



Fixing the Federal Student Lending System

Options for Policymakers in 2021

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Federal student loans help many college students access and complete postsecondary degrees that would not have been attainable otherwise (Black et al. 2020). But years of well-intentioned policymaking have left the student loan system a complicated mess that is difficult for borrowers to navigate and leads to unfair and inefficient distributions of taxpayer dollars. For many borrowers, especially Black students, low-income parent borrowers, and students whose education does not pay off, the loan program looks more like a predatory scam than a social program.

The Biden administration and a new Congress have an opportunity to fix the program for former, current, and future students. But tinkering at the edges of this program, as previous administrations and Congresses have done, would only make the program harder for the government to administer and for students to navigate. Instead, significant structural changes are needed for the program to function equitably and efficiently for today's students.

Changes to the student loan system should be made in concert with higher education policy changes aimed at college affordability and accountability. Loans should not be made to allow students to attend programs where they are unlikely to complete a credential of value. And reducing the prices students pay for college by lowering tuition or increasing grant aid can reduce students' overreliance on loans.

This brief focuses on potential changes to the loan system, discussing trade-offs among policy options while acknowledging that some of these choices should depend on other higher education policy choices. This analysis builds on the following goals and principles:

- The system should be simple enough for borrowers to understand and navigate and for the government and servicers to administer.

- Policymakers should adopt forward-looking policies (program reforms) and backward-looking policies (repayment reforms or debt forgiveness) that make sense together. For example, forgiving the debts of students who attended low-value institutions might be coupled with ending these institutions' ability to participate in the loan program.
- Loans should be loans, and grants should be grants. Running the loan program as a back-door grant program (e.g., with high borrowing limits that are sustainable only with generous forgiveness provisions) simply hides subsidies that would be better provided as up-front grants that reduce the prices students pay.
- Protections should be in place that make delinquency and default unlikely, especially for vulnerable borrowers.
- Reforms should mitigate the racially disparate impacts of the student loan program, especially the student loan crisis among Black borrowers (Miller 2019).

Fixing Student Loan Repayment for New Borrowers

Income-driven repayment (IDR), under which borrowers pay a fixed share of their income for a set number of years and then have any remaining balance forgiven, is an important safety net for student loan borrowers. But there is widespread agreement that the IDR system is too confusing, as evidenced by high delinquency and default rates (Blagg 2018).

A partial solution to the program's complexity is to automatically put all new borrowers into a single IDR plan (while still letting them pay down their debt more quickly if they want to).¹ From when students take out their first loans, they could receive information that would help them prepare to make payments based on their incomes and understand that their payments will be affordable even if they struggle in the labor market.

This initial step eliminates the need for borrowers to decide among different plans but still requires them to submit paperwork documenting their income annually. Many borrowers would still fall through the cracks, especially during times of financial distress.

The most promising solution to this problem is to have payments made automatically through payroll withholding. This approach (which is used in England and Australia) dramatically reduces the likelihood that borrowers default because their payments change automatically with their income without any action on their part (Baum and Chingos 2017). But creating such a system poses implementation challenges, and this policy may not be politically feasible.²

Regardless of how payments are made, designing an IDR plan requires choosing two parameters—what share of income is paid and for how long—that determine how subsidies flow to borrowers with different income levels (and trajectories) and amounts of debt. Under current policy, these parameters are generally the same for all enrolled borrowers: borrowers pay 10 percent of their income above 150

percent of the federal poverty level, regardless of whether they borrowed \$10,000 or \$200,000 or whether their annual income is \$50,000 or \$150,000.³

The challenge is to ensure that payments are affordable and that the loan program does not become a de facto grant program that loans money that borrowers know up front will never have to be repaid. Grant programs can be tailored (e.g., to low-income students), whereas back-door grant programs are most likely to benefit students savvy enough to play the system (e.g., a wealthy student who could pay for graduate school but instead takes out a loan that will be forgiven) and benefit low-quality institutions that encourage students to take on debts they are unlikely to repay.

