

Reforming Student Loans and Tax Credits

Jason D. Delisle

RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

STUDENT DEBT has reached the top of the national agenda, thanks in part to the significant expansion in the stock of outstanding student loans over the past decade. There is now \$1.3 trillion in federal student-loan debt outstanding, up from \$441 billion just a decade ago. The increase is a function of rising college costs, increases in student enrollments, and the expansion of federal loan programs. Over that period, total enrollments in post-secondary education grew from 17.5 to 20.3 million students.⁵⁶

The federal role in higher-education lending has expanded significantly since the first federal loan program was authorized in 1958 as part of the National Defense Education Act. The Higher Education Act of 1965 created the Guaranteed Student Lending Program, which made low-interest loans to needy students. In 1978, the Middle Income Student Assistance Act expanded eligibility for guaranteed loans to middle-income students. In 1980, Congress created a federal loan program for parents of undergraduates (Parent PLUS), and in 1992, policymakers eliminated annual and lifetime limits on Parent PLUS loans and authorized the unsubsidized Stafford Loan program, which allows all students to borrow federal loans regardless of their financial circumstances. In 2006, Congress created the Grad PLUS loan program which effectively removed any limit on the amount graduate students could borrow.

A series of higher-education tax benefits were created as part of the Taxpayer Relief Act of 1997 (Hope Scholarship, Lifetime Learning Tax Credit, student-loan interest deduction, and others). Lawmakers have expanded these benefits many times since then, most recently with the

American Opportunity Tax Credit in 2009. The benefits now total over \$20 billion in annual aid.

The resulting system of loans and tax benefits is complex, sprawling, and increasingly important to the federal budget. The size of federal loan programs has experienced remarkable growth, thanks in large part to the proliferation of programs and the expansion of enrollments over the past decade. In the 2001-2002 school year, the Office of Federal Student Aid at the Department of Education disbursed \$36 billion (in current dollars) across 9.4 million loans. By 2011-2012, those totals had reached \$106 billion and 22.8 million. Disbursements and borrowing declined somewhat after that peak, but in 2015-2016, FSA still handed out \$94.7 billion through 17.3 million loans. Even after adjusting for inflation, the amount of federal loan disbursements increased 44% between 2004-2005 and 2015-2016.⁵⁷

More troubling are the trends in delinquency and default. There are currently more than 8 million people in default on their federal student loans, and estimates suggest that over 40% of all borrowers who are expected to repay have defaulted, are delinquent, or are in forbearance or deferment.⁵⁸ Other research shows that the “effective delinquency rate” on student loans, after eliminating borrowers who are still in school or in a grace period, is about 30%.⁵⁹

Meanwhile, tuition prices continue to increase, forcing more and more students to rely on federal loans to finance their education. The sticker price of tuition at public four-year colleges—after accounting for inflation—has more than tripled since the early 1980s. At private nonprofit colleges, the sticker price of tuition is 2.5 times higher. Net prices—what students actually pay after subtracting grant aid and tuition discounts—have not risen as much thanks to an influx of federal grant aid, but stagnant family incomes mean that the price of college is consuming a larger chunk of family incomes each year. While there is significant scholarly debate as to whether the availability of federal student loans *causes* tuition inflation, new evidence suggests that they certainly seem to enable increases in tuition.⁶⁰

In light of this sorry state of affairs, policymakers should push for reforms to the federal student-loan program that aim to achieve four main goals: simplify federal loan programs and repayment options; make the programs operate more rationally and efficiently; eliminate wasteful features, with emphasis on those that distort the higher-education marketplace; and ensure that the program distributes public

resources in a fair manner to those who need them most, especially students from low-income families.

With respect to the tax benefits for tuition, policymakers should aim to eliminate and better target the budgetary resources (i.e., forgone tax revenue) that are currently used to fund the tax benefits. We suggest a number of reforms that simplify or better target federal aid that would increase taxpayer costs; we also identify places where savings from the elimination of or a reduction in tuition tax benefits can offset those costs.

A FLAWED STUDENT-LOAN REGIME

The federal government provides several types of student loans to help promote access to higher education. The common goal among the different loans is to allow students to obtain financing for higher education at better terms than those available in the private market. The programs entitle virtually all students to loans with below-market interest rates and flexible repayment options. Furthermore, loans are available to borrowers without respect to income, choice of institution, field of study, or academic performance (except in limited cases). Loans are available for short-term certificate programs, two- and four-year undergraduate study, and graduate study.

As of 2010, all federal student loans are provided through the Direct Loan program. Loans are issued directly by the U.S. Department of Education to the institutions of higher education that borrowers attend. The loans are administered by the Department of Education and private companies with whom the department has contracted to process loan disbursements and handle loan repayments and collections.

Unsubsidized Stafford loans are available to all undergraduate and graduate students. Dependent undergraduate students can borrow up to their cost of attendance, but no more than \$5,500 in their first year, \$6,500 in the second year, and \$7,500 each year thereafter, and they cannot borrow more than \$31,000 in total. Independent borrowers are eligible to borrow \$9,500 in the first year, \$10,500 in the second, and \$12,500 in the third, with the aggregate limit set at \$57,500. In order to qualify as an independent borrower, the individual must be over the age of 24, or serve in the military, be married, or have dependents. Graduate students may borrow no more than \$20,500 each year and \$138,500 in total in Unsubsidized Stafford loans. Borrowers do not need to make payments on the loans while in school. Loans can be repaid through a variety of plans discussed more below.

Congress sets the interest rates on Unsubsidized Stafford loans. The loans carry fixed interest rates that reset for newly-issued loans each academic year.⁶¹ For loans issued in the 2016-2017 academic year, the interest rate for undergraduates is 3.76%, plus a 1.1% origination fee. For graduate students the interest rate is 5.31%, plus a 1.1% origination fee.

Subsidized Stafford loans are the same as Unsubsidized Stafford Loans, except that interest does not accrue while the borrower is in school and the borrowing limit is lower. Historically, both undergraduate and graduate students were eligible for Subsidized Stafford loans, but legislation enacted in 2011 (the Budget Control Act) made graduate students ineligible for newly issued subsidized loans as of July 2012.⁶²

A dependent undergraduate student qualifies for a Subsidized Stafford loan if his or her parents meet financial eligibility requirements. Independent undergraduate students qualify if they themselves meet financial eligibility requirements. For both dependent and independent undergraduate students, the limits for borrowing are \$3,500 for the first year, \$4,500 for the second year, and \$5,500 for subsequent years, with the aggregate limit set at \$23,000.

Interest rates are the same for Subsidized and Unsubsidized Stafford loans to undergraduates. For loans issued in the 2016-2017 academic year, the rate is 3.76%, plus a 1.1% origination fee.⁶³

Parent PLUS loans are available to parents of undergraduate students. Through the program, parents may borrow an amount up to the cost of the student's attendance, which includes tuition, housing, and other expenses. Unlike with Stafford loans, parents must satisfy a limited credit check. The loans carry fixed interest rates that reset for newly issued loans each academic year. For loans issued in the 2016-2017 academic year, the interest rate is 6.31%, plus a 4.3% origination fee.

Grad PLUS loans are available to graduate students under the same terms as PLUS loans for parents of dependent undergraduates. Grad PLUS loans are meant for borrowers who exhaust eligibility for Stafford loans. The loans carry fixed interest rates that reset for newly issued loans each academic year. For loans issued in the 2016-17 academic year, the interest rate is 6.31%, plus a 4.3% origination fee.⁶⁴

Borrowers may repay their federal student loans under a variety of repayment plans. However, all borrowers are automatically enrolled in the standard repayment plan when they leave school. They must opt into any of the others, provided they meet the eligibility criteria.

Borrowers can opt into any plan for which they are eligible at any point during repayment and generally can change options during repayment. Borrowers may also pre-pay (make larger payments than the minimum required) at any time without penalty.

Federal Student Loan Fixed Interest Rates by School Year Issued

Loan Type	2012–13 ¹	2013–14	2014–15	2015–16	2016–17
<i>Undergraduate Unsubsidized & Subsidized Stafford</i> ²	5.46%	3.86%	4.66%	4.29%	3.76%
<i>Graduate Unsubsidized Stafford</i>	6.80%	5.40%	6.21%	5.84%	5.31%
<i>Grad PLUS</i>	7.90%	6.41%	7.21%	6.84%	6.31%
<i>Parent PLUS</i>	7.90%	6.41%	7.21%	6.84%	6.31%

Source: Department of Education

¹ Last year before enactment of Bipartisan Student Loan Certainty Act of 2013.

² Average interest rate on the two loan types weighted by issuance.

The standard repayment plan is a 10-year plan in which the borrower makes 120 monthly payments that fully repay the loan and any accrued interest. Borrowers can make fixed monthly payments or payments that gradually increase over the life of the loan.

The extended repayment plan allows borrowers with balances of \$30,000 and more to repay over 25 years at fixed or gradually increasing payments.

The consolidation repayment plan, like extended repayment, allows borrowers to lengthen the term of their loans, but allows them to do so with lower balances. For balances from \$7,500 to \$9,999 the term is 12 years; for \$10,000 to \$19,999 the term is 15 years; for \$20,000 to \$39,999 the term is 20 years; for \$40,000 to \$59,999 the term is 25 years; for \$60,000 or more the term is 30 years. Borrowers can make fixed monthly payments or payments that gradually increase over the life of the loan.⁶⁵

The Income-Based Repayment (IBR) plan allows borrowers to make monthly payments based on their incomes if they meet a debt-to-income test. Borrowers may opt into IBR if their payments under that plan would be lower than payments under the standard (10-year) repayment plan. For new and recent borrowers, eligibility and payments are set at 10% of adjusted gross income after a base exemption that

increases with household size. This plan is also called “Pay As You Earn” or “REPAYE.”⁶⁶ Unpaid loan balances are forgiven after a set amount of time depending on the plan—usually 20 years, or 25 years under some circumstances. Separately, borrowers in either plan qualify for loan forgiveness after 10 years of payments if they work in a nonprofit or government job.

TUITION TAX BENEFITS

The federal government provides a number of different tax benefits to offset college-tuition costs. There are three existing tax benefits for tuition and fees available to parents of students, or to students themselves if they are independent.

The first is the American Opportunity Tax Credit. It is available to students in their first four years of school, limiting it to undergraduate students. Students must be enrolled in a degree program at least half-time. Students (or their parents) may receive a tax credit up to \$2,500, or 100% of the first \$2,000 in tuition in fees and 25% of the next \$2,000. Up to \$1,000 of this credit is refundable, meaning the tax filer can claim it even if he has no tax liability to offset. Eligibility for the full AOTC is capped for single tax filers earning \$80,000 (\$160,000 for married filers). Those earning up to \$90,000 (\$180,000 if filing jointly) can claim a partial benefit under a phase-out provision. The AOTC is in law indefinitely; it does not expire.⁶⁷

A second tuition tax offset is the Lifetime Learning Tax Credit, which allows tax filers to reduce their federal taxes up to \$2,000. The credit is equal to 20% of the first \$10,000 in tuition and fee expenses. Income limits are indexed to inflation, and are set at \$55,000 or (\$110,000 for married filers) for the full benefit, while those earning above those amounts but less than \$65,000 (\$130,000) are eligible for a partial credit as the benefit is phased out. The Lifetime Learning Tax Credit is in law indefinitely; it does not expire. Graduate and undergraduate students may claim the benefit.⁶⁸

Third, the Tuition and Fees Deduction allows students or families to deduct up to \$4,000 in tuition and fees from their incomes, reducing their taxes by their marginal tax rates (e.g. 25% of \$4,000 for those in the 25% tax bracket). Students and families do not need to itemize deductions to claim it. Income eligibility is capped at \$65,000 for single filers, or \$130,000 for married filers. Above these limits, a partial deduction

of up to \$2,000 is available for those with incomes less than \$80,000 or \$160,000, depending on marital status. The benefit has been available since 2002. It has always been temporarily authorized, but has been extended multiple times. The last extension made the credit available through 2016, and lawmakers may still act to make it available for 2017. Graduate and undergraduate students may claim the benefit.⁶⁹

THE CURRENT STATE OF
FEDERAL STUDENT LOANS AND TAX CREDITS

There are several aspects of the current federal student-loan and tuition tax-credit regime that must be well understood before reforms can be attempted. There are clear political and ethical motivations behind each of these policies, but the policies themselves often cause more harm than good.

