reduces the smoothing of loan payments, and therefore of consumption, across the life cycle;
 - decreases the repayment period for borrowers with higher incomes; and
 - increases financial pressures on low-income workers.
- Repayment period. A longer period
 - increases the smoothing of loan payments, and therefore of consumption, across the life cycle;
 - increases the share of borrowers who pay off their balances;
 - decreases the share of borrowers whose balances are forgiven;
 - increases interest paid by the borrower; and
 - allows for a lower contribution rate while maintaining program solvency.
- Interest rate. A higher rate
 - does not affect the payments made by a borrower;
 - lengthens the repayment period;
 - increases the risk of negative amortization, where borrowers' balances rise because interest exceeds their payments; and
 - decreases costs for government and increases costs for borrowers.

less than 2 percent. Over forty years the median person with some college but no BA earns about \$0.9 million; the forty-year contribution rate required to pay off a \$10,000 loan is less than 4 percent. It appears, therefore, that a forty-year payment horizon allows for a considerably lower contribution rate. While these low rates are quite attractive from an efficiency standpoint, we expect that these longer repayment periods would be politically unpopular.

Eliminate in-school interest subsidies.

The subsidized Stafford loan, which is limited to students who display sufficient financial need, does not charge interest while students are in school. This is expensive for the government and does not put any money into the hands of students. Instead, these interest subsidies reduce monthly payments once borrowers enter the labor market. If the intent of the in-school subsidy is to encourage low-income people to attend college, the funds would be better spent on grants, which put funds directly into the hands of low-income students.

Under our proposal, there is no relationship between the interest charged and the payments students make when they enter the labor market. An in-school subsidy would only serve to shorten the repayment period for those who receive it—from, for example, fifteen years to twelve years. This early cessation of payments equally benefits borrowers with very high incomes and those with typical incomes. It does not benefit *at all* those with the lowest incomes, since their balances are forgiven after twenty-five years.

Most students who have subsidized Stafford loans *also* have unsubsidized Stafford loans, which are charged a different interest rate and which accrue interest during college. This means that even low-income students end up (in a single year!) with a mix of loans with different interest and subsidy rates. This makes it tougher for students to understand how much they are borrowing and how to interpret their aid offers.

We propose the elimination of these specialized loan programs and the establishment of a single, simple loan program. The

interest rate will be the same for all borrowers. All borrowers will accrue interest during college. The savings from eliminating the in-school subsidy can be plowed into grants.

Allow existing borrowers to join the new system.

Borrowers under the old system will have the opportunity to convert to the new system. Only federal, undergraduate loans can be repaid in this way. Loans made to parents of students will not be eligible. This includes Federal Family Education Loans (FFEL), which are private, and loans from the ED’s Direct Loan Program (Direct Loans), which are public.

Existing borrowers can be brought into the new system by having the ED purchase existing student loans from the private loan companies. There is a precedent for this: during the credit crunch ED was authorized to buy loans from private servicers in order to free up capital so more student loans could be made.

REPAYMENT EXAMPLES

We give examples for several types of borrowers to show how the proposed system works. We use data drawn from the National Longitudinal Survey of Youth (1979) to make earnings calculations.

The examples focus on hypothetical students that borrow either \$25,000 or \$10,000, which places them within the range of most borrowers (83 percent of borrowers pursuing a BA borrow \$20,000 or less; College Board 2012b). We assume an interest rate of 3 percent in these calculations.

For each borrower we compare payments in the current system to those under our proposed system of income-based contributions. The examples are based on a progressive schedule, with a 3 percent contribution for the first \$10,000 in earnings, 7 percent for the next \$15,000, and 10 percent for all earnings above \$25,000. We choose these parameters because they produce a repayment schedule with two desirable characteristics: contribution rates are lowest when income is the lowest, and an average borrower with typical earnings will repay the loan in roughly ten years. Of course, these parameters could be changed to meet other policy goals, such as shorter repayment periods or lower contribution rates. Box 2 lays out the effects of varying the parameters on the length and level of repayments.

For each of our hypothetical borrowers, tables 1–4 summarize educational attainment, student debt, income at ages twenty-five and thirty-five, and monthly payments under the current and proposed systems. Table A.2 in the appendix displays these data in a single table.

Avery is a typical BA graduate with \$25,000 in debt.¹⁸

Avery earns a BA and leaves college with \$25,000 in student-loan debt. Her salary right out of college put her in the middle of her classmates, with annual earnings of about \$23,000 when

she starts working at age twenty-five. When her hours are cut during a downturn, her earnings temporarily drop to \$20,000. By the time she hits her thirties, she is earning \$35,000. In her mid-forties, she is earning closer to \$50,000.

