OPPORTUNITIES TO SIMPLIFY AND MODERNIZE FEDERAL STUDENT AID

Statement of

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before the

Committee on Health, Education, Labor, and Pensions,

United States Senate

REAUTHORIZING THE HIGHER EDUCATION ACT: FINANCIAL AID SIMPLIFICATION AND TRANSPARENCY

Thursday, January 18, 2018

* The views expressed are my own and should not be attributed to the Urban Institute, its trustees, or its funders. I thank Greg Acs, Sandy Baum, Fiona Blackshaw, Kristin Blagg, Donald Marron, Amy Peake, Kim Rueben, Judy Scott-Clayton, Alex Tilsley, and Martin West for helpful comments.

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BIOGRAPHY

Matthew M. Chingos is director of the Urban Institute's Education Policy Program, which undertakes policy-relevant research on issues from prekindergarten through postsecondary education. Current research projects examine universal prekindergarten programs, school choice, student transportation, school funding, college affordability, student loan debt, and personalized learning.

Chingos is an executive editor of *Education Next* and coauthor of *Game of Loans: The Rhetoric and Reality of Student Debt* and *Crossing the Finish Line: Completing College at America's Public Universities*. His work has been featured in major media outlets and has been published in academic journals, including the *Journal of Public Economics*, *Journal of Policy Analysis and Management*, and *Educational Evaluation and Policy Analysis*.

Before joining Urban, Chingos was a senior fellow at the Brookings Institution. He received a BA in government and economics and a PhD in government from Harvard University.

OVERVIEW OF TESTIMONY

Federal student aid programs provide vital assistance to students and further national goals of increasing educational attainment and economic mobility, especially for students from disadvantaged backgrounds. The reauthorization of the Higher Education Act provides an opportunity to modernize and reform these programs to better support these goals.

Student Loan Repayment Crisis

For most students, debt is a tool that allows them to access educational opportunities that pay off in the long run. But the student loan system is harming too many students while providing arbitrary subsidies to others.

- 4.6 million borrowers are in default, a number that has doubled over the past four years even as the default rate has fallen.
- Borrowers with relatively small amounts of debt, especially college dropouts, are most likely to default.
- Income-driven repayment plans provide a safety net for struggling borrowers but have failed to sufficiently mitigate defaults.

One Grant, One Loan

Federal aid programs for undergraduates should be streamlined into a single grant program and a single loan program.

- Federal subsidies to college students should be delivered through need-based grants to the greatest extent possible, as grants reduce the prices students pay at enrollment and can be targeted to students who most need assistance.
- Subsidies currently embedded in the loan programs, such as the in-school interest subsidy and Public Service Loan Forgiveness, should be repurposed into need-based grants.
- Eligibility for grants could be determined through a simplified form or existing government records, enabling early communication with students and families.

Income-Driven Loan Repayment

Moving to a single income-driven repayment plan is a step in the right direction, but it is unlikely to stem the rising tide of defaults if borrowers must proactively enroll every year.

- Participation in income-driven repayment should be automatic, with payments made through the tax withholding system (as is done in England and Australia).
- The percentage of income paid or number of years prior to forgiveness should be tied to the amount borrowed, to ensure fairness to borrowers and reduce unintended consequences such as tuition inflation.
- The loan structure could be maintained, or Congress could move toward a system where borrowers pay for a set period rather than a set dollar amount, eliminating the need for a loan balance and interest rate.

FULL TESTIMONY

Chairman Alexander, Ranking Member Murray, and members of the committee, thank you for the opportunity to testify today about how our nation's federal student aid programs could be simpler and more transparent for students.

I direct the Education Policy Program at the Urban Institute here in Washington, DC. My colleagues and I provide original data and analysis to support education policymaking from prekindergarten through postsecondary. This year, we will focus significant attention on the Higher Education Act (HEA), producing original empirical analyses of reauthorization proposals and creating evidence-based tools aimed at elucidating trade-offs created by different policy options.

I am proud of the work we do at the Urban Institute, but I should emphasize that the views expressed in this testimony are my own, not those of any organization with which I am affiliated, its trustees, or its funders.