Given the design of the current loan program, where undergraduate students are limited to borrowing modest amounts and graduate students can borrow essentially unlimited amounts, it does not make sense for all borrowers to pay 10 percent of their income for up to 25 years. For example, a college dropout with a starting salary of \$20,000 will be asked to make small payments, starting at \$10 a month, for two decades, whereas a graduate degree holder with \$150,000 in debt will receive tens of thousands of dollars in forgiveness even if their starting income is \$80,000.

A fairer system would tie the amount borrowed to the share of income paid or the period of repayment. President-elect Biden's campaign proposed that borrowers pay 5 percent of their discretionary incomes above \$25,000 for 20 years.⁴ This could work well for undergraduate borrowers, whose debt averages about \$30,000 after graduation. Or it could be scaled to the amount borrowed, such as 1 percent of income paid per \$10,000 borrowed. This approach would mean that people who borrow more would pay back more than people with similar incomes but who borrowed less.

But 20 years is a long time to ask someone to pay off what may be a small loan. Instead of adjusting the share of income paid, the repayment period could be tied to the amount borrowed. For example, a \$5,000 debt might require only 2 years of repayment, \$20,000 would be paid off in 8 years, and only borrowers with at least \$50,000 of debt would pay for 20 years. Borrowers with small debts and low incomes, who are at significant risk of default, would likely make no payments and would be spared the burden of documenting their income for the next 20 years.

But asking graduate degree holders to pay no more than 5 percent of income is likely to be both expensive and regressive if policymakers continue lending essentially unlimited sums to graduate students. For example, a borrower who takes on \$150,000 in debt and pays 5 percent of their income for 20 years is only going to pay about \$90,000 (in net present dollars), even if their starting income is \$100,000.⁵ For these borrowers, the 1-percent-per-\$10,000-of-debt option might continue up to 15 percent or 20 percent for those with the most debt. The share of income paid could even be progressive (e.g., starting at 5 percent on the first \$50,000 in discretionary income and rising to 15 to 20 percent at \$150,000). This would help ensure that payments remain affordable even for those with the most debt.

Tying both the share of income paid and the repayment period to the amount borrowed is possible but would complicate the program and make it more difficult for borrowers to understand, so it is probably better to pick one or the other. Given concerns about saddling students with debt for long periods, and limitations in the share of income that can be devoted to loans, reducing the repayment

period for those who borrow small amounts and lengthening it for those who borrow large amounts may be most appealing to policymakers.

Changes to Loan Limits

Student loan policy debates generally focus on repayment, with little consideration of other important program rules, such as loan limits. These limits matter, as they keep undergraduate borrowing relatively low while allowing graduate students (and parents of undergraduates) to borrow large amounts.⁶ The widely varying limits make it difficult to design repayment policies that work well for borrowers and make equitable use of public resources.

Changing loan limits could substantially change student debt. At one extreme, policymakers could decide that student lending is a failed experiment, end the student loan program, and forgive some or all federal student debt. This could be done in concert with efforts to expand or create new programs that reduce the up-front costs of college, such as by increasing the maximum Pell grant or enacting federal-state partnerships to make college free or less expensive.

Ending student loans is unlikely to attract significant support, given the substantial role that loans have played in financing American higher education for decades. In the near term, states are unlikely to find the money to make college more affordable. And even making college tuition-free would still leave college students with living expenses to cover, so these students and the institutions they attend would both have an interest in their continued ability to borrow without turning to private lenders.⁷

But having the federal government provide unlimited financing for graduate education is a recent phenomenon, put in place in 2005. Graduate students now account for roughly half of all new loan dollars disbursed each year (Ma, Pender, and Libassi 2020). Policymakers could reduce the loan program's footprint by returning its focus to undergraduates. This could be achieved by lowering the lifetime borrowing limit, such as to the maximum amount that undergraduates can currently borrow (\$57,500 for independent students and some dependent students). Roughly 90 percent of bachelor's degree recipients do not max out their borrowing.⁸ These students could continue borrowing up to the limit for graduate school.