To start, federal student loans feature very little underwriting. In the private sector, lenders assess a borrower's likely ability to repay the loan as part of the underwriting process. Federal student loans feature no such underwriting, though they do place broad limits on which institutions and types of programs are eligible to receive student loans (even though graduation and default rates indicate that those standards are quite low). PLUS loans do feature a basic test of credit-worthiness—borrowers cannot have an “adverse credit history,” including defaults, foreclosures, or bankruptcies in the last five years—but that test does not assess a parent or graduate student's ability to repay.⁷⁰ As a result, students and parents have access to easy credit, which likely distorts their incentive to be cost and quality-conscious consumers.

Federal lenders also make credit available to any program at an accredited institution regardless of the price of attendance or the value of the credential. Indeed, the amount a student and their parents can borrow is directly tied to the cost of attendance, meaning that institutions that charge more in tuition are able to capture more federal aid. There are some basic standards that institutions must fulfill, but those standards tend to be low and ineffective in weeding out low-value institutions and programs.

Luckily, Stafford Loans have annual caps on borrowing and lifetime eligibility limits, and those limits are much higher for independent students than for dependent students (because the latter can rely on Parent PLUS loans). In contrast, Parent PLUS (and Grad PLUS) loans

allow for unlimited borrowing up to the cost of attendance to cover any amount not covered by other federal aid. This gives colleges and universities greater freedom to raise tuition, and likely encourages some to do so when loan limits increase.

Though there is plenty of scholarly debate about the so-called “Bennett Hypothesis”—the notion that the availability of federal grants and loans enables colleges to increase their tuition—several recent, well-designed studies have found that access to federal loans and changes in loan limits do affect tuition prices, particularly at private nonprofit and for-profit institutions.⁷¹ The PLUS programs have received far less scrutiny when it comes to tuition inflation, but it seems plausible that the lack of annual or lifetime caps on these loans has had an effect on tuition trends.

Meanwhile, the proliferation of loan repayment options increases complexity and detracts from successful repayment. Federal Student Aid (FSA) currently lists eight different repayment plans from which eligible students can choose. The standard 10-year repayment plan is the default option, but students can choose the graduated repayment plan (where payments increase over time), the extended repayment plan (if their balance is greater than \$30,000), the Pay As You Earn (PAYE) plan, the Revised Pay As You Earn (REPAYE) plan, the Income-Based Repayment (IBR) plan, or the Income Contingent Repayment plan (ICR). The number of options adds to the complexity of the repayment process, and many of the borrowers who would most benefit from income-driven programs are deterred because they must elect into them by filling out paperwork each year to certify their income. Enrollment in income-based repayment programs has increased of late, but many students are still defaulting on moderate amounts of debt, indicating the high cost of complexity and bureaucratic hurdles.⁷²

While income-based repayment programs show promise, the benefits of such programs as they are currently designed are skewed toward high-debt borrowers with graduate degrees, raising costs but not solving problems. Existing income-based repayment programs allow all student borrowers, including graduate students with PLUS loans (which allow for unlimited borrowing), to tie payments to their incomes and have any outstanding balance forgiven after 20 years (10 if they work in a “public service” job, a category that includes most nonprofit organizations). While these plans certainly help some undergraduate borrowers smooth their consumption and avoid financial hardship, the implicit

subsidies in the program (particularly loan forgiveness) flow disproportionately to borrowers with the highest debts—most of whom are graduate students. One study found that, depending on their program of study, graduate students who plan to go into the public or nonprofit sector can quickly approach the point at which they face no marginal cost for each additional dollar borrowed thanks to the loan forgiveness they will eventually receive.⁷³ Note that the problem here is not fundamental to the idea of income-driven repayment (where payments are tied to income), but arises from the eligibility rules and loan-forgiveness provisions.

Federal student-loan borrowers who fail to repay their loans feel few consequences for a number of years. Deferments and forbearances allow borrowers to avoid payments, but interest accrues throughout. A loan is considered to be in default if a borrower fails to make a payment for 270 days, and wage garnishment does not kick in for a number of years.⁷⁴ Eventually the federal government refers the loan to a collections agency, who can tack on a surcharge of up to 25% of the loan balance.⁷⁵ Though research on the effect of these delayed consequences is non-existent, some qualitative evidence suggests that some students who do not repay are making a rational decision to pay off other debts (credit cards, auto loans, mortgages) before their federal loan because the sanctions for non-repayment kick in much faster on those other products.⁷⁶

Finally, tuition tax benefits are politically popular, but accomplish little in the way of policy, while offsetting costs for high-income families. Research using tax records from the Internal Revenue Service shows that increasing shares of higher-income individuals have claimed the benefits as they have become more generous over time.⁷⁷ The research also raises doubts about whether these benefits encourage students to pursue further education, likely because they view tax benefits as a boost to income rather than a price discount.⁷⁸ Additionally, the argument that the tax benefits pay for themselves through a high return on investment are largely without conclusive evidence.⁷⁹

THE WAY FORWARD FOR STUDENT LOANS AND TAX BENEFITS

Each group of reforms discussed here differs in the degree to which it would change the existing loan program. The first group of reforms discussed below is mostly a simplification of the existing program, with some additional changes at the margin that limit the scale and scope of

the program. It is also the most politically feasible of the three groups of proposed reforms.

The second group of reforms still leaves the existing loan program structure in place, but makes bolder and more aggressive changes—both in terms of policy and political feasibility. The third group of reforms completely replaces the federal loan program with a new system based on the logic of an income-share agreement.

The three groups of reforms are not necessarily mutually exclusive. Components could be mixed and matched, and some proposals may work in tandem as part of all three groups of reforms. For example, a policy agenda could include minor changes that simplify the existing types and terms of loans, but also incorporates policies to overhaul how loans are collected in default. Some reforms are, however, mutually exclusive. It would be difficult, for instance, to enact a loan repayment system that operates through income tax withholding without other larger reforms. Those trade-offs are discussed throughout the sections below.

This first group of proposals leaves much of the scaffolding of the current federal student-loan system in place. At the same time, they work to simplify the system, making it more transparent for borrowers, and curtail some of the perverse incentives most prone to distort the higher-education marketplace.

Under this moderate plan, the first step should be the creation of one federal loan type for undergraduates, enabled by the elimination of the Subsidized Stafford loan. Ending this loan-subsidy benefit would, among other benefits, remove a confusing and oftentimes misunderstood distinction between Subsidized and Unsubsidized Stafford Loans, and result in only one type of federal loan for undergraduates. The entire program could then be called “Stafford Loans,” dropping the Unsubsidized and Subsidized modifiers. Borrowers would then have one loan type available to them that carries one set of terms.

To understand the rationale for this reform, one must understand the origin of the Stafford loan program. Since the passage of the Higher Education Amendments of 1992, all undergraduate borrowers have been able to take out federal Stafford loans regardless of income or other need-based tests, at terms that have been generally more favorable than those in the private market.⁸⁰ Prior to the enactment of that policy, the federal loan program allowed only financially needy students to borrow. Those loans had always included an interest-free benefit under

which the loan would not accrue interest while the borrower was in school. However, when policymakers opened up the federal student-loan program to borrowers of all income backgrounds in 1992, they maintained the interest-free benefit for borrowers who met a needs analysis test that accounted for the cost of attendance at students' institutions, but did not provide a similar benefit for other borrowers.

That interest-free benefit remains the distinction between the two loan types that still exist in today's program: Subsidized Stafford loans and Unsubsidized Stafford loans for undergraduates. In other words, Subsidized Stafford loans were not created to provide benefits over and above those on Unsubsidized Stafford loans. Rather, it is a benefit that was always provided as part of the federal student-loan program. The Subsidized and Unsubsidized Stafford loan distinction remains current policy mainly due to historical circumstances.

Borrowers are eligible for the same overall borrowing limits annually and in aggregate, but they qualify for a mix of Unsubsidized and Subsidized loans within those limits. In the 2011-12 academic year, for instance, 82% of undergraduates who had a Subsidized Stafford loan also had an Unsubsidized Stafford loan.⁸¹ Adding even more complexity, students are eligible for amounts of Subsidized Stafford loans on a sliding scale, meaning every borrower has a different amount of each loan type, sowing confusion for borrowers.

Subsidized Stafford loans also do not always provide the greatest benefits to the lowest-income students. Subsidized Stafford loans are awarded to borrowers according in part to the cost of attendance of their schools. In other words, a borrower can become "needy" by attending an expensive school. A similarly situated borrower who opts to attend a low-cost institution will qualify only for Unsubsidized Stafford loans. This is why, in spite of income and assets tests targeting the aid to lower income families, 13.9% of borrowers who receive Subsidized Stafford loans come from families earning over \$100,000 per year (see nearby table).⁸²

Furthermore, the interest-free benefit is made largely redundant by the income-based repayment plan. While the interest-free benefit makes the loan more affordable by reducing the balance due at repayment, income-based repayment makes the balance irrelevant for establishing a monthly payment. For a given borrower, payments are the same: They are based on his income, no matter what the size of his loan balance.

Policy Reforms to Strengthen Higher Education

Distribution of Total Subsidized
Stafford Loan Issuance by Family Income

<i>Family Income of Undergraduates (AGI)</i>	<i>Share of Total Subsidized Stafford Loan Issuance (2011–12)</i>
\$0–\$30,000	49.1%
\$30,001–\$50,000	15.9%
\$50,001–\$99,999	21.2%
\$100,000 and over	13.9%

Source: National Postsecondary Student Aid Study 2011–12.

For exactly that reason, the Obama administration recommended in 2011 that the government no longer provide Subsidized Stafford loans to graduate students going forward. Congress acted on that policy in the same year, redirecting the budgetary resources to the Pell Grant program.⁸³ The administration noted that, in addition to the income-based repayment option available to graduate and professional students, “eligibility for the interest-free benefit on Subsidized Stafford loans is based on ‘ability-to-pay’ at the time of enrollment, but the borrower realizes the benefit later—typically years later—in the form of lower loan payments after leaving school.”⁸⁴ The administration also argued that government aid should be targeted to the highest-need students. All of those arguments apply to the case for eliminating the Subsidized Stafford loan interest-free benefit for undergraduate students, particularly if IBR is the only repayment option for borrowers.

Estimates from the Congressional Budget Office have regularly shown that the benefit costs over \$3 billion per year.⁸⁵ Eliminating it would free up those resources for other uses, while IBR would ensure that the loans are affordable in repayment.

Estimated Budgetary Savings from Ending
Subsidized Stafford Loan Issuance

<i>Fiscal Years</i>	<i>Savings in Billions</i>
2017–21	\$11.2
2017–26	\$26.8

Source: Congressional Budget Office, December 2016.

The next step should be to automatically enroll students in the longest repayment term for which they are eligible, but “embed” a 10-year repayment term option. More specifically, policymakers should look to automatically enroll students in the “consolidation” repayment plan (or a new, comparable plan), where repayment terms are set based on the size of borrowers’ loan balances (i.e., longer terms for larger balances).