My testimony will provide an overview of how federal policy provides vital support, credit, and insurance for college students but could greatly benefit form modernization and reform through reauthorization of the HEA. Most important, the student loan system is harming too many students while providing arbitrary subsidies to others.

My analyses and recommendations are rooted in three principles:

> First, federal support for higher education should be allocated in ways that help students who need it most, with the goal of increasing educational attainment and economic mobility, especially for students from disadvantaged backgrounds.
>
> Second, federal aid programs should treat students fairly. This does not mean treating all students the same, but aid programs should treat students from similar circumstances similarly and be easily understood by students and families.
>
> Finally, the system should be as efficient as possible so taxpayer dollars are used to maximum effect.

Student Loan Repayment Crisis

For most students, debt is a tool that allows them to access educational opportunities that pay off in the long run.[1] Loans allow students to borrow from their higher-income future selves to invest in their educations today. The federal government, through the HEA, plays a critical role in extending credit to all college students, regardless of whether a private bank would make those loans.

But for far too many borrowers, student loans are doing more harm than good. The number of borrowers in default has more than doubled over the past four years, to 4.6 million, even though the default *rate* has fallen over this period.[2] This is because defaulted loans are unlikely to return to good standing.[3] Defaulting harms borrowers' credit and ability to borrow in the future.[4]

Default affects some groups of student borrowers more than others. Borrowers with relatively small amounts of debt, especially college dropouts, are most likely to default.[5] These patterns are linked to low college completion rates because earning a degree increases a borrower's earning capacity and ability to repay her loans.[6] Additionally, new data show large racial disparities in default rates, with black college graduates more likely to default than white dropouts.[7]

Broadly speaking, there is a repayment crisis in student lending.[8] A fixed monthly payment may work for a car loan, but the 10-year standard repayment plan asks too many student borrowers to make unaffordable payments shortly after leaving college, when their incomes are low. As a result, even students who have taken on reasonable debt levels to earn valuable degrees may struggle to repay early in their careers.

Existing income-driven repayment plans provide a safety net for struggling borrowers, which in theory should prevent defaults. But those plans have failed to do so, in part because they are too complicated. There are multiple programs with different rules, which borrowers often need to navigate at times of financial stress.[9] Borrowers need to reapply every year; between 2013 and 2014, half failed to do so.[10]

Options for Reform

The current federal aid programs resulted from years of well-intentional policy changes that would now benefit from consolidation and simplification. In my view, each set of programs should be limited to the purpose for which it is best suited: grants to reduce the prices that students pay, loans to provide credit on reasonable terms, and income-driven repayment to provide insurance against unaffordable loan payments.

Options for reform range from modest efforts to simplify and reduce the number of grant and loan programs (and repayment plans) to bolder proposals that would more fundamentally change how the student aid programs function. I discuss a range of options that Congress should consider as it reauthorizes the HEA.

One Grant, One Loan

Consolidating federal aid programs into one grant program and one loan program would make these programs more effective and easier for potential students to navigate.[11] The grant program could better support the college enrollment and completion of disadvantaged students by repurposing poorly targeted subsidies from other programs. And moving away from multiple loan programs might reduce the troublingly large number of students who are unaware of how much they have borrowed, or whether they even have a loan.[12]

Whenever possible, federal subsidies to college students should be delivered through a grant program.[13] This is the most effective mechanism for delivering subsidies to students, as it reduces the prices students pay at the time of enrollment and it can be targeted to students who most need assistance. For example, the need-based in-school interest subsidy would be better used to reduce college costs for lower-income students at the point of entry rather than the loan payments they make after leaving college. Likewise, the cost of the Public Service Loan Forgiveness (PSLF) program, which disproportionately benefits high-debt borrowers even if their incomes are not that low, could be repurposed into need-based grants.[14]

The primary purpose of the single federal loan program should be to extend credit to undergraduate students. Policymakers should consider capping or eliminating lending to parents of undergraduate students, perhaps in combination with increasing undergraduate loan limits, rather than operating a predatory lending program.[15] Limits on lending to graduate students should also be reinstated, or the eligibility of those loans for forgiveness curtailed, to preserve the fiscal sustainability of the federal lending program.