Current system: Loan payments of \$241 a month take up 13

TABLE 1.
Avery: College Graduate with Typical Earnings

Four-year Bachelor’s degree	
Student-loan debt: \$25,000	
Starting income at age 25: \$23,000	
Income at age 35: \$35,000	
Low earnings of \$20,000 due to reduced hours	
Monthly payment under current system	Monthly payment under proposed system
\$241 at age 25 (13 percent of income)	\$100 at age 25 (5 percent of income)
\$241 at age 35 (8 percent of income)	\$196 at age 35 (7 percent of income)
\$241 during low earnings (15 percent of income)	\$82 during low earning (5 percent of income)
Total repayment of \$25,000 of principal, plus \$3,968 in interest over 10 years	Total repayment of \$25,000 of principal, plus \$6,795 in interest over 13 years

percent of Avery’s starting salary of \$23,000. When her hours are cut, her loan payments represent nearly 15 percent of her earnings. Repayment gets considerably easier in her early thirties, when her pay rises to \$35,000 and her payments represent just 8 percent of her earnings. She has repaid the \$25,000 principal, plus \$3,968 in interest, after ten years.

Proposed system: When she gets her first job at age twenty-five, Avery’s payment is \$100 a month. The payment is calculated as 3 percent of her first \$10,000 in earnings and 7 percent of the next \$13,000 and, overall, amounts to 5 percent of her pay. She is paid bimonthly, so \$50 from each paycheck goes toward her student loan. When her hours are cut, her payment automatically drops to \$41 per paycheck, or \$82 a month (5 percent of earnings). When Avery lands a job paying \$35,000, her payment rises to \$98 a paycheck, or \$196 a month (7 percent of earnings). Over this longer period, she pays more interest under our proposal (\$6,795 vs. \$3,968) but experiences less financial distress and emerges with a better credit history.

Ben is a typical college dropout with \$10,000 in debt.¹⁹

Ben spends a few semesters in college but does not graduate. He leaves college with \$10,000 in student-loan debt. When

he drops out and starts repaying his loans, he is working two part-time jobs, with annual earnings of about \$13,000. He loses one of his part-time jobs during a downturn. By the time he is in his thirties, he has a more stable job and is earning \$25,000 a year. His earning increase slowly through his mid-forties, when he earns just over \$30,000 a year.

TABLE 2.

Ben: College Dropout with Typical Earnings

A few semesters in college, does not graduate	
Student-loan debt: \$10,000	
Starting income at age 25: \$13,000	
Income at age 35: \$25,000	
Low earnings of \$6,500 due to loss of one part-time job	
Monthly payment under current system	Monthly payment under proposed system
\$97 at age 25 (9 percent of income)	\$42 at age 25 (4 percent of income)
\$97 at age 35 (5 percent of income)	\$113 at age 35 (5 percent of income)
\$97 during low earnings (18 percent of income)	\$16 during low earnings (3 percent of income)
Total repayment of \$10,000 of principal, plus \$1,587 in interest over 10 years	Total repayment of \$10,000 of principal, plus \$1,997 in interest over 10 years

Current system: Today’s standard repayment system would have Ben paying \$97 a month right out of college (9 percent of Ben’s starting pay of \$13,000). When he loses one of his part-time jobs, his loan payments take up nearly 18 percent of his earnings. Things get somewhat easier in his late twenties, when his pay rises to \$25,000. His payments now represent less than 5 percent of his earnings. He has repaid the \$10,000 principal, plus \$1,587 in interest, after ten years.

Proposed system: Ben’s initial payment is \$42 a month. He is paid weekly, so a bit less than \$10 of each check goes toward his loan, which is 4 percent of his earnings. When he loses one of his part-time jobs, his payment automatically drops to \$16 per month, or \$4 per check (3 percent of his earnings). When Ben lands a job paying \$25,000, his payment rises to \$113 a month (\$26 a paycheck, or 5 percent of his earnings). He has repaid the \$10,000 principal, plus \$1,997 in interest, after ten years. Thus, he pays off his loan under our proposal at about the same pace as he would have with the standard payment plan, but his experience is very different: payments drop to near zero when he hits a rough patch and rise slightly above the standard schedule when his pay increases. He pays

slightly more interest under the proposal (\$1,997 vs. \$1,587), but emerges with an undamaged credit record.

Cathy is a well-paid BA graduate with \$25,000 in debt.²⁰

Cathy earns a BA and leaves college with \$25,000 in student-loan debt. In her starting job at age twenty-five, she out-earns most of her classmates with annual earnings of about \$50,000. By the time she is thirty, she is earning \$75,000. In her mid-forties, she is earning close to \$180,000. In the twenty-five years after graduating, she earns about \$2.9 million.

Current system: Today’s standard repayment system would have Cathy paying \$241 a month—the same as her lower-paid classmates. Loan payments represent 6 percent of her starting

TABLE 3.