At present, the automatic repayment plan for a federal student loan is currently the standard 10-year repayment plan. Under this plan, a borrower makes equal monthly payments in the amount necessary to pay off the entire loan, plus interest, in a 10-year period. Most borrowers are enrolled in this plan, but it is just one of many options a student can choose from. Note that it is the standard 10-year repayment plan that has the highest delinquency rate of all the repayment options. This suggests that a 10-year repayment window is unduly burdensome on some borrowers, requiring them to pay too much too soon.

Borrowers owing more than \$7,500 automatically qualify for longer terms, up to 30 years, but they must know about that benefit and fill out the necessary paperwork. Unlike loans in the private market, extending the term on a federal loan *does not increase the interest rate*—it remains the same as the original rate. Thus, longer terms are effectively a free benefit.

Borrowers can request an “extended” repayment plan that allows them to repay the loan in fixed payments over 25 years if they have a balance of more than \$30,000. Extending the term reduces the borrower’s monthly payment, but increases the interest he will accrue and pay. Extended repayment is not the only way borrowers can lengthen the term of their loans and reduce their monthly payments. They can also do so through the “consolidation” plan, the terms of which are completely different from extended repayment. As the name suggests, this option converts a borrower’s multiple loans into one (although, confusingly, he needs only one loan to be eligible for consolidation), but by far its largest benefit is that it allows borrowers longer repayment terms based on their loan balances. It allows borrowers with balances of \$7,500 to \$9,999 to pay over 12 years; borrowers with \$10,000 to \$19,999 in loans to pay over 15 years; borrowers with \$20,000 to \$39,999 in loans to pay over 20 years; borrowers with \$40,000 to \$59,999 in loans to pay over 25 years; and borrowers with \$60,000 or more in loans to pay over 30 years.

Those terms should be made automatic (and the redundant “extended” option should be eliminated). That is, a borrower entering

repayment should have the length of his repayment term set by rules for the consolidation option, or some variation of them. A borrower entering repayment with a \$13,000 balance should have his monthly payments set to a 15-year amortization schedule; a borrower with \$30,000 should have his set to a 20-year schedule, and so forth. Such a policy gives borrowers automatic access to the free benefit for which they already qualify under current law.

Some in the policy community will worry that this encourages, or even misleads, borrowers to follow longer repayment terms where they accrue more interest. Yet there is no prepayment penalty for a federal student loan, so borrowers can always pay on a faster schedule. The policy could even inform a borrower of what he would need to pay to finish his loan repayment in 10 years. Under this “embedded option,” each month a borrower receives his bill (or when he logs into the servicing website) he can also see the amount he needs to pay to stay on a 10-year repayment plan based on when he began repaying. Even so, the payment he must make according to the maximum term he was automatically enrolled in would be his “minimum monthly payment.”

This next option is meant to be budget neutral: Eliminate the above-the-line tax deduction for student-loan interest and use the savings to offset the cost of eliminating the origination fee on undergraduate student loans (Stafford loans). It nets one benefit borrowers currently receive (a tax deduction for interest) against a fee they currently pay (the origination fee) on a federal student loan. By ending both policies, the net effect leaves current policy largely unchanged, but it is vastly more simple and transparent.

Under current policy, borrowers are assessed an origination fee on undergraduate loans that is automatically rolled into the loan balance and repaid as part of the principal balance. Other federal student loans charge origination fees as well, but this proposal would leave them in place. The borrower does not pay the fee upfront like a true origination fee; it is therefore simply part of the effective interest rate on the loan. The origination fees are significantly different for Stafford and PLUS loans: 1.1% and 4.3%, respectively.

Separately, borrowers who earn less than \$80,000 (\$160,000 if filing a joint return) in adjusted gross income can deduct from their federal income taxes up to \$2,500 per year in interest they paid on their student loans. This is an above-the-line-deduction that can be claimed regardless

of whether a tax filer itemizes or claims the standard deduction. Federal and private loans qualify for the benefit, but because most outstanding debt is federal, the benefit largely applies to those loans. The estimated annual cost to taxpayers in forgone revenue from the benefit is \$1.8 billion.

These two policies, the origination fee and the interest deduction, effectively cancel each other out. Borrowers are charged higher effective interest rates through the origination fee, then are charged lower effective interest rates when they claim the deduction. These policies should be eliminated to simplify the loan program.

Another policy option would eliminate the Parent PLUS Loan Program, increase loan limits for dependent undergraduates, and end the distinction between dependent and independent undergraduate loan limits. As the cost of attending college has soared, so too have Parent PLUS loan disbursements. Like Grad PLUS loans, these loans are not subject to annual or aggregate borrowing caps. Parents can access them to pay the full cost of attendance at any school eligible for federal student aid. Additionally, “cost of attendance” is defined by the college or university, not federal statute or regulation, and thus many colleges use these loans when packaging financial aid to fill large gaps in financial-aid awards.

Because parents can borrow up to the cost of attendance at the schools their children attend—meaning that families can easily overborrow—institutions have an easy source of funds if they wish to raise tuition. Moreover, the federal government does not track or publish the rate at which parents default on PLUS loans at each institution. Lastly, the loans carry a relatively high fixed interest rate of 6.3% and origination fee over 4%, which can pose a financial risk to vulnerable families; and the loans are eligible only for the least generous income-based repayment plan—Income-Contingent Repayment.

As part of eliminating the Parent PLUS program, policymakers should partially offset the reduction in access to federal loans by increasing the amount that dependent undergraduate students can borrow. Under this proposal, the annual limits for all undergraduates would be \$6,000 for a first year student (up from \$5,500 for dependent students), \$7,000 for a second-year student (up from \$6,500 for dependent students), and \$9,000 for a third-, fourth-, or fifth-year student (up from \$7,500 for dependent students). The aggregate limit for undergraduates would be \$36,000, instead of \$31,000 under current law for dependent students.

Current policy already acknowledges that borrowing limits should be higher when parents cannot or will not borrow for their children. Students whose parents opt to apply for PLUS loans but fail the very limited credit check for these loans may borrow Unsubsidized Stafford loans at the independent student limits, which are about \$4,000 higher per year. This set of reforms would make that policy effectively universal by discontinuing Parent PLUS loans and increasing undergraduate loan limits.

This reform simplifies the federal loan program by eliminating the distinction between dependent and independent undergraduates and allowing both types of students to borrow the amounts listed above. While those limits are higher than dependent undergraduates can currently borrow on their own, they are less than what independent undergraduates can access now. The current loan limits for independent students can lead to excessive amounts of debt. As of now, an independent undergraduate student who borrows the maximum in federal loans would begin repayment with a principal and interest balance of approximately \$74,000 (which includes accrued, unpaid interest), an amount that would require fixed monthly payments of \$486 over 30 years to repay under the currently available repayment plans.

Another set of reforms would reduce the benefits provided to graduate students and high-debt borrowers through the income-based repayment program for federal student loans. The reforms to IBR include setting timelines for loan forgiveness in accordance with amounts borrowed and eliminating the maximum loan-repayment cap as well as closing a tax-filing loophole for married borrowers and addressing tax treatment for forgiven debt.

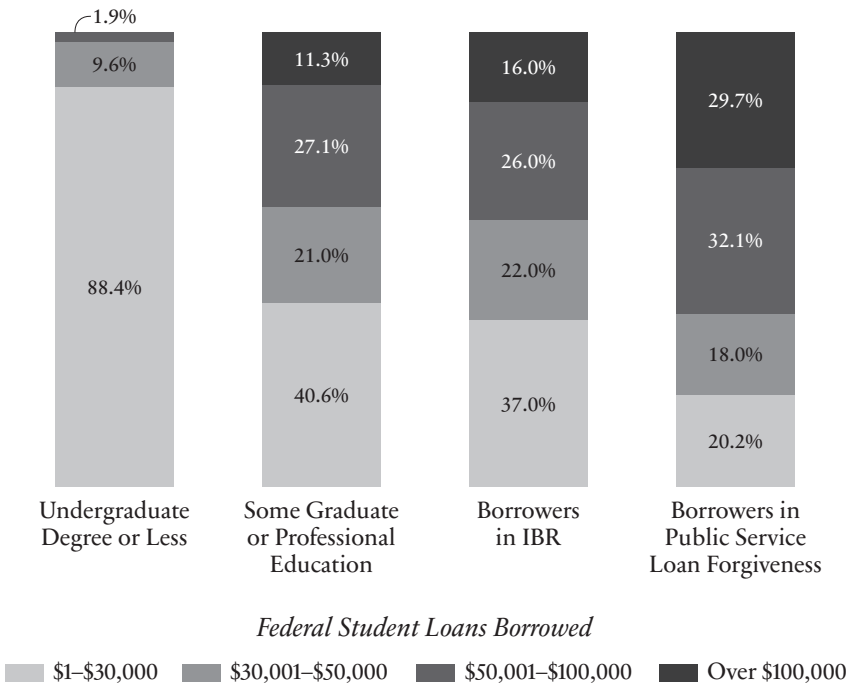
The current IBR program provides larger subsidies to borrowers who attended graduate school than it does to those who borrowed only to finance an undergraduate education. The federal loan program lets graduate students accumulate very high loan balances, but imposes low annual and aggregate limits on undergraduates. Because borrowers with large loan balances can repay their loans under the *same IBR terms as those with low and moderate balances*, the bigger the loan balance, the bigger the benefit.

What's more, the windfall graduate-school benefits are available even to borrowers earning middle and upper incomes during repayment and turn the program into a de facto tuition subsidy for graduate school.⁸⁶ That is because payments are low enough under the IBR terms, and the repayment term short enough, that earning a high income does not

guarantee that a borrower will repay his loan if he remains in IBR for the full term. Department of Education data indicate that students with debt from graduate school are heavily over-represented in the income-based repayment plan, given that the average balance in the program is \$56,384, over three times more than what an undergraduate who completes his education typically borrows.⁸⁷

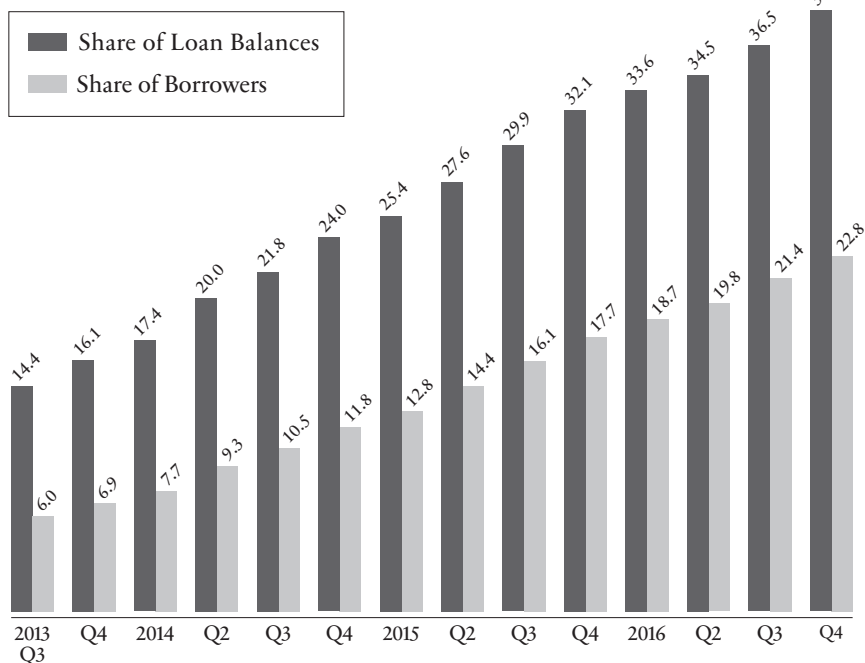
These windfall benefits were introduced in the program when the Obama administration and Congress cut borrowers payments under IBR by 33% (to 10% of discretionary income from 15% enacted in the original 2007 version of the program) and shortened the loan-forgiveness term from 25 to 20 years of payments.⁸⁸ Enrollment in IBR since the Obama administration’s changes has grown rapidly. Today 39% of loan dollars are enrolled in the program.

