

Reforming Federal Student Loan Repayment: A Single, Automatic, Income-Driven System

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Higher education is an investment that pays off well for most students over the long run. Relying on loans to cover a portion of the costs is reasonable, and a federal student loan system that makes credit available on good terms is a critical component of higher education financing. The federal student loan system opens the door to college for many students by enabling them to access their future earnings to pay college tuition bills and other expenses they must cover while they are in school.

But higher education is an investment that involves considerable uncertainty, and the student loan repayment system should mitigate the risk for borrowers, a risk that is increasing as college prices rise and reliance on debt increases. Historically, the student loan repayment system, under which almost all borrowers were on 10-year fixed payment schedules, did not account well for risk. The addition of income-driven repayment options has been a step in the right direction, but the current system is complicated and not carefully designed to appropriately apportion costs and risks across borrowers and taxpayers. The federal government should simplify the system, developing one income-driven repayment plan for all borrowers, with payroll withholding automatically adjusting required monthly payments.

Background

Considerable variation in economic outcomes leads to differences in borrowers' ability to repay debt. Some of the variation is predictable. Earnings differ widely by type of institution, credential, and field of study. But some outcomes are difficult to predict. Some students leave school without completing their programs. Some graduate into weak labor markets or work for employers that pay low wages. These borrowers are likely to struggle to repay their loans on a 10-year fixed monthly payment plan.

This uncertainty, combined with the national interest in increasing educational attainment, creates a strong argument for a system that provides insurance protecting borrowers from unforeseen outcomes that make loan repayment difficult. In 2009, the federal government changed the way many former students repay their loans to make this type of insurance widely available. Under the Income-Based Repayment (IBR) plan, borrowers whose incomes are below 150 percent of the federal poverty level for their household size have no required monthly payment. Those with higher incomes pay 15 percent of the amount by which their incomes exceed this threshold. The government forgives remaining balances after 25 years of payments.

In the following years, the Obama administration added several new income-driven repayment (IDR) plans. Pay as You Earn (PAYE) lowered monthly payments to 10 percent of discretionary income and shortened the time to loan forgiveness to 20 years. Revised PAYE (REPAYE) expanded eligibility, but removed the cap that limited monthly payments to what they would be under a standard 10-year plan and extended the time to forgiveness to 25 years for borrowers with graduate school loans.¹ Under Public Service Loan Forgiveness (PSLF), borrowers who work for the government or qualifying nonprofits and participate in any of these IDR plans will have remaining balances forgiven after just 10 years. All these plans create a confusing array of options for borrowers, who are placed in the fixed-payment 10-year plan unless they choose a different option. All the IDR plans involve a quite a bit of paperwork, including annually verifying income levels.

In addition to providing insurance, the newer programs provide significant subsidies to borrowers overall. Lower interest rates, lower payments relative to income, and shorter time to forgiveness generate broad subsidies. These subsidies can create undesirable incentives for institutions to raise tuition and for students to borrow large amounts and are likely to impose growing costs on taxpayers.

The Trump administration's budget proposal for 2017–18 would eliminate the PSLF program for future borrowers. The budget also proposes a single income-driven repayment option that would set payments at 12.5 percent of discretionary income and reduce the time to forgiveness to 15 years for undergraduate borrowers, but lengthen it to 30 years for graduate borrowers.

The system should be simpler and less confusing.

The Problem

The federal government offers multiple income-driven repayment plans in addition to the standard 10-year plan and a graduated payment plan. Borrowers are automatically enrolled in the standard plan unless they choose an alternative. Understanding all the differences and making a choice is challenging. Overcoming bureaucratic hurdles to enroll in IDR is even more daunting. Borrowers must document their incomes and renew that documentation annually. Between 2013 and 2014, more than half of IDR participants failed to recertify and found themselves returned to the standard repayment plan.² Moreover, many borrowers who have defaulted and gone through the necessary steps to get back into good standing through “rehabilitation” do not enroll in an income-driven plan and default again. These default problems would diminish if enrollment in IDR were automatic (Frotman 2017).