Curtailling borrowing for graduate school would make it easier to design a simple repayment program with a progressive distribution of benefits, where borrowers who struggle in the labor market have most or all of their debt forgiven and economically successful borrowers repay their loans with interest. For example, policymakers could set payments at 10 percent of income for 1 to 20 years, depending on the amount borrowed, without worrying about doctors having much of their \$200,000 loans forgiven.

The potential downside of capping lifetime borrowing is that it would push graduate borrowers who cannot draw on family wealth into the private loan market, which would likely provide credit only to students attending programs with a significant economic return and have a disparate impact on Black students in light of the racial wealth gap.⁹ Policymakers would need to ensure this market is

appropriately regulated and may want to create a targeted grant program that supports enrollment in graduate programs that are socially valuable but have weak economic returns. Such a program could support policymakers' goals more effectively and efficiently than a loan program that enables students to take on debt they often cannot repay.

The loan program for parents of undergraduate students (PLUS) also needs reform to reduce the harm it causes by extending credit to families who lack the income or wealth to repay but want to support their children's educational aspirations (Baum, Blagg, and Fishman 2019). Imposing limits on parent loans could be accompanied by modest increases in limits for undergraduate students who need access to credit to complete their studies.¹⁰

What about Current Borrowers?

It will take several decades to fully transition to a new system, as existing borrowers will always have the option of repaying their loans under the current system. Current borrowers could be nudged into a new system by being offered more generous repayment terms, such as a lower interest rate or a modest amount of principal reduction.

But current policy requires most borrowers to annually certify their incomes for at least 20 years before they are eligible for forgiveness. For borrowers with consistently low incomes, who likely never completed a credential (or who earned one with little value in the labor market), this is a waste of their time and public resources. Providing targeted forgiveness to truly struggling borrowers could help these borrowers and do so at little true cost to the government if most of the forgiven balances would not have been repaid anyway.

Policymakers who want to ensure fairness for borrowers and efficient use of public resources should design forgiveness in a way that avoids providing windfalls to borrowers who do not need help (e.g., high-income doctors and lawyers) and undermining the loan program going forward (i.e., stop people from paying or borrowing more than they otherwise would, because they expect future forgiveness). Policymakers could send a clear message that forgiveness is truly a one-time policy by enacting it as part of a major change to the student loan program.

Forgiveness could be targeted to borrowers who are unlikely to ever repay, such as those with several years of low incomes or who participate in federal benefits programs such as the Supplemental Nutrition Assistance Program (SNAP) or Temporary Assistance for Needy Families.¹¹ It is important that eligibility for forgiveness be measured using administrative records (e.g., from the Internal Revenue Service, Social Security Administration, or state SNAP records) so that it is applied fairly to all who are eligible, not just to those who sign up.

Policymakers could also forgive the debt of borrowers who attended programs that should not have been allowed to participate in the loan program. Congress could implement tougher accountability standards that end lending for programs where few students find success in the labor market, and it could forgive the debts of students who previously borrowed to attend these programs. This approach

might not be necessary if policymakers provide forgiveness to borrowers with consistently low incomes, but the approach could be justified on fairness grounds, given that students were ripped off by their colleges with the federal government's express permission.

Finally, a modest universal forgiveness program could be used as an incentive for borrowers with large balances to opt into a new, simpler repayment system (such as automatic IDR). As part of a full system overhaul, Congress could offer \$5,000 in forgiveness to borrowers who voluntarily opt into the new system. It is crucial that struggling borrowers receive information to get them on a path that will work for them. A national forgiveness program could be used as an opportunity to reach struggling borrowers and help them get on a sustainable path (including providing more generous forgiveness to those who are unlikely ever to repay).

What about Public Servants?

Current policy provides forgiveness for borrowers who make 10 years of income-driven payments while employed in the public or nonprofit sectors (a categorization that includes about 25 percent of the economy). This program has strong political support and helps ensure that college graduates feel they can enter public service professions even if they have student debt. But when combined with the current lending program, Public Service Loan Forgiveness (PSLF) provides arbitrarily large benefits to the borrowers who took on the most debt (especially those who went to graduate school), even if they make reasonably high incomes (Delisle 2016). The program is also hard for borrowers to navigate, in part because they have to document their employment over a 10-year period.