Thirty Percent of People Registered for Public Service Loan Forgiveness Borrowed More Than \$100,000



Sources: AEI using National Postsecondary Student Aid Study statistics on graduate and undergraduate borrowing, 2011-12; Government Accountability Office for borrowers in IBR, 2014; Department of Education Office of Federal Student Aid for PSLF balances, 2015.

Federal Student Loan Portfolio Share Enrolled in Income-Based Repayment*



* For Direct Loan portfolio only; excludes loans in the FFEL program. Includes loans repaid in the Income-Based Repayment plan, Pay As You Earn plan and REPAYE. Calculated as a share of the \$682 billion Direct Loans in repayment.

Source: AEI using U.S. Department of Education data.

The series of reforms proposed here would curtail the windfall loan-forgiveness benefits that the IBR program now provides to graduate students, but maintain its safety-net function for undergraduate levels of debt that can become *unexpectedly* burdensome for the borrower. The reforms should apply only to future borrowers, not those who have loans now or are about to start borrowing. A separate section discusses specific changes to the Public Service Loan Forgiveness benefit embedded in the IBR program.

In 2014, the Obama administration proposed to roll back some of the changes it had made to IBR to “better target” benefits. But none of these adjustments have been enacted. The initial estimate of budget savings for

the Obama administration's changes was about \$600 million a year. But the administration raised that estimate in 2016 to about \$5 billion a year.

The most important of this set of reforms would link the loan forgiveness timeframe in IBR to the amount borrowed. It would maintain the new forgiveness timeframe of 20 years of payment, but only for borrowers whose loan balances when they enter repayment do not exceed \$40,000. Borrowers with higher initial balances would qualify for loan forgiveness after 25 years of repayment. Policymakers might also consider creating a loan-forgiveness threshold earlier than 20 years for borrowers with balances below \$20,000.

Reforms to IBR should also eliminate the maximum-payment cap in the program so that borrowers must always pay on an income-based formula, no matter how high their incomes. The current program bases a borrower's payments on his income until they reach what he would pay if he repaid his initial loan balance according to a 10-year fixed payment plan. For example, a borrower whose payment under a 10-year fixed payment is \$200 is assured under the current IBR program that he would never pay more than he would under IBR, even if his income rises steadily during his repayment term.⁸⁹ That provision works to increase how much loan-forgiveness borrowers receive.

IBR also allows borrowers to make payments based only on their individual income even if they are married, by filing a separate income-tax return or filing "alternative documentation" with a loan servicer.⁹⁰ Policymakers should close this loophole and require that payments be calculated on combined household income even if borrowers file separate income tax returns. This change should make an exception for borrowers in families where each spouse has federal student loans and each repaid through IBR. To avoid double-counting their incomes, IBR payments should be based on one half of the combined household income.

As long as the above reforms are enacted, policymakers can then address a quirk in the tax treatment of forgiven debt under IBR. Under current law, the forgiven amounts (principal or interest) are considered taxable income in the year they are forgiven, as is the case for most debt that is forgiven. This provision runs contrary to the purpose of IBR, which is to ensure that student-loan payments never exceed a set share of income, and should be repealed. However, policymakers must first address the other flaws in the program that provide benefits to middle- and upper-income borrowers and those who have high amounts of graduate-school

debt before altering the taxability of forgiven debt. Otherwise, they will make the program even more generous for that group of borrowers.

Another policy that should be addressed is the Public Service Loan Forgiveness (PSLF) benefit. Policymakers should limit the amount of debt that can be forgiven under PSLF.

PSLF works in tandem with IBR and allows borrowers working in a qualified public-service job to receive loan forgiveness after they pay for only 10 years (120 cumulative payments) under IBR. There is no limit to the amount that can be forgiven, and all amounts forgiven are considered tax-free income.⁹¹ PSLF effectively amplifies all of the problems with IBR discussed above simply by making the loan-forgiveness term much shorter at 10 years.

Additionally, the law defines “public service” so broadly that it captures 25% of the U.S. workforce.⁹² The nature of the job is irrelevant for eligibility; only the status of the employer matters. Employment at any 501(c)(3) tax-exempt nonprofit qualifies, as does any government position (state, federal, local, and tribal). For example, an accountant at a nonprofit hospital would qualify for PSLF. In other words, borrowers who might not be considered employed in traditional public-service jobs will in fact qualify for loan forgiveness after 10 years.⁹³

The program should include a \$30,000 limit on the amount a borrower can have forgiven. That is based on the principle that the federal government should provide no more in aid to someone with a master’s or professional degree (really the only people who can get large benefits under PSLF due to loan limits and having to make 10 years of payments) for working in a “public service” job than it does to students from the poorest families in the form of Pell Grants to pay for an undergraduate education. The Obama administration has proposed a \$57,500 limit based on the logic that undergraduates can borrow up to that amount in federal student loans.⁹⁴ However, very few undergraduates borrow even near that much, and \$57,500 in loan forgiveness for attending graduate school will strike many as an excessive and regressive government benefit.

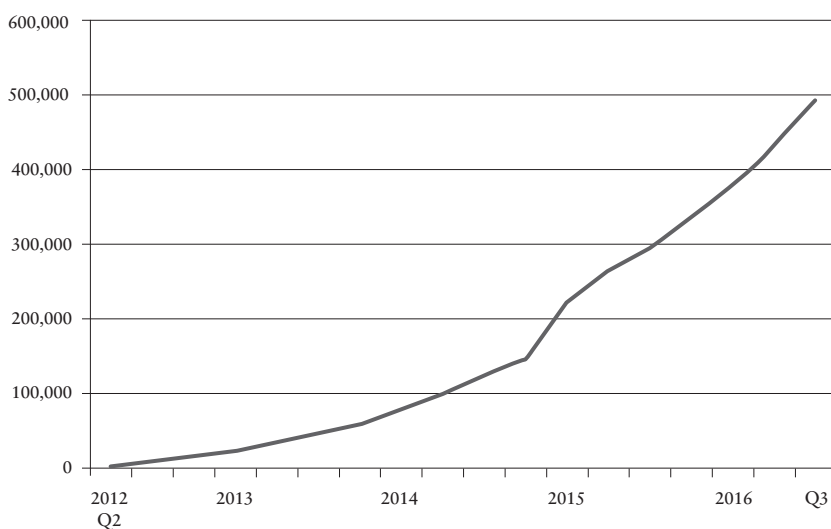
Many of the criticisms about PSLF and the justifications for limiting it also make the case for ending the program altogether. This is true, particularly given that IBR allows people to make affordable payments on their loans regardless of income, making PSLF unnecessary. It is IBR that allows borrowers with high debt to pursue lower-paid public-service jobs because it sets their *payments as a fixed share of income*.

The amount of debt that stands to be forgiven under the program is alarming. For example, take a borrower who has an outstanding federal loan balance of \$100,000 with an average interest rate of 6.5% from graduate studies. He earns a starting salary of \$60,000 (adjusted gross income equivalent of \$54,000) and a 6% annual salary raise every year. In 10 years his salary is therefore \$87,000. He works at a 501(c)(3) tax-exempt nonprofit organization for those 10 years. After his 10th year of payments, he has \$119,000 forgiven, the remaining balance on his federal student loans at that point. Despite his moderate income level, IBR never requires that he even make principal payment or even cover all the interest on his debt.

Again, the Department of Education reports that 30% of borrowers who are making progress toward PSLF borrowed more than \$100,000 in federal student loans. Over half of them borrowed more than \$50,000.⁹⁵ Enrollment in the program in the form of pre-certifications is growing rapidly, despite the fact that the program is not well-known.

The only study to project the effects of IBR and PSLF reveals that the benefits are large enough that it could become common for the government to pay for a student’s entire graduate education via loan forgiveness under PSLF, especially in some professions.⁹⁶ That is

Cumulative Public Service Loan Forgiveness Certifications



Source: AEI using statistics from Government Accountability Office and Department of Education.

because the debt levels at which borrowers bear no incremental cost in borrowing more when using IBR and PSLF are low relative to what many graduate and professional degrees cost and to what students already borrow in federal loans. Even typical levels of debt will result in substantial amounts of loan forgiveness for borrowers earning more than most of their peers. In short, IBR and PSLF are likely to have a significant impact on what students opt to borrow and what institutions of higher education charge for many degree programs.

IBR and PSLF provide substantial benefits to borrowers with typical debt loads who earn median or even high incomes for their professions. For example, a teacher with a master's degree who borrows typically leaves school with \$42,000 in federal debt from undergraduate and graduate studies combined. If he earns at the 75th percentile for his age over his first 10 years of repayment, he will have \$32,711 forgiven. In other words, a teacher with a master's degree who has a typical debt load, who earns an above average income, has over \$30,000 forgiven under IBR and PSLF. Put another way, having at least \$30,000 forgiven if you are a teacher with a master's degree stands to become the norm if you make use of IBR and PSLF.

Even if policymakers end the Grad PLUS program (as discussed later), limiting PSLF is still important. Based on cases profiled in a 2014 study, borrowers in many professions are likely to qualify for substantial loan forgiveness using Stafford loans alone, well before they reach debt levels where they would have to access Grad PLUS loans.⁹⁷ This is even more the case if a borrower enters graduate school with federal debt from undergraduate studies and repays the combined balance through IBR. For example, a dependent student who borrows the maximum in undergraduate loans over five years would enter graduate school with a balance of about \$34,000 (including accrued interest and assuming he did not make any payments). If he attends graduate school for two years and borrows the maximum in Stafford loans, his combined loan balance (including accrued interest from both sets of loans) would total approximately \$80,000.

Finally, it is important to keep in mind that, under this proposal, once a borrower has received his *limited* loan forgiveness for public service, he can still make payments on any remaining balance using income-based repayment and still qualify for loan forgiveness after IBR's other forgiveness benefits kick in (after 10 or 15 more years of

payments). That is why the final loan forgiveness (after 20 or 25 years) in IBR should be left without a limit. That is how the program provides a safety net. If you haven't repaid by that length of time, your debt is forgiven. Putting a limit on it would obviate that function. PSLF is not a safety net; IBR is the safety net.

This moderate proposal would also disallow Parent PLUS loans from repayment under the Income-Contingent Repayment plan. Currently, Parent PLUS loans may be repaid through that program if they are "consolidated"—a free benefit for which nearly all Parent PLUS loan borrowers are automatically eligible. This loophole should be closed, particularly if policymakers do not eliminate the Parent PLUS loan program going forward. But it should also be closed even if Parent PLUS is eliminated, because it will prevent the outstanding stock of those loans from taking advantage of this loophole.

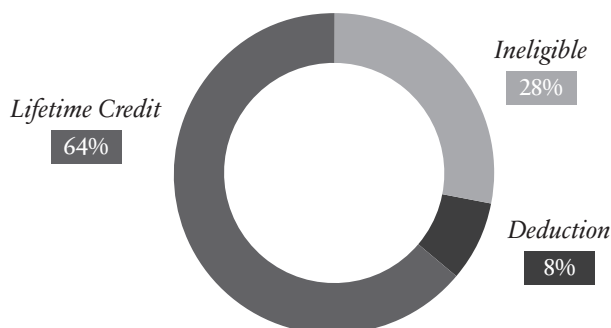
Under current law, all future and recently issued Parent PLUS loans can be repaid through the Income-Contingent Repayment (ICR) plan. ICR is a predecessor program to IBR and is far less generous. Payments are equal to 20% of a borrower's income in excess of 100% of the federal poverty guidelines, and loan forgiveness occurs after 25 years of payments (federal student loans are also forgiven when the borrower dies.) Even though ICR is not a very generous program, when combined with Parent PLUS loans, it invites abuse. Parents can borrow unlimited amounts and then can cap their loan payments as a share of their incomes and ultimately qualify for loan forgiveness after 25 years of payments.