Cathy: College Graduate with Above-Average Earnings

Four-year Bachelor's degree	
Student-loan debt: \$25,000	
Starting income at age 25: \$50,000	
Income at age 35: \$75,000	
No period of low earnings	
Monthly payment under current system	Monthly payment under proposed system
\$241 at age 25 (6 percent of income)	\$321 at age 25 (8 percent of income)
\$241 at age 35 (4 percent of income)	\$529 at age 35 (8 percent of income)
Total repayment of \$25,000 of principal, plus \$3,968 in interest over 10 years	Total repayment of \$25,000 of principal, plus \$3,795 in interest over 7 years

salary of \$50,000. When her salary increases to \$75,000, payments are less than 4 percent of her earnings. After ten years she has repaid the \$25,000 principal, plus \$3,968 in interest.

Proposed system: Cathy’s payment starts at \$321 a month, or about 8 percent of her earnings (3 percent of her first \$10,000 in earnings, 7 percent of the next \$15,000, and 10 percent of the remaining \$25,000). When her pay rises to \$75,000, her payment automatically increases to \$529 per paycheck (8 percent of her earnings). Soon after she gets her raise she finishes paying off the loan, at age thirty-one. Because of her high earnings, she pays off her loan in just seven years, faster than under the standard payment plan. She therefore pays slightly less interest (\$3,795 vs. \$3,968).

Dana is a very-low-earning college dropout with \$10,000 in debt.²¹

Dana spends a few semesters at a for-profit college but does not graduate. She leaves college with \$10,000 in student-loan debt. When she drops out and starts repaying her loans, she is unable to find affordable care for her infant. She works part-time at night so she can watch her baby during the day. She earns about \$6,000 a year at first, and although her earnings rise and fall, they never get much above \$10,000.

TABLE 4.
Dana: College Dropout with Low Earnings

A few semesters at for-profit college, does not graduate	
Student-loan debt: \$10,000	
Starting income at age 25: \$6,000	
Income at age 35: \$10,000	
Low earnings of \$6,000 due to part-time job	
Monthly payment under current system	Monthly payment under proposed system
\$97 at age 25 (19 percent of income)	\$15 at age 25 (3 percent of income)
Cannot make payment at age 35	\$24 at age 35 (3 percent of income)
Cannot make payment during low earnings	\$15 during low earnings (3 percent of income)
Unable to make payments, goes into default	Repayment of \$8,527 over 25 years, and \$8,561 of debt is forgiven

Current system: Loan payments of \$97 a month represent 19 percent of Dana’s pay when she leaves college. She finds this impossible to pay given her other expenses, and her loan goes into default within a few years. She is harassed constantly by a collection agency. She misses out on several jobs when employers run a credit check and see the default in her record. She is unable to return to school because she is ineligible for a Pell Grant while in default.

Proposed system: When Dana leaves college, her payment is \$15 a month (3 percent of her earnings). In good years, when she earns close to \$10,000, her payment is \$6 per check, or about \$24 per month (3 percent of her earnings). After twenty-five years she has paid \$8,527 of her loan. The remaining balance of \$8,591 is forgiven. Dana pays back a substantial portion of her loan under our plan, albeit at a very slow pace. Under the standard plan she made only a few payments of \$97 before going into default, and the government spent a substantial sum on collection efforts.

As these examples show, the current system results in some borrowers owing a much higher share of their income in loan payments—which particularly affects those students least able to pay. This is especially true when times are tough, as when a borrower loses a job or work hours, but is also true for those with persistently low earnings.

REFORMING THE PRIVATE SECTOR’S ROLE IN STUDENT LOANS

While the reforms just described will help the vast majority of borrowers, a small fraction of borrowers accrue very large levels of debt that they will struggle to repay under any repayment system. Most of these largest debts include private loans. The situation with private lenders is analogous to the underwriting scandals in the mortgage market that left borrowers with loans that were far too large for their incomes to support. The answer in that case was not to eliminate mortgages for everyone or to cut mortgage rates, but rather to tighten consumer protections.

We propose stronger regulation of the private loan market in order to protect students from unmanageable debt. Students with large, private loans have little recourse because of changes in bankruptcy law in 2005 that extended special protections to banks making these loans. Bankruptcy law should revert to treating private student loans the same as any other unsecured, private loan.

Private loans more closely resemble unsecured consumer credit than they do student loans. The assets of a cosigner with a credit history secure these loans, so lenders do not bear the unique risks of traditional student loans. The interest rates often vary with the creditworthiness of the borrower, again unlike true student loans (Consumer Financial Protection Bureau [CFPB] 2012). These private loans do not correct the market failure of missing liquidity for investment in human capital and should not be thought of in the same way as the federal loans that do not require a cosigner or a credit score. Private loans should be regulated with the same vigor applied to credit cards, the financial instrument that they most closely resemble.

Private student loans should not survive bankruptcy.