Recommendations

First, Congress should simplify the IDR system so borrowers do not have to navigate complicated provisions to decide which plan is best for them or face bureaucratic hurdles to enrolling. There should be one student loan repayment plan, which would base required monthly payments on the borrower's household income. To coordinate easily with the tax system, payments should be based on the joint income and debt of married couples.³

Required monthly payments would be a share of income exceeding 150 percent of the federal poverty level, with no cap on the payment amount. Some borrowers might choose to make larger payments to retire their debt more quickly, and there should be no penalty for that. Allowing larger payments and providing information to borrowers about the time it will take them to repay and the interest they will incur under different payment schedules makes proposals to maintain a fixed payment system alongside the income-driven system unnecessary and complicated.

Second, payments should be collected through the payroll withholding system. The withholding system reduces the psychological and logistical burdens of loan payments. Borrowers who lose their jobs do not have to do anything to eliminate required payments. It also ensures that student loan payments will take priority in borrowers' budgets. There would be logistical problems to solve, for which the estimated tax payment system might serve as a model, and avenues of appeal for borrowers with extenuating circumstances, such as unusually high medical expenses, would be appropriate to avoid undue hardship. But payment compliance should not depend on borrowers deciding they would rather pay off their student loans than their credit cards or other forms of spending.

Third, payments should be based not just on wages and salaries, but on total income, which is a better measure of financial capacity. Borrowers who are self-employed or own small businesses would make payments through a system analogous to the one through which they make tax payments in lieu of payroll withholding. Coverage of non-tax filers would have to include some combination of alternative income verification, automatic zero payments for borrowers not required to file federal income taxes, and a fixed repayment schedule for those whose income cannot easily be documented.

The system should provide incentives for both students and institutions to limit borrowing.

The Problem

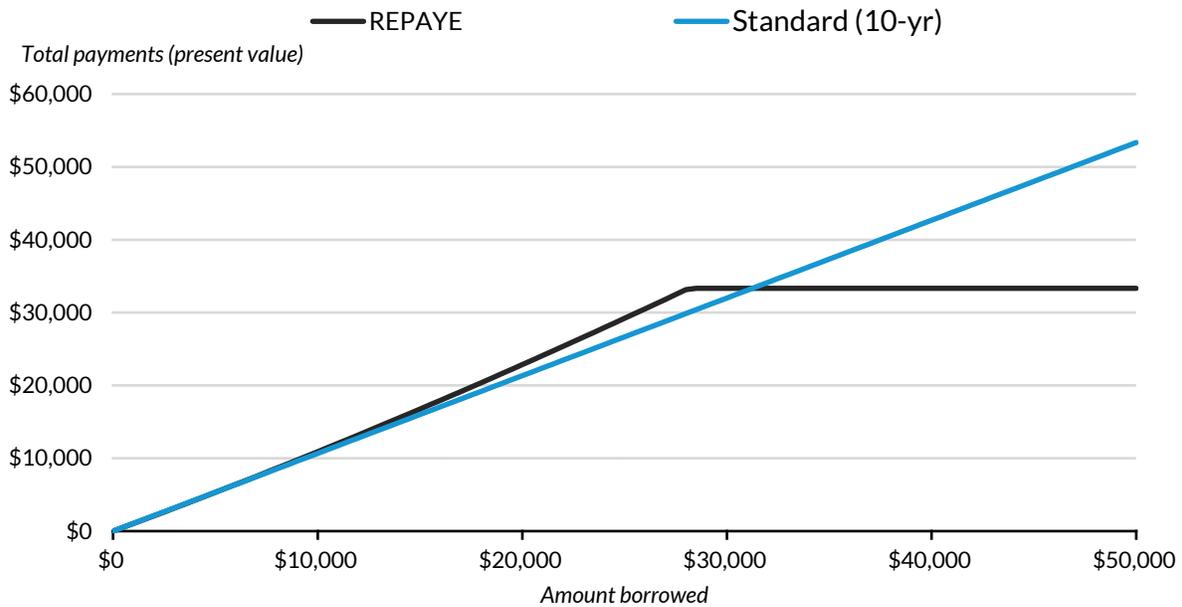
Federal borrowing for undergraduates is limited to \$31,000 for dependent students and \$57,500 for independent students. But the federal Grad PLUS program allows graduate students to borrow up to the full cost of attendance (including living expenses in addition to tuition and fees) for as many years as they are enrolled. All these loans are eligible for IDR.