More troubling still, borrowers repaying through ICR can exclude non-taxable income (such as Social Security retirement benefits, Supplemental Security Income, child support, etc.) from their income calculations. Parent PLUS borrowers are far more likely to collect untaxed income for a substantial portion of their loan repayment term than someone who more recently completed an undergraduate degree. Someone living entirely off untaxed income, such as Social Security retirement benefits, would qualify for \$0 payments under ICR. And even parents with some taxable and some non-taxable income would qualify for very low or \$0 payments.

Consider a Parent PLUS loan borrower who collects \$1,300 a month in Social Security benefits and earns another \$950 a month in taxable income from another source. The income reported on his federal tax return—which is made up of only the \$950 a month—is still below the

poverty threshold. Enrolling in ICR would result in a \$0 monthly payment for this borrower. (Note that the borrower can exclude a spouse's income from the ICR calculation by filing separate taxes or through the "alternative documentation" process.)

Tax Benefit Eligibility of Graduate Students (2011–12)



Source: Delisle, *A New Look at Tuition Tax Benefits*.

Finally, ending two tax benefits for graduate and professional school—the Lifetime Learning Tax Credit and the Tuition and Fees Deduction—would free up resources to be redirected to undergraduate students through grant aid or other programs. Roughly 72% of graduate students are eligible for one of these tax benefits.⁹⁸

First graduate and professional students are eligible for the Lifetime Learning Tax Credit. It allows filers to reduce their federal taxes up to \$2,000. The credit is equal to 20% of the first \$10,000 in tuition and fee expenses. Income limits are indexed to inflation, and are set at \$65,000 (\$130,000 for joint filers) for 2015. The benefit can be claimed for an unlimited number of years. This benefit is permanently authorized. Repealing it for graduate students would save approximately \$2 billion annually.⁹⁹

Second, the Tuition and Fees Deduction allows graduate students to deduct up to \$4,000 in tuition and fees from their incomes, reducing taxes by their marginal tax rates (e.g., 25% of \$4,000 for those in the 25% tax bracket). Students and families do not need to itemize deductions to claim it. Income eligibility is capped at incomes less than \$80,000 (\$160,000 joint filers) for 2015. The benefit has been available since 2002. It has always been temporarily authorized, but has been extended multiple times. The last extension made the credit available through 2016,

and lawmakers have until the end of 2017 to extend it for that tax year.¹⁰⁰ Extending it costs approximately \$300 million per year.

A BOLDER PROPOSAL

There are other avenues of reform that are bolder than those just outlined. These proposals include more aggressive reforms to the existing federal student-loan program. They could be implemented with much of the current federal loan program in place. Many could be adopted alongside reforms listed in the section above. In other cases, these reforms are extensions of the proposal outlined above, such as eliminating Grad PLUS loans in addition to Parent PLUS loans. Others, where indicated, would only work if other specific reforms are enacted.

Under such an agenda, reformers would eliminate all existing repayment plans and require borrowers to repay through either a new income-based repayment program that replaces the existing plans or a fixed 10-year repayment term. This proposal reduces the repayment plan options in the federal student-loan program to just two—mainly it eliminates the extended and consolidation plans that let borrowers extend their loan terms. Borrowers would repay either under an income-based repayment option or a 10-year fixed-payment term, and could switch between the two annually if they desired. Taken alone, this reform simplifies the federal student-loan program, but when coupled with an origination-fee model discussed below, it offers even more improvements.

The income-based repayment option under this plan would mirror the reforms outlined above. Payments would be set to 10% of a borrower's discretionary income; loan forgiveness is available after 20 years of payments for those who enter repayment with \$40,000 or less, and after 25 years of payments for those who enter with more; payments would be set off a borrower's household income no matter how he filed his taxes; payments would always track income, as there is no payment cap based on a 10-year repayment term.

Reformers should also eliminate the interest rate charged on federal student loans and replace it with a one-time origination fee added to the loan balance when the loan is disbursed. This policy works best when implemented in tandem with the above proposal to establish only two repayment plans for borrowers: an income-based plan and a 10-year fixed-payment plan. Note that the proposal to eliminate origination fees in the first set of reforms outlined in this chapter is meant to

simplify the loan program. In this case, eliminating interest rates on the loans completely and replacing them with an origination fee simplifies the program, while also better targeting benefits (explained below).

To ensure that the origination fee fluctuates with changes in the interest rates in the economy, it should be linked to interest rates on 10-year U.S. Treasury securities. Specifically, when rates on the bonds are 1.5% and below when the loans are issued, it should be a 25% fee; between 1.5% and 3%, it should be a 30% origination fee; between 3% and 4%, it would be a 35% origination fee. For each additional 1 percentage-point increase in the interest rates on 10-year Treasury bonds when the student loans are issued, the fee would increase by 5 percentage points.

While those rates seem high at first, they are quite similar to the annual interest rates charged under the current system. Currently, a student who borrows \$10,000 at an interest rate of 5% over four years pays about \$14,000 in principal and interest over a 10-year fixed-payment term. This proposal simply makes the initial loan balance \$14,000 from the start (the \$10,000 loan plus the \$4,000 origination fee added to the balance). This proposal is designed to be approximately budget-neutral, but changing the size of the origination fee can make it more or less costly relative to the current student-loan program.¹⁰¹

This approach has a number of advantages over the current system of annual interest rates, especially when combined with the two-option repayment-plan approach. First, it is *more* transparent. The borrower knows exactly how much he owes and will pay on the loan from day one. The balance cannot grow if he uses income-based repayment and his payments are low. Every single payment he makes always reduces his balance because interest is never accruing. And borrowers would not see interest accrue and their loan balances rise while they are in school—they would no longer be surprised by the amount that was eventually due when they enter repayment compared with what they borrowed when they entered school.

Another advantage of this approach compared with charging annual interest rates is that it better targets subsidies to borrowers who need them most. If all the interest is added at once and does not accrue, then the longer a student takes to repay his loan, the lower the “effective” interest rate on the loan. Because under this system there are only two repayment options (10-year and income-based), the only way to extend the term on the loan and reduce the effective interest rate is for the borrower

to enroll in the income-based repayment option. And that plan will only lengthen his loan term if his income is low relative to his debt load for a prolonged period of time. Conversely, a higher-income borrower would pay down his debt faster by using income-based repayment, thereby increasing his effective interest rate. Of course, he may use the 10-year fixed-payment plan instead, but that is the longest term he can opt into.

To see this effect, consider the earlier example of the borrower who pays for 10 years with that \$4,000 origination fee. Recall that he pays the same amount as someone who had a loan with an annual interest rate of 5%. But if he paid off the entire loan during the first year, his effective interest rate is 9%. If he took 20 years to repay using income-based repayment, his effective interest rate would be as low as 2%. Under this system, the interest-rate subsidy is more closely correlated with the borrower's income during repayment than under the current system.

Policymakers should also end the Grad PLUS loan program. This program allows graduate and professional students to borrow up to the full cost of attendance at an institution of higher education, with no time or aggregate limit. Such a policy, especially when coupled with loan forgiveness and income-based repayment, can discourage prudent pricing on the part of institutions and prudent borrowing by students. This policy leaves in place the annual limit on Unsubsidized Stafford loans for graduate students at \$20,500 (and an aggregate limit of \$138,500), but the annual limit could be raised as part of this proposed reform.

The Grad PLUS program was enacted in 2006 and since then, the debt that students have been taking on for graduate schools has grown rapidly.¹⁰² A report that uses the National Postsecondary Student Aid Study shows that median debt grew from \$40,000 in 2004 to \$58,000 in 2012, after adjusting for inflation.¹⁰³ A separate study that used a different dataset—the Survey of Consumer Finances—found similarly large increases in graduate-school debt, increases that were much larger and more rapid than debt for undergraduate studies.¹⁰⁴ In fact, an estimated 40% of all outstanding student debt is from graduate and professional studies, not undergraduate degrees.¹⁰⁵

If institutions can no longer rely on PLUS loans to fund their tuition programs and if the private market is responsive to the ability of borrowers to repay, then graduate schools may have to set their pricing based, in part, on students' expected earnings. Since those in graduate school already have an undergraduate degree and are preparing for a profession, it

is more reasonable to expect that loans above the Stafford limits be based on prospective ability to repay. Underwriters will likely focus most intently on institutional characteristics to determine risk. Consequently, programs that poorly prepare students to repay their debts will find that their students cannot access much credit in the private market, which should change institutional behavior in terms of quality and pricing.

In the same spirit, reformers should also replace Stafford loans for graduate students with a subsidized private-market program. The case for a heavily subsidized student-loan program for graduate and professional students is much weaker than it is for undergraduate students. At the same time, the now-defunct Federal Family Education Loan (FFEL) program—the Department of Education’s main program for issuing federal Direct loans to undergraduate and graduate students from 1993 to 2010—was a flawed model for incorporating private-market actors in the federal loan program for a number of reasons. Mainly, it set subsidies for lenders through a political process, not through market signals and competition.

But, private lenders could play a more constructive role in a new loan program for graduate students only. By definition, private lenders have access to key information about the creditworthiness of graduate students that they do not have for undergraduate students. Graduate students are all over the age of 18, have had the opportunity to work and establish a credit history, and *already have four-year college degrees*. Moreover, statistics show that they have a low likelihood of default.¹⁰⁶ Thus, there is little need to make unlimited, heavily subsidized credit available to graduate students.

Policymakers may, however, see a need for a smaller, more selective, and less subsidized graduate student-loan program. For example, they may see the benefit of providing limited amounts of government-backed credit for certain types of graduate credentials. Or they may want to guard against the under-provision of credit during times of economic recession, which is exactly the time that enrollment in graduate school increases and may be the most productive time for students to enroll. In that case, they could enlist private lenders in the effort through the following policy.

Policymakers would first eliminate all federal loan programs for graduate and professional education, leaving only the loans for undergraduates as those issued directly by the federal government. The government would

then partially guarantee against default loans that private lenders make to graduate students so long as those loans meet certain guidelines. For example, the loans must carry basic protections and be subject to borrowing limits, but the program would not dictate the specific terms of the loan (i.e., interest rate) and would allow lenders flexibility in deciding to whom they would lend and how much, up to the limit. Private lenders would thus underwrite the loans, and the partial default guarantee would ensure that they bear sufficient risk in the transaction and lend prudently. Lenders would own the loans as assets and retain any interest income that they earn.

This approach stands in contrast to the defunct FFEL program in a number of ways. First it enlists private lenders as underwriters — a task for which the government is particularly ill-suited. That means students are *not* entitled to loans at terms set by the government as they are today and were under the FFEL program. Lenders in the FFEL program did not, and could not, underwrite. They simply issued loans at terms dictated by the government to borrowers who were entitled to the loans.

This proposed approach also requires lenders to take much more risk in making the loans because it only offers partial insurance against default. Under the FFEL program, lenders received a 97% guarantee against default and a guaranteed quarterly interest rate. Those policies were appropriate given that lenders could not underwrite, turn away less credit-worthy borrowers, or issue loans with terms that matched the risk profile of the borrowers.