Streamlining existing aid into one grant and one loan program would help students who are already navigating the system, but it would not reach students who lack awareness of their eligibility for federal aid. Simplifying the Free Application for Federal Student Aid (FAFSA) is a modest first step, but a more ambitious option is to target aid based on information the federal government already collects rather than through a separate form.

Eligibility for Pell grants could be determined automatically using tax records. For example, families could learn about Pell eligibility when their children are in elementary or middle school, perhaps through an "account" that would increase in value each year the family's economic circumstances made them eligible. This notification could be sent to all families who claim one or more children on their federal income tax returns.[16]

Providing aid to families based on average income over a long period would preserve needs-based targeting, and it would arguably be fairer than considering a single year's income. It would also allow for communicating eligibility directly, early, and clearly, without the need for an onerous application. Research indicates that lowering these kinds of barriers can increase the rates at which children from low-income families enroll in college.[17]

An aid application would not be needed to administer a single federal loan program that provided credit on the same terms to all undergraduate students. Encouraging colleges to offer federal loans to all their students could reduce the likelihood that students borrow too little. A recent study found that nudging community college students to borrow—in this case, by including nonbinding loan offers in financial aid award letters—increased both the amounts they borrowed and their academic success rates.[18]

Ending the Repayment Crisis

Streamlining income-driven repayment into a single plan would be a useful step forward from current policy, which provides borrowers with several options including the original income-based repayment (IBR), a newer version of IBR, pay as you earn (PAYE), and revised pay as you earn (REPAYE). When a borrower faces financial hardship, it will be easier to pick a single income-based option than decide among several.

But simply reducing the number of plans is unlikely to significantly stem the rising tide of defaults. A borrower would still have to know that income-driven repayment is an option and take proactive steps to enroll and remain enrolled. And moving to a single plan is unlikely to address concerns about the fiscal sustainability of current policy.[19]

Making income-driven repayment automatic would do much more to reduce student loan defaults. Borrowers could be placed into such a plan after leaving college, using their prior-year income to calculate payments (which would change each year). Payments would generally start out low and increase with the borrower's income. Although this type of plan would adjust payments annually, it still would have limitations. For example, it would not be responsive to short-term changes such as a job loss. And borrowers might still fail to make payments, even affordable ones.

The boldest proposals would have all borrowers make income-driven loan payments through the tax-withholding system (while retaining the option to pay them off more quickly). For example, under the Dynamic Repayment Act proposed by Senators Warner and Rubio, employers would collect payments and remit them to the federal government in the same way that they withhold income taxes.[20]

In an automatic system, it would be difficult for most borrowers to default on their loans in the same way that it is difficult to underpay payroll taxes.[21] This is the approach taken by several countries, including England and Australia, and it is also used in the US in the form of "wage garnishment" for severely delinquent loans.[22]

A significant downside of current income-driven plans is that borrowers pay the same percentage of income, regardless of whether they borrowed $10,000 for an undergraduate degree or $100,000 for a professional degree.[23] Combined with loan forgiveness options after 10–25 years, this means that a borrower can take on more debt without necessarily paying back any more.[24] This could lead to price-insensitivity among students, further driving up the prices that institutions (especially graduate programs) can charge and the costs to taxpayers.

This problem can be solved by tying the amount borrowed to the percentage of income paid.[25] For example, borrowers might pay 1 percent of their income for each $10,000 that they borrow. Under such a system, the undergraduate borrower with $10,000 in debt would pay 1 percent of income, whereas the graduate degree holder with $100,000 would pay 10 percent. Payments would continue until the loan is paid off (with interest), or Congress could specify a maximum period after which any remaining balance is forgiven (which could also be linked to the amount borrowed).

Even with these changes, two significant drawbacks of income-driven repayment would remain. First, an increasing loan balance (i.e., negative amortization) could impose psychological harm on borrowers and prevent them from taking on other forms of debt such as mortgages. Second, taxpayers assume all the risk of nonpayment and reap none of the reward when borrowers are economically successful (beyond repayment of principal and interest).

An alternative would be to require borrowers to pay a set percentage of their income for a fixed period (which could vary based on the amount borrowed), even if it exceeds what the borrower would have paid under a traditional loan.[26] A system along these lines, which would be a public-sector analogue of "income share agreements," would eliminate the concept of a loan balance, and interest rates would no longer be needed.