Lower monthly payment amounts and shorter required payment periods before loan forgiveness open the door to significant amounts of debt being forgiven for borrowers with relatively high incomes and high levels of debt—not the borrowers who should reap most of the benefits of the insurance offered by IDR. Many borrowers who have accumulated several hundred thousand dollars in debt for medical school, dental school, law school, or other graduate programs are likely to receive considerable subsidies from taxpayers.

Unlimited graduate borrowing coupled with forgiveness provisions under IDR means that beyond a certain level of borrowing, for many students, additional borrowing will not lead to any additional payments. Under the REPAYE plan, a borrower with a starting salary of \$30,000 will not make

additional payments for any amount borrowed over about \$28,000 (figure 1).⁴ Under the same assumptions, a borrower with a starting salary of \$50,000 would not pay back any amount borrowed over \$65,000.

FIGURE 1
Estimated Total Payments Based on Amount Borrowed, for Borrower with \$30,000 Starting Salary



Source: Matthew Chingos, “Jeb Bush’s Student Loan Plan Should Outlive His Campaign” (Washington, DC: Brookings Institution, 2016).

Notes: REPAYE = Revised Pay as You Earn. Assumes income growth of 4 percent a year (not adjusted for inflation). Based on payments of 10 percent of income exceeding 150 percent of the federal poverty level and loan forgiveness after 20 years.

Public Service Loan Forgiveness amplifies this problem. A borrower with a starting salary of \$50,000 will not face any additional cost for any amount borrowed over about \$32,000. A starting salary of \$100,000 increases that amount to about \$80,000. A student who borrows \$180,000 to attend law school and then earns a starting salary of \$100,000 at a PSLF-eligible employer will only pay back the first \$80,000 borrowed with interest (about \$87,000 total). Federal taxpayers will cover the remaining \$100,000 plus interest.

This feature of the IDR system is likely to make students less sensitive to the amount of debt they accumulate and to the prices institutions charge, further accelerating increases in tuition.

Recommendations

First, Congress should restore limits on federal lending to graduate students. The goal of federal lending coupled with IDR is to protect borrowers whose education does not pay off as well as anticipated. The

federal government could limit its lending to graduate students while allowing their loans to be eligible for IDR by eliminating Grad PLUS but maintaining Direct Loans for graduate students. The latter program offers graduate and professional students up to \$20,500 a year, with a lifetime maximum of \$138,500 (including undergraduate borrowing).

Second, additional borrowing should affect the amount repaid. This is a more serious problem for graduate borrowers than for undergraduates. Borrowers accruing the largest debts are generally those who stay in school for a longer time, earning at least a bachelor's degree and often an advanced degree. For example, only 4 percent of 2011–12 undergraduate certificate recipients and 8 percent of associate degree recipients borrowed \$30,000 or more, compared with 30 percent of bachelor's degree recipients and about 80 percent of those earning graduate or professional degrees (Baum, Elliott, and Ma 2014).

The REPAYE approach of setting a longer repayment term for borrowers with any graduate school debt and the proposed doubling of the time to forgiveness for graduate versus undergraduate borrowers under the Trump budget, both designed to address this problem, create severe inequities because a small amount of graduate borrowing can dramatically reduce the protection offered to borrowers for their undergraduate loans.