The amount of the guarantee under the proposed program should be set through a competitive bidding process, not set in law at an arbitrary level like the subsidies in the FFEL program. One way to structure that process is for the government to grant exclusive rights for two or three lenders to make the new graduate student loans to a group of schools for a set number of years. Lenders would compete for the right to make the loans by bidding on a guarantee rate they would require to make loans that met the general guidelines set by the government. The government would select the second-lowest bids (if there were to be two winners) on the guarantee, and then those two lenders would compete for business among graduate students attending each group of graduate schools. This is similar to an auction approach outlined in a 2007 law that became moot when lawmakers ended the FFEL program in 2010.¹⁰⁷

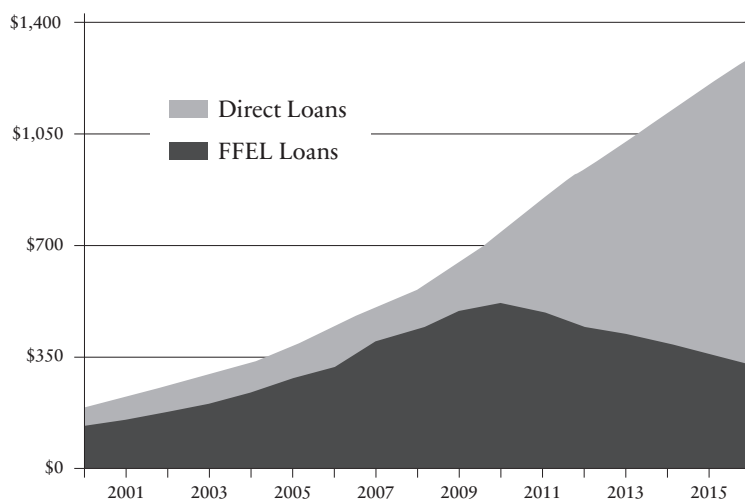
Policymakers should also overhaul policies for delinquent and defaulted loan collection and reform forbearance benefits. More specifically,

Policy Reforms to Strengthen Higher Education

reformers should look to charge small fees for late loan payments; initiate wage garnishment earlier in the repayment process; end the seizure of defaulted borrowers' Earned Income Tax Credits and Social Security payments; and impose stricter time limits on loan forbearance. These reforms would make loan repayment and collections processes more effective, fair, and rational for students and taxpayers alike.

Of the borrowers whose loans have come due (i.e., the borrowers who are not in school), over 40% are not making payments on their loans.¹⁰⁸ About half of that group is in default, having not made a payment for nearly a year, and the other half is delinquent or enrolled in a forbearance or deferment option. The loans accrue interest while borrowers postpone payments, and in the case of default, collection agencies can add fees up to 20% to the loan balance. Due to these trends, the federal loan portfolio is now growing due only to accrued and unpaid interest, as fewer students are borrowing today, and when they do, they are borrowing less than in the past.

Outstanding Federal Student Loans (in billions)

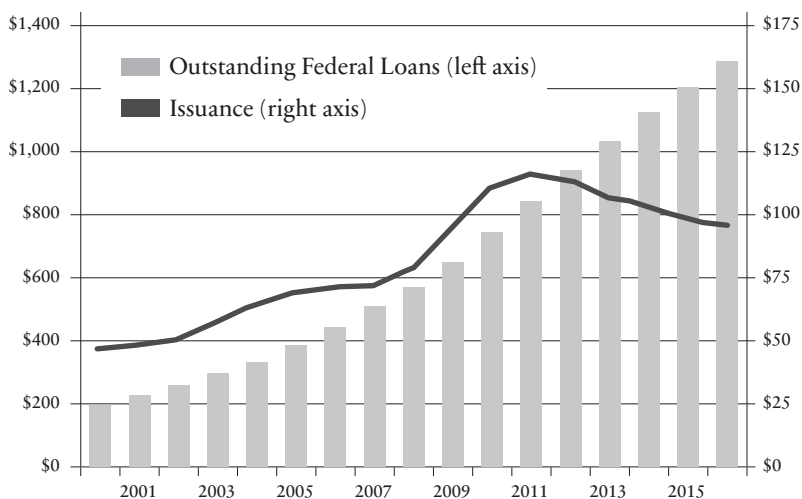


Source: AEI using U.S. Department of Education data.

Policymakers have built much flexibility and leniency into the loan-repayment terms, but this also encourages borrowers to make student loans a low priority, fueling the rise in loan balances. The forbearance

benefit, for example, lets borrowers postpone payments for up to three years. Over 10% of borrowers with loans due were enrolled in forbearance in late 2015.¹⁰⁹ Loan-servicing companies have a lot of discretion to grant forbearances, and getting one takes only a phone call on the part of the borrower. Forbearance also cures the delinquency status on a loan. Payments cease and the loan is put in good standing. When the loan finally comes due, however, the monthly payment will be higher than the payment the borrower originally found too difficult to pay, thanks to accruing interest. Forbearances are thus a double-edged sword. They help borrowers keep their loans in good standing, but they also preclude borrowers from making progress on paying down their debts, putting borrowers in worse standing.

Federal Student Loans:
Outstanding Debt vs. Issuance (in billions)



Source: AEI using U.S. Department of Education and College Board data.

While official budget projections show that the federal government collects about 80% of the value of defaulted loans, no data is available to confirm those figures. The Congressional Budget Office estimated in 2007 that the collection rate was only 50% of the value of the defaulted loans.¹¹⁰ Countless stories in the news media have profiled borrowers with debt from decades ago.¹¹¹ One recent article reports, “Education Department

officials note that some defaulted loans are from prior decades and, unlike private lenders, the government is severely limited in its ability to write them off and remove them from the books. . .[and they] acknowledge that a large pool of borrowers have essentially fallen off the radar.”¹¹²

Participants in a series of focus groups in 2014 explained that often years had lapsed before the government imposed consequences punitive enough that they began making payments on their loans. They also noted that years lapse between when they stop making payments and have their wages garnished. Some even expressed that, at the time, the penalties for default felt more manageable than making the required monthly payment. These experiences differ from the perception within the policy community that the consequences for defaulting on a federal student loan are swift, severe, impossible to evade, and always a borrower’s worst option.¹¹³

Loan servicers for federal student loans generally do not charge a penalty for late payments, per instructions from the U.S. Department of Education, until the loans are in default. Interest continues to accrue, however, and the borrower’s credit score suffers. Even when a late fee is assessed, it is not as severe as for other types of debt. The student-loan servicer can never increase the interest rate on the loan, which is common for credit cards, nor repossess an asset, nor shut off a vital service.

There are a number of reforms policymakers can implement to address this repayment and collections crisis. These reforms are meant to make the loan repayment and defaulted collections process more effective, but also more fair and rational for both borrowers and taxpayers. The proposals are based on the principle that penalties and collection efforts should happen faster, but be less severe. And the myriad opportunities borrowers have to postpone payments should be curtailed to discourage borrowers from assigning low priorities to their student loans and going deeper into debt due to accruing interest.

First, the government should charge small late fees for missed payments on a federal student loan. In exchange, it should reduce the fees it charges on defaulted student loan. This remedies the current flaw in the program that allows borrowers to delay payment with impunity, but then imposes extremely harsh penalties (a fee up to 25% of the loan balance) after nearly a year of missed payments. This results in a “bait-and-switch” feeling among borrowers and discourages them from repaying once the high fees are accessed.

Second, policymakers should initiate wage garnishing much earlier in the default process. Borrowers and officials at the Department of Education say that wage garnishing is the most effective way to bring a borrower back to repaying his loan. Yet they also say it is the last option the government uses, often waiting years while a borrower accrues more interest on this loan. Wage garnishing is hardly punitive given that borrowers have a percentage of their discretionary income garnished, meaning it is effectively an income-based repayment program. Moreover, it only affects borrowers who are working, by definition.

Third, policymakers should end the practice of seizing Earned Income Tax Credits from borrowers who have loans in default. While offsetting federal income-tax refunds is a sound policy to recover a federal debt—it nets \$1.9 billion a year—the EITC is a wage supplement to keep working families with children out of poverty.¹¹⁴ In fact, many borrowers who qualify for an EITC almost surely qualify for a \$0 payment under IBR (due to the exemption it provides of 150% of the federal poverty guidelines adjusted for household size), but have not brought their loans into good standing to enroll. They may not even know about the benefit.

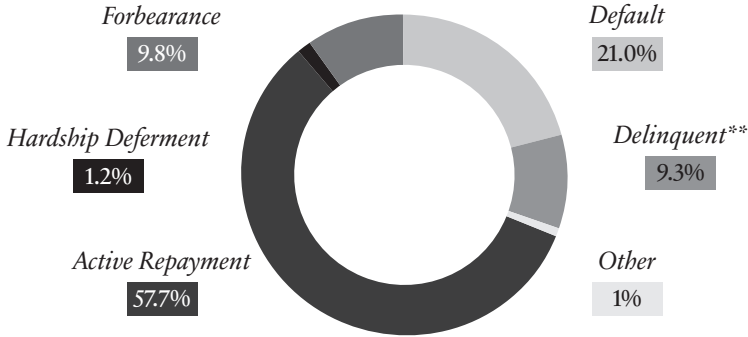
Fourth, policymakers should change the practice of garnishing Social Security payments for borrowers in default.¹¹⁵ A new process could be implemented to check whether the borrower would qualify for a \$0 payment on the student loan under IBR. If so, the government should suspend the garnishing. The vast majority of borrowers who receive income from Social Security retirement benefits likely qualify for \$0 student-loan payments under the income-based repayment program, but they do not know it. That is because Social Security retirement benefits are generally excluded from someone's adjusted gross income on a federal tax return—and IBR bases payments on adjusted gross income. Nevertheless, if a borrower does not know that and does not take action to put his loan in good standing and enroll in IBR, his Social Security benefits, which are exempt from income under a federal formula for student-loan payments, *are seized to pay his student loan*.

Fifth, policymakers should impose stricter time limits on forbearances. The current limit is three years, far too long for a program that offers so many options to reduce and extend payments, such as income-based repayment. A six-month limit would be a big improvement over the current system and help discourage borrowers from postponing

Policy Reforms to Strengthen Higher Education

payments and accruing additional interest. Forbearance is an important benefit in many cases and should be maintained, particularly because borrowers can use it while transitioning from delinquency to a new repayment plan, but it should be a more limited benefit.

Federal Loan Portfolio, Borrowers in Repayment* Q4 2016

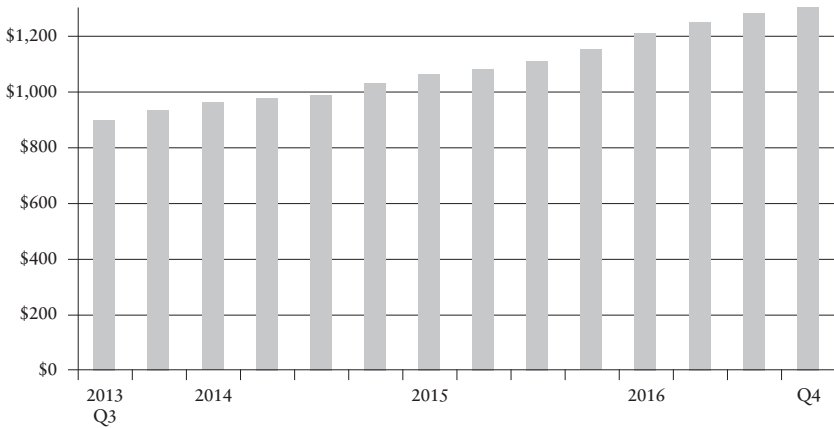


* Based on the 39 million borrowers and \$976 billion in loans that have come due and are not in in-school deferment. Includes duplicated accounts for borrowers with loans in both Direct and FFEL programs.