A potential fix is to move away from an all-or-nothing benefit that kicks in only after 10 years in the public or nonprofit sector. One approach is to provide incremental forgiveness (e.g., 10 percent of the balance for each year worked in public service). An alternative option would be to reduce the time to forgiveness by one year for every year worked in the public or nonprofit sector (up to 10 years). For example, borrowers who work 5 years in public service would get forgiveness after 15 years instead of 20.

This approach could provide a more progressive distribution of benefits by reducing forgiveness to borrowers who work for a few years in public service before moving to lucrative jobs in the private sector. For example, a lawyer who works as a public defender for three years before going to a corporate law firm would get significant forgiveness (up to 30 percent of their balance) under the first approach but none under the second.

These kinds of fixes to PSLF do not completely solve the distributional challenges. Those challenges could be addressed either by limiting total borrowing (e.g., to \$57,500) or by limiting the amount of debt eligible for forgiveness under PSLF (as the Obama administration proposed). An alternative approach would be to replace PSLF with a grant program for students from low-income families (e.g., those who receive the maximum Pell grant) who are pursuing degrees in targeted fields (e.g., social work or education).

Conclusion

Student loans play an important role in American higher education and can continue to do so if they are part of a better-designed system. This will require an ambitious redesign of the student loan program, coupled with efforts to make college more affordable and to hold low-quality providers accountable. To the extent these changes lower the costs to taxpayers of providing student loans (e.g., by reducing loan forgiveness among high-income borrowers), those savings could be reinvested in grant programs that more efficiently and equitably provide access to postsecondary opportunities.

Notes

- ¹ Sandy Baum and Matthew Chingos, “Incremental Steps toward Bold Student Loan Reforms,” *Urban Wire* (blog), Urban Institute, March 15, 2018, <https://www.urban.org/urban-wire/incremental-steps-toward-bold-student-loan-reforms>.
- ² Implementation challenges include calculating payments correctly for married borrowers (which may be based on the combined debt or income of the borrower and their spouse) and working with employers to do the withholding.
- ³ Students who borrowed to attend graduate school pay for an additional five years (25 years versus 20 years) compared with students who borrowed only for their undergraduate degrees under one of the most popular IDR plans.
- ⁴ “The Biden Plan for Education beyond High School,” JoeBiden.com, accessed November 13, 2020, <https://joebiden.com/beyondhs/#>.
- ⁵ Kristin Blagg and Matthew Chingos, “Charting Student Loan Repayment,” Urban Institute, last updated October 9, 2018, <https://apps.urban.org/features/student-loan-repayment/>.
- ⁶ Dependent undergraduate students can borrow up to \$31,000 over the course of their programs. Independent students can borrow up to \$57,500 (as can dependent students whose parents cannot obtain PLUS loans). See “Subsidized and Unsubsidized Loans,” US Department of Education, Office of Federal Student Aid, accessed November 13, 2020, <https://studentaid.gov/understand-aid/types/loans/subsidized-unsubsidized>.
- ⁷ Sandy Baum and Michael McPherson, “‘Free College’ Does Not Eliminate Student Debt,” *Urban Wire* (blog), Urban Institute, August 22, 2019, <https://www.urban.org/urban-wire/free-college-does-not-eliminate-student-debt>.
- ⁸ Author’s calculations from the 2015–16 National Postsecondary Student Aid Study.
- ⁹ Matthew Chingos, “What Do Racial and Ethnic Wealth Gaps Mean for Student Loan Policy?” *Urban Wire* (blog), Urban Institute, February 25, 2019, <https://www.urban.org/urban-wire/what-do-racial-and-ethnic-wealth-gaps-mean-student-loan-policy>.
- ¹⁰ Students whose parents do not qualify for PLUS loans already have significantly higher loan limits.
- ¹¹ Matthew Chingos, “Can We Design Student Loan Forgiveness to Target Low-Income Families,” *Urban Wire* (blog), Urban Institute, May 14, 2019, <https://www.urban.org/urban-wire/can-we-design-student-loan-forgiveness-target-low-income-families>.

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