Congress should tie the terms of repayment to the total amount borrowed:

- The period before forgiveness could gradually increase with the amount borrowed. For example, remaining balances might be forgiven after 10 years of payment for those who borrowed \$10,000 or less, increasing to 20 years for \$30,000 in debt and 30 years for \$90,000 in debt.
- The share of income required for monthly payments could gradually increase with the amount borrowed. For example, students might pay 1 percent of income for every \$10,000 borrowed. This approach would make it more difficult to help students predict future loan payments when they are making borrowing decisions, but would ensure that higher debt levels lead to higher repayment expectations for all borrowers.

The system should be easy for borrowers to understand, especially at the time they are deciding how much to borrow. But moving toward an automatic IDR system that operates through payroll withholding means that some complexity is tolerable on the repayment end because payments are calculated and withheld from income automatically.

To be fiscally sustainable, the system should provide insurance and well-targeted subsidies for borrowers in difficult financial circumstances, rather than generous subsidies to all borrowers.

The Problem

The current IDR system is likely to impose high costs on taxpayers. The US Department of Education estimates that the cost to the federal government for borrowers in IDR plans will rise from \$4.0 billion for the fiscal year 2010 (FY 2010) cohort to \$9.2 billion for FY 2014 and \$14.6 billion for FY 2017. The US Government Accountability Office contends that because of shortcomings in estimation, the actual costs for current and future cohorts are likely to be even higher (GAO 2016).

Recommendations

The reforms recommended above, especially limiting borrowing by graduate students and tying repayment terms to the amount borrowed, will help ensure the IDR program's fiscal sustainability. This can be done while retaining loan forgiveness provisions, as long as the period of repayment and share of income required for payments are set at levels that ensure most borrowers repay their debt.

First, loan forgiveness for most borrowers should occur after no fewer than 20 years. Forgiveness limits the psychological burden imposed on borrowers and is unlikely to have large fiscal impacts because borrowers whose incomes have been too low to retire their debts for so many years are not likely to make payments in the final years of their working lives that significantly reduce the federal responsibility for the loans. But forgiveness after short periods, such as through the PSLF program, is problematic because of the difficulty of targeting these potentially large subsidies. Policymakers seeking to subsidize employment in certain sectors of the economy can do so directly (e.g., through tax credits) in a more focused way than through PSLF (for which roughly one-quarter of jobs are eligible) (GAO 2015, 27).

Forgiven loan balances should not be taxed, as they currently are (except under PSLF). Loan forgiveness is based on the idea that some borrowers cannot repay their debts over the long run. Assuming that the forgiveness is well targeted, the people who benefit should be unable to pay the associated tax bills. No actual income out of which the payment could be made is associated with the loan forgiveness, so imposing a tax on a forgiven loan just converts a student debt to a tax debt. Eliminating the tax provision would be unlikely to cost the government much, given most people's inability to pay.

Second, the monthly payment amounts and the time to forgiveness should be set to ensure most borrowers repay their entire debt with interest, but borrowers with the lowest payoff to their education benefit from the IDR insurance. A low assessment rate (required payment as a percentage of income) combined with a short payment span before forgiveness will lead to an expensive program that heavily subsidizes borrowers in relatively strong financial positions. When setting an appropriate rate, it is important to think about the impact on the targeting of subsidies.

It is important to retain the provision that eliminates required payments for borrowers with income below 150 percent of the federal poverty level. Borrowers should not be forced to make choices between meeting basic needs or repaying their loans. For single individuals with income of \$18,090 or lower in 2017, no payment would be required under IDR, so lowering the assessment rate from 15 to 10

percent would not affect them. In 2015, among adults ages 25 to 34 with at least some college, 29 percent had incomes this low.⁵ The 150 percent of federal poverty level income set-aside solves the short-term repayment problems of many borrowers.