** Excludes loans in the FFEL program.

Source: AEI using U.S. Department of Education data.

Outstanding Federal Student Loans in Default (in billions)



Source: AEI using U.S. Department of Education statistics.

Sixth, under current law, default is defined as 270 days without payment. In practice, it can be closer to 360 days. As is the case with the forbearance benefit, this timeframe drags out the process for the borrower while he goes deeper into debt. Policymakers should move up the default timeframe to no longer than six months, which is still about twice as long as what the private loan market considers default.

TOTAL REFORM FOR FEDERAL STUDENT LOANS

A third set of reforms represents an entirely new approach to the federal student loan system. It gives students access to a simpler, more flexible student-aid program built around income-share agreements that avoid many of the worst qualities and shortcomings of loans. It also targets benefits to the lowest-income families and does not subsidize upper-income families. These reforms are meant to be implemented together and would not necessarily work if adopted in part or alongside the existing federal student-loan program.

To start, reformers would replace all federal student loans and borrowing limits with a \$50,000 account for each student that is repaid as an income-share agreement. Those who tap into this funding repay with a percentage of their incomes proportional to the amount they accessed. Students would repay 1% of their future income for every \$10,000 that they draw down for 25 years. The most someone would ever pay would be 5% of his income, because the maximum amount available in the account is \$50,000. Someone who used only \$5,000 would repay half of one percent of his income.

Those payment amounts are generally lower than what borrowers pay today relative to their incomes. Multiple studies have shown that median student-loan payments over the past fifteen years have ranged from 5% to 7% of household income.¹¹⁶ That is one reason why the repayment term for this program is relatively long at 25 years. The proposal stretches out the loan term to keep payments at a very low share of income.

First-year, full-time students could draw down up to \$10,000. After that, they would be free to draw down the account at any rate. (Students attending schools where graduates have strong repayment records could be exempt from that first-year limit.) That is in contrast to the current federal loan program, which provides fixed disbursements for every semester a student enrolls and includes annual loan limits that increase as a student progresses.

The \$50,000 account could be used for any level of post-secondary education from a short-term certificate to a master's degree. In some respects, that allows students more financing than under the current system. It is \$19,000 more than most undergraduates can borrow now, and the first year limit of \$10,000 is \$4,500 more than dependent undergraduates can borrow now and \$500 more than independent undergraduates can borrow now. It is, however, less than what graduate students can borrow under the existing federal loan program — which allows graduate students to borrow unlimited sums. Median student-loan debt for all types of students who borrow was \$19,647 in 2014, suggesting that \$50,000 does increase the amount of financing available to students relative to current policy.¹¹⁷

The proposed program would not charge interest. But, in a way, it charges an effective interest rate because borrowers could still end up repaying more than the principal that they borrowed. However, payments will still be lower for most borrowers than under the current student-loan program, except for those earning higher incomes.

There would be no “loan balance” for a borrower to repay under this design. Rather, the factors that dictate payment are the percentage of income and the 25-year repayment term. However, the plan can include a maximum payment cap of 1.75 times the amount drawn down. That is an upside cap to assure that students who go on to earn high incomes do not pay disproportionately more than they used to finance their educations. (Students today in the federal loan program will typically pay about 1.5 times what they borrowed after making interest payments over the life of the loan.)

Consider an example comparing the proposed income-share agreement with the current student-loan program's income-based repayment plan. A borrower under the current system with a \$10,000 loan at 5% interest and an initial adjusted gross income of \$35,000 makes monthly payments of \$103. If her income grows at 5% annually, she will pay a total of \$11,361, discounted present value (2.5% discount rate). Under the income-share agreement, she would make initial monthly payments of just \$25 and make total payments over the life of the agreement of \$9,978, discounted present value. The income-share agreement is a better deal for her; she receives a larger subsidy.

Now consider a different borrower. She has a \$50,000 loan balance (with a 5% interest rate) from attending graduate school. Her income

when she begins repaying under the existing income-based repayment plan is \$60,000 (adjusted gross income), and she receives an 8% annual raise. Her initial monthly payment is \$353 and in total she will repay \$58,562, discounted present value. Under the income-share agreement, her initial monthly payment is lower at \$250, but she pays more overall, \$66,212. Because her income grows rapidly from a \$60,000 starting point, she hits the 1.75 times payment cap in her 16th year of repayment, meaning she no longer needs to make payments at that point.

One difficult issue that policymakers must address as part of this income-share agreement plan is how to treat the income of married borrowers. The federal income-tax system generally treats married borrowers as one unit. That poses complications for this system. If one earner in a married household does not have an income-share agreement and the other does, both would have to make adjustments on their payroll withholding. Furthermore, if the income-share agreement is meant to be linked to the return on the investment it financed, then it logically follows that only the recipient's income should be used to repay the obligation. Therefore, the simplest solution is to base the recipients' payments for the income-share agreement on one half of the household's income. Joint tax filers who each have an income-share agreement would each make payments on one half of their household income. While this solution will create both marriage "bonuses" and "penalties," it is still preferable to a complicated process that assigns income to each tax filer on a joint return.

Note also that there are key distinctions between IBR and the income-share agreement proposals that justify the opposite treatment of income from married households. For one, federal student loans repaid in IBR do not have the same kind of "upside risk" for the borrowers as an income-share agreement. Once a borrower repays the principal balance on a loan in IBR, he is done repaying; under the income-share agreement he could pay more than if he had a loan. It makes more sense in the case of IBR for student loans to capture household income because that approach guards against windfall benefits for high-debt borrowers with middle- and high-incomes, a problem that arises in the current program due to its generosity. The income-share agreement already guards against such windfall benefits by linking payments closely to the amount of financing accessed, by limiting the amount of financing to \$50,000, and by requiring that higher-income borrowers pay

more in total on the loan than under the current income-based repayment system. Therefore, the income-share agreement can be based only on an individual's income rather than household income — without causing the same problems as the income-based repayment program.

Policymakers should establish an exemption for low-income individuals and families for payments under the income-share agreement. Low-income borrowers would be exempt from making payments under two provisions: Tax filers who qualify for the Earned Income Tax Credit would have their obligations reduced or cancelled that year, and anyone who earns too little to file federal income taxes would also owe nothing. These two provisions are meant to align with a payment-collection system for the income-share agreements that operate as part of federal income-tax collection. The income-share agreement proposal outlined here could operate with a servicing and collections system like the one that exists for the federal student-loan program today. But there are major advantages to a withholding approach like the one that exists for federal income taxes, which is discussed in a subsequent section.

Some individuals and families are not required to file federal income taxes because they earn too little or earn no taxable income (individuals earning approximately \$10,000 or less and joint filers earning \$20,000 or less are not required to file). The income-share agreement plan should exempt those borrowers from payments in any year that they do not need to file income taxes, but it would still give those borrowers credit for that year toward their 25 years of payments.

Another provision would target lower-income families with children by linking an exemption to the Earned Income Tax Credit (EITC), a refundable tax credit for low-income families. These families would have their payments toward the income-share agreement cancelled or rebated up to 15% of the value of the EITC for which they are eligible that year. The rebate would be halved for married households in which only one individual owes on the income-share agreement to align with the rule that married tax filers make payments on one half of household income. This approach creates a means-tested, household-size adjusted exemption from payments. The EITC provides refundable credits based on a tax filer's earned income and the number of children in the household. It phases out gradually as income increases. Linking an exemption to the EITC closely tracks the current exemption structure of income-based repayment in the federal loan program, which is 150% of federal poverty guidelines.

For example, a married couple with two children and a combined income of \$30,000 would receive a federal EITC of \$4,201, exempting them from \$630 in payments due on the income-share agreement that year.¹¹⁸ Assume only one member of the household had used \$20,000 of the income-share agreement years ago (about the median amount of student debt borrowers use today). He would owe \$300 for the year on the agreement (2% of half the household income because he is married), but that is less than the \$315 exemption (half of \$630) for which he qualifies based on his EITC, and he therefore owes nothing.

Earned Income Tax Credit Limits and Amounts, 2016

	No Children	One Child	Two Children	Three Children +
<i>Maximum Credit</i>	\$506	\$3,373	\$5,572	\$6,269
<i>Income Limit (single, head of household, widowed)</i>	\$14,880	\$39,296	\$44,648	\$47,955
<i>Income Limit (married)</i>	\$20,430	\$44,846	\$50,198	\$53,505

Source: Internal Revenue Service.

Reforms should also include handling all repayment of the new income-share accounts through income-tax withholding and the income-tax payments system. The income-share proposal is well suited to a repayment system designed around the existing income-tax process. The income-share agreements are an obligation owed to the federal government and payments are based on the recipient's income, similar to an income tax. Moreover, unlike a loan, the income-share agreement does not have a balance or an interest rate, which makes it easier to repay through the tax-collection system, as it avoids issues of tracking and crediting payments in real time. The tax-collection system cannot currently track cash flows on a monthly or even quarterly basis, as would be required to properly track and credit loan payments.

The payment process under this new system would operate in the following manner: The IRS form W-4 that employees file with employers instructing them on how much to withhold for federal income taxes would be modified to incorporate payments on an income-share agreement. Currently, the form includes a step-by-step worksheet by which an employee calculates the number of exemptions he should claim,

thereby determining how much his employer will withhold. (Self-employed individuals undertake a similar process when they file their estimated quarterly tax payments.)¹¹⁹

To incorporate income-share agreement payments, the form would include a question about whether the filer has an income-share obligation. If he does, then the form would instruct him to make the necessary adjustment to the number of exemptions he claims or any additional amounts he has withheld. Those adjustments would be calibrated to the amount of the income-share agreement. An individual who used \$5,000 of the \$50,000 account, and therefore owes an additional 0.5% of his income on his withholding, may not need to have his withholding adjusted at all given how small the amount is. He would simply receive a smaller refund when he files his tax return. Someone who used the full \$50,000, however, would owe an additional 5% of his income and would be instructed to reduce the number of exemptions he claims accordingly or withhold an additional nominal sum.

About 80% of tax filers already over-withhold on their federal income taxes and are due refunds. For 2015, the average refund was over \$3,000.¹²⁰ That suggests that even if a tax filer did nothing to adjust his withholding for an income-share agreement, he would withhold sufficient additional income to cover the obligation. For example, an individual with an adjusted gross income of \$50,000 who used \$30,000 of the income-share agreement account would owe \$1,500 for the year, less than half the typical tax refund. For that reason, it is important that this system set payments at a low share of an individual's income to reduce the likelihood that he would underpay his income-share agreement in a given year.

Anyone with an income-share agreement under this plan would reconcile the amount he had withheld with the amount he owed as part of the annual tax-filing process. His payments and obligation would be figured on a schedule or a line on the IRS form 1040.¹²¹ Over-payments would be included in any tax refund for the year. Under-payments would be treated exactly like underpaid federal income taxes. Up to a certain amount, filers would pay the amount due without penalty as a lump sum when they file their income taxes. Amounts over the safe-harbor exemptions for underpaid taxes would be subject to the existing penalties and interest and the IRS collections processes.

There would be only a very limited need for administrative overhead under this system. The existing federal student-loan system relies

on federal employees, numerous private contractors, and collections agencies to service the loans, costing taxpayers \$3 billion a year.¹²² This proposed system would piggyback off the existing tax-collection system, reducing the need for loan servicers and collections agencies. Some administrative overhead will still be necessary. For example, an agency must still disburse the funds from the accounts, track how much students had drawn down, and track an individual's progress toward fulfilling the obligation during repayment.