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A single need-based grant program, combined with an easy-to-understand loan program that protects borrowers through automatic income-driven repayment, will increase the effectiveness of federal support for higher education and reduce the harm that noncompletion and loan default disproportionately inflict on disadvantaged individuals.

Optimal design of federal grant and loan programs requires considering how they interact with each other and with other components of the HEA, such as the rules that govern institutional eligibility to award federal grants and loans. How to protect students and taxpayers from low-value programs is beyond the scope of this hearing, but it is critical to a well-designed federal aid system.

The reauthorization of the HEA provides an important opportunity for Congress to streamline and strengthen the federal aid programs that are critical to college access and completion in the United States. I hope my testimony will contribute to that important effort, and would be happy to answer any questions.

Notes

[1] Beth Akers and Matthew M. Chingos, *Game of Loans: The Rhetoric and Reality of Student Debt* (Princeton, NJ: Princeton University Press, 2016).
[2] Paul Fain, "Growing Number of Borrowers Are In Default," *Inside Higher Ed*, December 14, 2017, https://www.insidehighered.com/quicktakes/2017/12/14/growing-number-borrowers-are-default; and "US Department of Education Releases National Student Loan FY 2014 Cohort Default Rate," US Department of Education, press release, September27, 2017, https://www.ed.gov/news/press-releases/us-department-education-releases-national-student-loan-fy-2014-cohort-default-rate
[3] Executive Office of the President, *Investing in Higher Education: Benefits, Challenges, and State of Student Debt* (Washington, DC: Executive Office, 2016, https://obamawhitehouse.archives.gov/sites/default/files/page/files/20160718_cea_student_debt.pdf), p. 33.
[4] There is little systematic evidence on the consequences of student loan default, but because defaults appear on borrowers' credit records, they should mechanically reduce credit scores and future ability to borrow.
[5] See Meta Brown, Andrew Haughwout, Donghoon Lee, Joelle Scally, and Wilbert van der Klaauw, "Looking at Student Loan Defaults through a Larger Window," Liberty Street Economics (blog), Federal Reserve Bank of New York, February 19, 2015, http://libertystreeteconomics.newyorkfed.org/2015/02/looking_at_student_loan_defaults_through_a_larger_window.html; and Figure 2015_14A, "Two-Year Student Loan Default Rates by Repayment Cohort and Degree Completion Status, 1995–96 to 2011–12," *Trends in Student Aid*, College Board, https://trends.collegeboard.org/student-aid/figures-tables/two-year-student-loan-default-rates-degree-completion-status-over-time.
[6] Only 59 percent of students who start at four-year public colleges earn a bachelor's degree from any institution within six years (the corresponding figure for private, nonprofit colleges is 72 percent). Among students who start at community colleges, only 39 percent earn any degree from any institution within six years (*Completing College: A National View of Student Attainment Rates – Fall 2010 Cohort* [Herndon, VA: National Student Clearinghouse, 2016], figure 12).
[7] Judith Scott-Clayton, *The Looming Student Loan Default Crisis Is Worse Than We Thought* (Washington, DC: Brookings Institution, 2018), https://www.brookings.edu/research/the-looming-student-loan-default-crisis-is-worse-than-we-thought/.
[8] Susan Dynarski and Daniel Kreisman, *Loans for Educational Opportunity: Making Borrowing Work for Today's Students* (Washington, DC: Brookings Institution, 2016), https://www.brookings.edu/wp-content/uploads/2016/06/THP_DynarskiDiscPaper_Final.pdf.
[9] *Game of Loans*, p. 118.
[10] Kelly Field, "Thousands Fall Out of Income-Based Repayment Plans," *Chronicle of Higher Education*, April 2, 2015, http://www.chronicle.com/article/Thousands-Fall-Out-of/229031.
[11] The grant program might be bifurcated into one component for traditional-age college students and a second for older adults who return to school, including after a period of unemployment (see Sandy Baum et al., "Rethinking Pell Grants" [New York: College Board, 2013]; and Sarah Turner, *Labor Force to Lecture Hall: Pell Grants and Postsecondary Policies in Response to Job Loss* [Washington, DC: Brookings Institution, 2017], http://www.hamiltonproject.org/papers/labor_force_to_lecture_hall_pell_grants_and_postsecondary_policies_in_respo).
[12] Elizabeth J. Akers and Matthew M. Chingos, *Are College Students Borrowing Blindly?* (Washington, DC: Brookings Institution, 2014).
[13] Federal tax credits are outside the scope of the Higher Education Act, but there is strong evidence that these credits have no impact on college enrollment (George B. Bulman and Caroline M. Hoxby, "The Returns to the Federal Tax Credits for Higher Education," Working Paper 20833 [Cambridge, MA: NBER, 2015]). The tax credits should be eliminated and the funds used to expand need-based grants.
[14] PSLF is likely to deliver the largest benefits to borrowers with graduate degrees, who can borrow much more than individuals with a bachelor's degree or less. Repurposing PSLF might involve creating a grant program for graduate programs (e.g., one targeted to individuals from disadvantaged backgrounds entering socially valuable fields).