This unprecedented level of protection to private lenders, which was established only in 2005, should be repealed. The protection from bankruptcy gives lenders incentives to make loans even to students who are unlikely to be able to handle the payments, since the lender knows the borrower cannot ever escape the debt. An excellent way to generate a bubble is to assure private lenders that borrowers can never escape their loans, even in bankruptcy.

Loans that require a credit check or cosigner will not be marketed as student loans.

Private lenders—and, for that matter, public lenders and schools—should not be allowed to use the label “student loan” for a loan that requires a cosigner or credit history. True student loans are secured only by the future earnings stream of the student. The lender’s willingness to make such a loan is limited by the potential earnings of the student borrower.

If a parent or other relative wants to help a student attend a college by borrowing against her own credit, she is free to do so. But the borrower—and the student—should recognize this loan for what it is: a consumer loan. The loan is not extended based on potential benefit of college to the student, but is based on the creditworthiness of the cosigner. Labeling them student loans (and setting high borrowing limits) signals to students and parents that they should take out large loans for college.

Removing the student loan label ensures that borrowers cannot confuse them with federal student loans and signals to students that they should borrow with caution. This point is related to our next recommendation.

Students must exhaust federal loans before taking out private loans.

There is evidence that students take out private loans without exhausting their Stafford loan options. Since private loans

are never a better deal than Stafford Loans, this reflects a lack of financial sophistication on the part of the borrowers and/or unscrupulous behavior on the part of private lenders. Requiring that colleges certify a student’s need before she can take out a private loan is a good step, but is probably not sufficient to rein in borrowing at for-profit colleges, where the share of students taking out private loans is three times as high as among other undergraduates (CFPB 2012).

BUDGETARY IMPACTS OF THIS PROPOSAL

This proposal can be implemented without adding to the federal deficit, and in fact we expect it will save money for the federal government. The only major costs that the government would bear are those associated with administering repayment of the loans, which is currently handled by the private sector. These costs, however, can be more than offset by three provisions of our proposal. First, under our proposal, the federal deduction of loan interest should be eliminated for federal borrowers paying through the new system (which, in time, should be everyone), saving \$1 billion in tax expenditures. Second, the proposal eliminates the contracts with private loan servicers, which currently cost about \$360 million annually (Office of Management and Budget 2012). Finally, as discussed above, the proposal eliminates the in-school subsidy, which will reduce by billions the cost of the federal loan program.

Chapter 4: Questions and Concerns

Don't we already have an income-based repayment plan?

A small share of borrowers use the income-sensitive plans. As of 2013, 88 percent of borrowers with Direct Loans are enrolled in a fixed repayment plan. Borrowers are pushed away from alternative payment plans by materials that portray them as having much higher costs than do the mortgage-style payments. The plans are also difficult to negotiate. Payments do not flex automatically. Borrowers have to send to their servicers documentation from the IRS that confirms their income. This must be repeated each year. The paperwork likely

There are income-contingent loan programs in many countries, including Australia, Chile, New Zealand, Thailand, and the United Kingdom, with generally favorable results.

puts off borrowers (especially those in financial distress) who would benefit from the income-based plans.

Perhaps most importantly, an income-based repayment plan is not the default option. As we have seen in multiple policy settings, defaults matter. Switching from the default payment plan to an alternative takes time and effort. A borrower in financial trouble has the least capacity to handle the process of reducing her payment by switching to an income-based repayment plan. If a loan is in distress and has gone to collection, evidence indicates that collection agencies also do not aid (and in fact actively discourage) the process of going into an income-based repayment.

In all of the current income-based repayment plans, we tax students on the value of any loan balance that is forgiven. This provision will be eliminated under our proposal.

We do not support making the Pay As You Earn (PAYE) program the default repayment option. PAYE, as currently structured, is extremely expensive and can forgive the loans of high earners. PAYE reduces payments below the standard, ten-year payment when earnings are low but does not raise them above that standard payment when earnings are high. As a result, borrowers with high, lifetime earnings will have their loans forgiven when the twenty-year repayment window closes (Delisle and Holt 2012).

Have similar proposals been tried elsewhere?

Yes. There are income-contingent loan programs in many countries, including Australia, Chile, New Zealand, Thailand, and the United Kingdom, with generally favorable results (International Comparative Higher Education and Finance Project n.d.). In the United Kingdom, for instance, workers contribute 9 percent of any income that exceeds £21,000; any remaining student-

loan balance is forgiven after thirty years. These countries can be useful models as policymakers explore switching to an income-based repayment schedule.

What about need analysis?

Our proposal decouples loans from need analysis. Any college student can access these loans as long as she agrees to repay them via the proposed payroll system. This simplifies the lives of borrowers, who are currently required to complete the lengthy FAFSA in order to get a loan. Our proposal thereby complements efforts to simplify the student financial aid system (Dynarski and Scott-Clayton 2007).

What about graduate students?