Lowering the assessment rate targets borrowers who are significantly above the bottom of the income distribution. A 5 percentage point reduction in the fraction of income required would reduce payments for a borrower whose annual income is \$5,000 above the threshold by \$250 a year. It would reduce payments for a borrower whose income is \$30,000 above the threshold by \$1,500 a year.

Finally, interest rates should reflect the cost of borrowing,⁶ administrative costs, and the riskiness of loans. The goal is to provide liquidity, not to provide a systematic subsidy to students. Under IDR, the interest rate affects the length of time required to pay off loans, but not monthly payments. Lowering interest rates on all loans brings the largest benefits to borrowers with high debt levels, many of whom have high incomes. A more targeted interest subsidy is to limit the unpaid interest that accumulates when required payments are too low to cover monthly interest charges. This strategy prevents borrowers in difficult financial circumstances from seeing their balances balloon, without providing a broad subsidy to all borrowers. Funds spent on general-interest subsidies would be better spent on grants and counseling.

Loans in the IDR system should have a variable, market-based interest rate, with a cap to prevent interest rates from rising too far. Fixing interest rates for the life of the loan, as is done under current policy, means there will be outstanding debt carrying various interest rates. Allowing the interest rate on individual loans to vary with market rates will not affect monthly payments under IDR. It will allow the chosen level of subsidy—or lack thereof—to prevail on all loans.

Conclusion

Income-driven repayment is critical to an efficient and equitable student loan system. For many borrowers, the difficulty of repayment is related to timing, not to long-term adequacy of income. Between 2009 and 2013, median annual earnings for 23-year-olds with a bachelor's degree were \$32,000. For 30-year-olds, the median was \$51,000.⁷ There is a strong argument for allowing borrowers to wait to make payments until they can better afford them.

The system we have proposed will be easier to understand, accessed automatically, and flexible in timing. It provides insurance for borrowers whose long-term income is too low to support their debts, without asking taxpayers to repay loans for borrowers who are in the upper segment of the income distribution. The system directs subsidies only to those borrowers whose financial circumstances make them appropriate recipients of transfers from taxpayers.

These reforms can make a significant difference for students, making college a less risky, more affordable option. The reforms can also reduce the impact of the student loan program on the federal budget.

Notes

1. "Income-Driven Plans," US Department of Education, Office of Federal Student Aid, accessed June 20, 2017, <https://studentaid.ed.gov/sa/repay-loans/understand/plans/income-driven>.
2. Kelly Field, "Thousands Fall Out of Income-Based Repayment Plans," *The Chronicle of Higher Education*, April 2, 2015, <http://www.chronicle.com/article/Thousands-Fall-Out-of/229031>.
3. The system should not advantage married couples who file separately.
4. The estimates assume income increases by 4 percent (nominal) each year.
5. "PINC-03. Educational Attainment—People 25 Years Old and Over, by Total Money Earnings, Work Experience, Age, Race, Hispanic Origin, and Sex," US Census Bureau, Current Population Survey, last updated August 26, 2016, <https://www.census.gov/data/tables/time-series/demo/income-poverty/cps-pinc/pinc-03.html>.
6. Controversy surrounds the appropriate interest rate to use to measure the cost of the loan program to the government. For insights into differences between accounting under the Fair Credit Reform Act and "fair value" accounting, see Matthew Chingos, "End government profits on student loans: Shift risk and lower interest rates," Brookings Institution, April 30, 2015, <https://www.brookings.edu/research/end-government-profits-on-student-loans-shift-risk-and-lower-interest-rates/>; and Paul N. Van de Water, "'Fair-Value' Approach Would Make Student Loan Accounting Less Accurate, Not More," Center on Budget and Policy Priorities, April 25, 2014, <http://www.cbpp.org/blog/fair-value-approach-would-make-student-loan-accounting-less-accurate-not-more>.
7. American Community Survey, Five-Year Sample, 2009–13.

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Errata: This memo was updated on January 10, 2018. A legend and note were added to figure 1 for clarity.

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