[15] Rachel Fishman, “An Unsatisfying Consensus Reached on PLUS Loans,” EdCentral, New America Foundation, May 27, 2014, https://www.newamerica.org/education-policy/edcentral/unsatisfying-consensus-reached-plus-loans/.

[16] Alternative means would be needed to identify eligible children whose parents do not file federal tax returns. Congress would also need to decide whether to use this determination to calculate a lifetime Pell award, or whether Pell should continue to be available to low-income adults who were not economically disadvantaged as children.

[17] Eric P. Bettinger, Bridget Terry Long, Philip Oreopoulos, and Lisa Sanbonmatsu, “The Role of Application Assistance and Information in College Decisions: Results from the H&R Block FAFSA Experiment,” *Quarterly Journal of Economics* 127, no. 3 (2012): 1205–42, https://academic.oup.com/qje/article-abstract/127/3/1205/1921970.

[18] Benjamin M. Marx and Lesley J. Turner, “Student Loan Nudges: Experimental Evidence on Borrowing and Educational Attainment,” Working Paper 24060 (Cambridge, MA: NBER, 2017), http://www.nber.org/papers/w24060.

[19] See, for example, Jason Delisle, *The Coming Public Service Loan Forgiveness Bonanza* (Washington, DC: Brookings Institution, 2016).

[20] S. 799, 115th Cong., https://www.congress.gov/bill/115th-congress/senate-bill/799?q=%7B%22search%22%3A%5B%22Dynamic+Repayment+Act%22%5D%7D&r=1

[21] Nonwage employees (including “gig” workers) could be a subject to a system modeled on the IRS’s estimated tax system. All workers would be subject to an annual reconciliation of earnings and debt payments. For a detailed proposal along these lines, see Sandy Baum and Matthew Chingos, “Reforming Federal Student Loan Repayment: A Single, Automatic, Income-Driven System” (Washington, DC: Urban Institute, 2017), http://urbn.is/2D6iY09.

[22] “EPI’s DC Conference, ‘Restructuring Student Loans: Lessons from Abroad,’ ” Gerald R. Ford School of Public Policy, University of Michigan, June 14, 2016, http://fordschool.umich.edu/news/2016/epis-dc-conference-restructuring-student-loans-lessons-abroad

[23] Under REPAYE, borrowers pay for up to an additional five years if they borrowed to attend graduate school (see https://studentaid.ed.gov/sa/repay-loans/understand/plans/income-driven), but the percentage of income paid each month is the same.

[24] See Jason Deslise and Alexander Holt, *Zero Marginal Cost* (Washington, DC: New America Foundation, 2014), https://www.newamerica.org/education-policy/policy-papers/zero-marginal-cost/; and Matthew M. Chingos, “Jeb Bush’s Student Loan Plan Should Outlive His Campaign” (Washington, DC: Brookings Institution, 2016), .

[25] Alternative solutions include loan limits (especially for graduate students), making forgiveness provisions less generous (e.g., eliminating Public Service Loan Forgiveness), or tying the length of time prior to forgiveness to the amount borrowed.

[26] Total payments would likely need to be capped (e.g., at some multiple of the amount borrowed). Otherwise, the fiscal sustainability of the system would be undermined by borrowers with high earnings potential turning to the private market for financing.