Our proposal is limited to undergraduate loans: there is less of a repayment problem among graduate students. Even though graduate students' loan balances are much higher, their default rate is only 3 percent, much lower than the 21 percent among undergraduates (Cunningham and Kienzl 2011, tbl. 3).

Our proposal will help those with graduate loans by making the payment of their undergraduate loans more manageable. We suspect that federal graduate loans could be integrated into this proposal, but further analysis would be necessary to estimate the required contribution rates.

What about PLUS Loans?

Loans to the *parents* of college students currently constitute about 10 percent of student loan volume (College Board 2012b). These loans are extended based on the creditworthiness of the parent, *not* on the potential benefit of college to the student. Recent news reports indicate that the ED has been lax in checking the creditworthiness of parents, in some cases extending loans to families who cannot possibly support the payments (Field 2013).

Loans taken out by parents will not be paid through the payroll system. The system we propose is a means for young people to access their future earnings.

Labeling loans to parents as student loans (and setting high borrowing limits) signals to students and parents that they should take out large loans for college. We suggest that the federal government get out of the business of making loans to parents. Comparable products exist in the private sector. Labeling them as federal aid is not warranted and may in fact make it easier for families to overborrow (Burd et al. 2013).

How should policymakers account for the costs of student loans in the federal budget?

Under the rules of the Federal Credit Reform Act of 1990, the costs of student loans are currently incorporated into the budget on a present-value basis using interest rates on U.S. Treasury Securities. The Congressional Budget Office (CBO) has urged that, instead, the costs of these loans be calculated using a market rate (CBO 2013). This is called fair-market value (FMV) scoring.

The CBO should carefully differentiate between different types of government credit when applying FMV methodology.

Some federal loans duplicate a product in the private market, and the FMV methodology makes sense for these products. As we explain below, Stafford loans and the proposed LEO do not have a market analogue, and so FMV methodology cannot be applied to these loans.

Parental PLUS loans require a co-signer with a credit record, and are secured by the assets of the parent. Because of this, they more closely resemble consumer loans than they do true student loans (such as Stafford loans and LEO), which require no minimum credit score and are secured only by the future earnings of the student.

There are many products on the market that resemble parental PLUS loans, including home-equity loans, credit cards, and other lines of credit. Because PLUS loans have a market analogue, we agree with the CBO that the FMV approach should be used to score parental PLUS loans.

However, we also recommend that the government stop making parental PLUS loans for two reasons. First, similar private products are available. Second, labeling PLUS loans as student loans suggests to families that the loan is offered because it is justified by the future earnings of the student, when in fact, it is justified by the credit-worthiness of the parent.

FMV does not make sense for LEO or Stafford loans, for which there is no market analogue. No lender will make a loan that is secured only by the future earnings of a student, at least not at a rate that reflects the economic value of this investment. Credit cards are the closest product, but they have much lower borrowing limits than student loans. Student loans are economists' classic example of a market failure: attending college is a good investment, but private lenders will not make the funds available at the appropriate rate, since it is so risky to lenders to make a loan that is unsecured by any tangible asset.

Since the private version of LEO and Stafford loans does not exist, the appropriate market rate is infinity. The FMV approach cannot be credibly applied to this product. But the current approach is also wrong, since the interest rate on Treasury Securities understates the government's cost of making these loans. Appropriately calculated, the cost of LEO and Stafford loans includes the administrative costs of running the programs, the credit risk, and the covariance of loan repayments with the overall economy.

Chapter 5: Conclusion

Student borrowing more than doubled between 2001 and 2011, with borrowing per student rising by 54 percent. Contrary to the popular narrative, loans are moderate in size, with 69 percent of students borrowing less than \$10,000 and just 2 percent borrowing more than \$50,000. For the vast majority of students, the amount they borrow is dwarfed by the lifetime payoff to a college education.

Yet, statistics on loan distress are disturbing. Seven million student loans are in default. Surprisingly, loans in distress are smaller than those that are not. Young workers have the hardest time paying their loans, with their likelihood of default several times higher than it is for older workers.

These four facts—moderate debt for the typical student borrower, the high payoff to college, high rates of default on typical loans, and higher rates of default among young workers—suggest we do not have a debt crisis but rather a repayment crisis. By compressing repayment into early careers, when earnings are lowest and most variable, the current system turns reasonable levels of debt into crippling payment burdens. While loans are manageable given the lifetime return to college, for many students they are not always manageable during the years right after school.

We propose a better model of student-loan repayment. Payments will automatically rise and fall with a borrower's earnings and will be automatically deducted from paychecks, just like Social Security contributions. We call this proposal

Loans for Educational Opportunity (LEO). Instead of paying off loans during a fixed, ten-year period, borrowers will have up to twenty-five years to repay. Most borrowers will repay in about ten years, as is true now. But those with low earnings will take more time and those with high earnings will take less time. Any borrower can opt to pay off the loan more quickly than the automatic, default payment would imply.