Another advantage of using the tax-collection system in this manner is that it all but eliminates the delinquencies and defaults that are rampant in the existing federal student-loan program. Some 8 million borrowers are currently in default on their federal loans. Payments would be withheld by employers and remitted to a federal agency with tax receipts rather than billed monthly to the borrower. That feature also makes income-based payments automatic, and payments track income in real time. Compare that with the current loan program where income-based repayment is opt-in, requires an annual renewal process along with much paperwork, and bases payments on a borrower's income from at least a year earlier, or even two years earlier.

To be sure, individuals with the new income-share agreements can still effectively default just as they can under-withhold federal income taxes, fail to file a tax return, or fail to pay an amount due on their taxes at the end of the year. Even so, Americans are less likely to owe back taxes than they are to default on a federal student loan—mainly because payments are withheld regularly from their paychecks.

Ideally, borrowers with existing federal loans could convert their loans into an obligation under the income-share agreement, but wouldn't be required to. While the proposed program is envisioned for new students going forward, policymakers could allow borrowers with federal loans under the old system who have left school to opt in. Under this arrangement, borrowers would convert their existing loan balance to an obligation under the new system. Borrowers would then receive the same terms as if they were accessing the new program. For example, if a borrower converts a \$35,000 loan balance into the new system, he would repay 3.5% of his income for no longer than 25 years or 1.75 times the balance (\$61,250), whichever occurred first. Borrowers with high loan balances would likely not opt into the new system as the existing terms on federal student loans are more generous, and they would have already

made progress toward the requisite number of payments to receive loan forgiveness. Opting into the new system would also mean they start over on a new repayment term—25 years in the new system.

In addition, reformers should eliminate all tuition tax benefits, redirecting those budgetary resources to the new income-share agreement system, helping to keep payments a low share of income. Because the income-share agreements are more subsidized for the typical student than the current system, policymakers will need to enact budget offsets to keep the plan budget neutral if that is the desired effect. An ideal and logical place to achieve the offsetting savings is by eliminating the federal tax credits and deductions for tuition, the American Opportunity Tax Credit (AOTC) and the Lifetime Learning Credit. Some of those savings would occur automatically in the case of the deduction for student-loan interest. Because the income-share agreements do not charge interest, the deduction would cease to reduce federal revenue and therefore produce savings relative to current law. (The tuition and fees deduction expires under current law, so there would be no savings from that provision.)

The AOTC and Lifetime Learning Credit together account for about \$19 billion per year in forgone revenue and refundable tax credits.¹²³ They are logical benefits to move into the income-share agreements because they are federal benefits for paying tuition. A subsidized income-share agreement is as well (it is even figured on an individual's income taxes). In other words, both policies provide federal aid to help families finance a higher education through the tax system. Maintaining both policies is redundant, and the tax benefits can be eliminated in order to keep the subsidy on the income-share agreement larger than it would be otherwise—and slightly more generous than the current system for low- and middle-income borrowers.

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- 1, 2011, the school in which the student is enrolled has a cohort default rate, calculated under either subpart M or subpart N of 34 CFR part 668, of less than 15 percent for each of the three most recent fiscal years for which data are available.”
54. The College Board’s Rethinking Student Aid Study Group’s report called for using three years’ worth of income information in needs analysis. See College Board, *Fulfilling the Commitment*.
 55. Robert Kelchen and Sara Goldrick-Rab, “Accelerating College Knowledge: Examining the Feasibility of a Targeted Early Commitment Pell Program,” (working paper, University of Wisconsin, Madison, 2012), www.insidehighered.com/sites/default/server_files/files/Kelchen%20Goldrick-Rab%20Early%20Commitment%20Paper%20with%20summary.pdf.

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56. Reflects total enrollment in degree-granting postsecondary education institutions from 2005-2015. See National Center for Education Statistics, “Table 303.10. Total Fall Enrollment in Degree-Granting Postsecondary Institutions, by Attendance Status, Sex of Student, and Control of Institution: Selected Years, 1947-2025,” February 2016, http://nces.ed.gov/programs/digest/d15/tables/dt15_303.10.asp?current=yes.
57. College Board, “Table 6: Number of Borrowers and Average Amount Borrowed through Federal Loan Programs in Current Dollars and in 2014 Dollars, 1995-96 to 2014-15,” <http://trends.collegeboard.org/student-aid/figures-tables/federal-loans-current-constant-dollars-over-time-all-postsecondary-undergraduate-graduate>.
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60. For instance, see David O. Lucca, Taylor Nadauld, and Karen Shen, *Credit Supply and the Rise in College Tuition: Evidence from the Expansion in Federal Student Aid Programs*, Federal Reserve Bank of New York, July 2015, www.newyorkfed.org/medialibrary/media/research/staff_reports/sr733.pdf; Stephanie Riegg Cellini and Claudia Goldin, “Does Federal Student Aid Raise College Tuition? New Evidence on For-Profit Colleges” (working paper, National Bureau of Economic Research, February 2012), www.nber.org/papers/w17827; and Grey Gordon and Aaron

- Hedlund, “Accounting for the Rise in College Tuition” (working paper, National Bureau of Economic Research, February 2016), www.nber.org/papers/w21967.
61. *The Bipartisan Student Loan Certainty Act*, Public Law 113-28, 113th Cong., 1st sess. (August 9, 2013), www.congress.gov/113/plaws/publ198/PLAW-113publ198.pdf.
 62. *Budget Control Act of 2011*, Public Law 112-25, 112th Cong., (August 2, 2011), www.congress.gov/112/plaws/publ25/PLAW-112publ25.pdf.
 63. See U.S. Department of Education, “Subsidized and Unsubsidized Loans,” <https://studentaid.ed.gov/sa/types/loans/subsidized-unsubsidized>.
 64. See U.S. Department of Education, “Direct PLUS Loans,” <https://studentaid.ed.gov/sa/types/loans/plus>.
 65. See U.S. Department of Education, “Repayment Plans,” <https://studentaid.ed.gov/sa/repay-loans/understand/plans>.
 66. See 34 CFR § 685.209(a), “Income-Contingent Repayment Plans,” www.law.cornell.edu/cfr/text/34/685.209; and 20 USC § 1087e, “Terms and Conditions of Loans,” www.law.cornell.edu/uscode/text/20/1087e.
 67. The benefit was made permanent as part of the *Protecting Americans from Tax Hikes (PATH) Act of 2015*, Public Law 114-113, 114th Cong., 1st sess. (December 18, 2015), www.gpo.gov/fdsys/pkg/PLAW-114publ113/pdf/PLAW-114publ113.pdf.
 68. First established in the *Taxpayer Relief Act of 1997*, Public Law 105-34, 105th Cong., 1st sess. (August 5, 1997), www.gpo.gov/fdsys/pkg/PLAW-105publ34/html/PLAW-105publ34.htm.
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- Tuition?” *Regulation*, Summer 2016, <http://object.cato.org/sites/cato.org/files/serials/files/regulation/2016/6/regulation-v39n2-4.pdf>.
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 74. Statute and regulation do not clearly spell out when garnishment kicks in. See 34 CFR § 34.4: “Notice of Proposed Garnishment,” www.law.cornell.edu/cfr/text/34/34.4:

“(a) We may start proceedings to garnish your wages whenever we determine that you are delinquent in paying a debt owed to the United States under a program we administer. (b) We start garnishment proceedings by sending you a written notice of the proposed garnishment. (c) At least 30 days before we start garnishment proceedings, we mail the notice by first class mail to your last known address. (d)(1) We keep a copy of a certificate of service indicating the date of mailing of the notice. (2) We may retain this certificate of service in electronic form.”
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86. Jason Delisle and Alex Holt, *Safety Net or Windfall: Examining Changes to Income Based Repayment*, New America, October 2012, www.newamerica.org/education-policy/policy-papers/safety-net-or-windfall/.
87. The median cumulative amount borrowed in federal loans for undergraduates who completed a degree in 2011-12 was \$16,856, see National Center for Education Statistics, *2011-12 National Postsecondary Student Aid Study*.
88. See 20 USC § 1098e(e), “Income-Based Repayment,” www.law.cornell.edu/uscode/text/20/1098e; Implementing regulations can be found in 34 CFR § 685.221, “Income-Based Repayment Plan,” www.law.cornell.edu/cfr/text/34/685.221; For the original 2007 version of the program, see the *College Cost Reduction and Access Act*, Public Law 110-84, 110th Cong, 1st sess., (September 27, 2007): title II § 203(a), 121 Statute 784, 792, www.gpo.gov/fdsys/pkg/PLAW-110publ84/html/PLAW-110publ84.htm. The law set the effective date on and after which borrowers could enroll at July 1, 2009. Also note: The Obama administration used the authority under a provision added to the Higher Education Act in 1993 that allows the secretary of education to offer an income-contingent repayment plan within certain parameters, see 20 U.S.C. § 1087e, “Terms and Conditions of Loans.” A “new borrower” for purposes of the plan is someone who takes out a federal student loan for the first time on or after the specified date. For the Pay As You Earn plan, the borrower must also have taken out a loan on October 1, 2011 or after. Someone who borrowed initially prior to that

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date but repaid the earlier loans in full before borrowing again on or after that date is also considered a new borrower.

89. See 34 CFR § 685.221(d)(1)(i)-(ii), “Income-Based Repayment Plan”: “Changes in the payment amount. (1) If a borrower no longer has a partial financial hardship, the borrower may continue to make payments under the income-based repayment plan, but the Secretary recalculates the borrower’s monthly payment. The Secretary also recalculates the monthly payment for a borrower who chooses to stop making income-based payments. In either case, as result of the recalculation—The maximum monthly amount that the Secretary requires the borrower to repay is the amount the borrower would have paid under the standard repayment plan based on the amount of the borrower’s eligible loans that were outstanding at the time the borrower began repayment on the loans under the income-based repayment plan; and The borrower’s repayment period based on the recalculated payment amount may exceed 10 years.”
90. See 34 § CFR 685.221(a)(1), “Income-Based Repayment Plan”: “For a married borrower filing jointly, AGI includes both the borrower’s and spouse’s income. For a married borrower filing separately, AGI includes only the borrower’s income.”
91. See *College Cost Reduction and Access Act*.
92. Consumer Financial Protection Bureau, *Public Service and Student Debt: Analysis of Existing Benefits and Options for Public Service Organizations*, August 2013, http://files.consumerfinance.gov/f/201308_cfpb_public-service-and-student-debt.pdf.
93. See 34 CFR § 685.219, “Public Service Loan Forgiveness Program,” www.law.cornell.edu/cfr/text/34/685.219.
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95. Barbara Hoblitzell, Ian Foss, and Dan Weigle, “Public Service Loan Forgiveness,” (presentation, U.S. Department of Education, 2015 FSA Training Conference for Financial Aid Professionals, December 2015), <http://fsaconferences.ed.gov/conferences/library/2015/2015FSACConfSession5.ppt>.
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101. The examples in this section are based on those developed by Alexander Holt of New America, see Alexander Holt, “Student Loans Don’t Need Interest Rates,” New America, February 13, 2015, www.edcentral.org/eliminateinterestrates/.
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104. Beth Akers and Matthew M. Chingos, *Is a Student Loan Crisis on the Horizon?*, The Brookings Institution, June 2014, www.brookings.edu/~media/research/files/reports/2014/06/24-student-loan-crisis-akers-chingos/is-a-student-loan-crisis-on-the-horizon.pdf.
105. Recent disbursal figures for a complete academic year suggest graduate loans comprise approximately 36% of federal loans; because those loans are typically larger and borrowers enroll in extended repayment terms, the graduate-loan share of the entire outstanding federal student-loan portfolio is likely closer to 40%.
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