Our proposal is based on the premise that student-loan policy should be designed for the 98 percent of students who borrow a manageable amount. We also propose better consumer protection for the other 2 percent—in particular, we propose tighter regulation of the private lenders who own most of these very large loans.

LEO need not cost taxpayers any more than the current system. In fact, our approach could save money, as it will reduce defaults and cut the cost of loan servicing, which is currently contracted out to private loan companies. Further savings will come from eliminating the student-loan interest deduction and the in-school interest subsidy.

Student loans are, for the foreseeable future, part of the student aid landscape. They need to work for today's borrowers, both when they are in school and after they enter the labor market.

Our proposal allows borrowers the time and flexibility they need to repay their loans without jeopardizing their financial stability, credit, or job opportunities.

Appendix

TABLE A.1.

Current Federal Student Loan Repayment Options

	Standard Repayment	Graduated Repayment	Extended Repayment	Income-Based Repayment	Income-Contingent Repayment	Income-Sensitive Repayment	Pay As You Earn Repayment
Eligible loans	Direct and Federal Family Education Loan Program (FFELP)	Direct and FFELP	Direct and FFELP	Direct and FFELP	Direct	FFELP	Direct
Eligibility	Default plan.	By request.	Must have >\$30k in FFELP or direct loans.	Partial financial hardship.	Based on adjusted gross income (AGI) and total debt.	Based on AGI.	Based on AGI and loan debt.
Payments	Monthly payments \geq \$50.	Payments start low and increase every two years.	Fixed annual or graduated repayment.	Payments capped.	Payments are the lesser of 0.2* (AGI-(poverty level/12)), or (payment on a 12-year plan)* (percentage factor that varies with income).	Low pay forbearance lowers payments for 12 months at a time.	Payments are capped.
Term	10 years (up to 30 years if consolidated).	10 years (up to 30 years if consolidated).	Up to 25 years.	25-year term; any remaining balance is forgiven.	25-year term; any remaining balance is forgiven.	5 years, then defaults to standard or graduated.	Remaining balance after 20 years of qualifying payments is forgiven.
Note	If you do not select another plan, you are put on standard repayment.	Amount due each month must cover interest.	—	Reapply annually to qualify for the reduced partial financial hardship amount.	Adjusted annually; capitalization will not exceed 10% of the original amount.	Reapply annually.	Reapply annually to qualify for the reduced partial financial hardship amount.

Source: Nelnet, Inc. 2012.

TABLE A.2.

Repayment Scenarios under Current and Proposed System

The student	Avery: College graduate with typical earnings		Ben: College dropout with typical earnings		Cathy: College graduate with above-average earnings		Dana: College dropout with low earnings	
Educational attainment	Four-year Bachelor's degree		A few semesters in college, does not graduate		Four-year Bachelor's degree		A few semesters at a for-profit college, does not graduate	
Student-loan debt	\$25,000		\$10,000		\$25,000		\$10,000	
Starting income at age 25	\$23,000		\$13,000		\$50,000		\$6,000	
Income at age 35	\$35,000		\$25,000		\$75,000		\$10,000	
Reason for and income during periods of low earnings	Reduced Hours: \$20,000 income		Loses one part-time job: \$6,500 income		None		Part-time job out of college: \$6,000 income	
Difference in repayment under current system and proposed system								
	Current repayment system	Proposed repayment system	Current repayment system	Proposed repayment system	Current repayment system	Proposed repayment system	Current repayment system	Proposed repayment system
Monthly payment and percent of income at age 25	\$241 (13 percent)	\$100 (5 percent)	\$97 (9 percent)	\$42 (4 percent)	\$241 (6 percent)	\$321 (8 percent)	\$97 (19 percent)	\$15 (3 percent)
Monthly payment and percent of income at age 35	\$241 (8 percent)	\$196 (7 percent)	\$97 (5 percent)	\$113 (5 percent)	\$241 (4 percent)	\$529 (8 percent)	N/A	\$24 (3 percent)
Monthly payment and percent of income during periods of low earnings	\$241 (15 percent)	\$82 (5 percent)	\$97 (18 percent)	\$16 (3 percent)	N/A	N/A	N/A	\$15 (3 percent)
Total repayment	\$25,000 of principal, plus \$3,968 in interest over 10 years	\$25,000 of principal, plus \$6,795 in interest over 13 years	\$10,000 of principal, plus \$1,587 in interest over 10 years	\$10,000 of principal, plus \$1,997 in interest over 10 years	\$25,000 of principal, plus \$3,968 in interest over 10 years	\$25,000 of principal, plus \$3,795 in interest over 7 years	Unable to make payments, goes into default	\$8,527 in repayment over 25 years; \$8,561 of debt forgiven

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Susan Dynarski is a professor of public policy, education, and economics at the University of Michigan, where she holds appointments at the Gerald R. Ford School of Public Policy, School of Education, Department of Economics, and Institute for Social Research. She is a Faculty Research Associate at the National Bureau of Economic Research and the Center for Analysis of Postsecondary Education and Employment. Dynarski earned an A.B. in Social Studies from Harvard, a Master's in Public Policy from Harvard, and a Ph.D. in Economics from MIT.

Dynarski has been a Visiting Fellow at the Federal Reserve Bank of Boston and Princeton University as well as an associate professor at Harvard University. She has been an editor of *The Journal of Labor Economics and Education Finance and Policy* and is currently on the board of *Educational Evaluation and Policy Analysis*. She has been elected to the boards of the Association for Public Policy and Management and Association for Education Finance and Policy. The National Association of Student Financial Aid Administrators awarded her the Robert P. Huff Golden Quill Award for excellence in research on student aid.

Dynarski has testified about education and tax policy before the U.S. Senate Finance Committee, the U.S. House Ways and Means Committee, and the President's Commission on Tax Reform.

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Daniel Kreisman is a postdoctoral research fellow at the Gerald R. Ford School of Public Policy at the University of Michigan. He studies how we invest in human capital and how these investments are rewarded in the labor market. This research spans education policy, labor economics, education finance, and the economics of education. In recent work, he evaluates labor market returns to community college, the impact of high school vocational programs, K-12 school finance, racial disparities in early skill development, and labor market discrimination.

Kreisman has worked for The National Opinion Research Center and Chapin Hall at the University of Chicago and has received grant and fellowship awards from the American Education Research Association, the Institute of Education Sciences, and the Institute for Research on Poverty. He holds a Ph.D. in public policy from the University of Chicago and a BA in history and philosophy from Tulane University. Before attending graduate school, he taught high school English in New Orleans.

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The ideas in this proposal draw heavily from papers and commentaries of academics and policy advocates working on loan policy in Australia, the United Kingdom, and the United States. We have particularly benefited from the work of Nicholas Barr and from conversations with Greg Clark, Dan Madzellan, Judith Scott-Clayton, and Sarah Turner. Jonathan Hershaff and Mark Wiederspan provided expert assistance in data analysis. Any errors are our own.

Endnotes

1. According to the Federal Reserve Board of New York (FRBNY), the top two forms of debt are home mortgages and car loans (see, e.g., Lee 2013).
2. These statistics are for borrowing during the first six years after starting college and are based on students who entered college in 2003–04. Data are from *National Postsecondary Student Aid Survey* (National Center for Education Statistics [NCES] 2013) as analyzed by College Board 2012b. These statistics include the 44 percent of students who borrow nothing. Statistics that focus on the distribution of borrowing *among those who borrow* will, by mathematical necessity, show larger shares, with debt above \$50,001. For example, the FRBNY data (e.g., Lee 2013), describe debt among those who have borrowed.
3. In a recent cohort, the typical loan in default was \$6,625, exactly the same as loans that were repaid without incident. Loans that go into delinquency (a status short of default) are smaller than loans that are paid without incident: about \$5,500 versus \$6,625 (Cunningham and Kienzl 2011).
4. Calculated from data in spreadsheet “Direct Loan and Federal Family Education Loan Portfolio by Loan Status” (ED 2013). These are statistics for Direct Loans and FFEL loans. There are 6.5 million borrowers in default as of the third quarter of 2013, representing \$89.3 billion in loans. The average loan for this group is \$13,738 (= \$89.3 billion/6.5 million borrowers). There are 39.5 million borrowers not in default as of the third quarter of 2013, representing \$805.7 billion in loans. The average loan for this group is \$21,709 (= \$805.7 billion/39.5 million borrowers). For these calculations, “borrowers not in default” excludes those who could not possibly be paying (those in school or in their grace period) but does include those in deferment or forbearance.
5. Additionally, although graduate students borrow more than undergraduates, they are less likely than undergraduate borrowers to default. Only 3 percent of graduate borrowers default (Cunningham and Kienzl 2011).
6. Calculated from data in spreadsheet “Direct Loan Portfolio by Repayment Plan” (ED 2013).
7. We suspect that many of the large student-loan balances documented in recent reports by the FRBNY (e.g., Lee 2013) are the result of just such a spiral, since the rate at which students borrow cannot explain these large debts. We reach this conclusion by comparing statistics on the flow of borrowing (e.g., from the *National Postsecondary Student Aid Survey* [NCES 2008]) to the stock of debt shown in the FRBNY reports.
8. Note that private student loans do not fit this description of student loans. Private student loans require a cosigner with a credit record to back the loan. The cosigner’s possessions serve as the collateral for these loans.
9. Total fall enrollment (undergraduate and graduate) rose from 15.9 to 21.0 million between 2001 and 2011 (NCES 2013, tbl. 221).
10. Besides Stafford, most other loans are also federal; just 7 percent of student loan volume was from private sources in 2011–12. PLUS loans to parents are the second-largest source of student borrowing (10 percent of volume), followed by PLUS loans to graduate students (6 percent) (College Board 2012b, fig. 6). The private and parental PLUS loans require a credit check or cosigner and so, as discussed earlier, are not classic student loans, which are secured only by the future earnings of the borrower.
11. Numbers are based on a cohort of 1.7 million students who borrowed in 2005.
12. Calculated from data in spreadsheet “Direct Loan and Federal Family Education Loan Portfolio by Loan Status.” (ED 2013). These are statistics for Direct Loans and FFEL loans. There are 6.5 million borrowers in default as of the third quarter of 2013, representing \$89.3 billion in loans.
13. These statistics are from the 2012 March Current Population Survey (U.S. Census Bureau 2013; authors’ calculations); they exclude full-time students but include former students who are out of the labor force or unemployed. The twenty-fifth percentiles for those with a BA are \$14,000, \$24,000, and \$15,000, respectively. Among those with some college but no BA, median earnings are \$24,000 for those aged twenty-four to thirty, \$30,000 for those in their thirties, and \$34,000 for those aged forty-one to forty-eight. The twenty-fifth percentiles for this group are \$6,000, \$15,000, and \$12,000, respectively.
14. Yale famously attempted such a program decades ago. It unraveled because students who expected high earnings did not use the program. We predict the same would happen with the Oregon program if this aspect of its design is maintained.
15. The IRS already plays a small part in the student loan system by garnishing the wages and tax refunds of delinquent borrowers.
16. This is similar to how information about student-loan payments is moved between agencies in the United Kingdom. Personal communication with Nicholas Barr.
17. Specifically, 3 percent of earnings up to \$10,000, 7 percent between \$10,001 and \$25,000, and 10 percent above \$25,001.
18. In the National Longitudinal Survey of Youth (NLSY 1979), Avery corresponds to the middle fifth of the lifetime earnings distribution of those with a BA degree or higher.
19. In the NLSY (1979), Ben corresponds to the middle fifth of the lifetime earnings distribution of those with some college experience but no BA.
20. In the NLSY (1979), Cathy corresponds to the top fifth of the lifetime earnings distribution of those with a BA degree or higher.
21. In the NLSY (1979), Dana corresponds to the bottom fifth of the lifetime earnings distribution of those with some college experience but no BA.

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Highlights

In a new Hamilton Project discussion paper, Susan Dynarski and Daniel Kreisman of the University of Michigan propose the creation of a new, income-based system of student-loan repayment to replace current federal loan programs. In this increasingly competitive global labor market, it is more important than ever that student-loan policy be designed to help make a college education accessible to all students.

The Proposal

Replace the current student-loan system with an income-based repayment system. A single, simple, income-based repayment system, Loans for Educational Opportunity (LEO), will replace the current complicated federal loan system. Employers will withhold a fixed percentage from individuals' paychecks, and payments will be spread out beyond the low-earning early years so that young workers are not hit with large payments when they can least handle them. Instead of paying off loans during a fixed, ten-year period, borrowers will have up to twenty-five years to repay, although most borrowers will repay in about ten years, as is the case now.

Following the model of Social Security, the proposal creates a board that calls on outside academic expertise to undertake the analyses and projections necessary to administer LEO. Additionally, the U.S. Department of Education will purchase federal loans now held by private loan companies to allow existing borrowers to shift to the new system, and student-loan rates will be pegged to a variable interest rate that adjusts during the life of the loan.

Eliminate private servicing of loans and regulate private loans more tightly. Currently there are protections in the student-loan system for lenders, but not enough protections for borrowers. To protect students and their families from taking on too much debt and to ensure that individuals are properly informed of their options in repaying their loans, the authors propose a number of changes to how private lenders operate: private student loans should not survive bankruptcy, loans that need a credit check will not be marketed as student loans, and individuals must exhaust all federal student loans before being allowed to take out any private loans.

Benefits

By compressing repayment during the first ten years of borrowers' careers, when earnings are lowest and most variable, the current system turns reasonable levels of debt into payment burdens that are difficult to manage. This proposal will make it easier for borrowers to pay back their student loans by linking workers' repayments to their earnings, thereby lengthening the repayment period for individuals with lower incomes who would otherwise struggle to make their payments. The proposal also suggests ways to improve consumer protection for the relatively few individuals who take out large, private student loans. This proposal will likely save taxpayers' money because it will reduce defaults and cut the cost of loan servicing, which is currently contracted out to private loan companies. Further savings will come from eliminating the student-loan interest deduction and the in-school interest subsidy. Finally, this proposal allows borrowers the time and flexibility they need to repay their loans without jeopardizing their financial stability, credit, or job opportunities.



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