

WHITE PAPER

Addressing Student Loan Repayment Burdens

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Executive Summary

At a November 2005 symposium jointly sponsored by the American Enterprise Institute and the Project on Student Debt, leading researchers and policy experts explored the implications of rising student debt and presented several innovative proposals. In response to interest generated by the symposium, the Project on Student Debt conducted a review of U.S. student loan repayment policies and analyzed the extent to which borrowers are subjected to excessive repayment burdens. The review and analysis found that existing safeguards are well intentioned but flawed, leaving many borrowers without adequate protection. This white paper describes the current system, assesses its strengths and weaknesses, and identifies practical ways to achieve a more rational and effective balance of borrower obligations and protections.

Context: rising debt, higher interest rates. More students are borrowing larger amounts to pay for college than ever before. About two-thirds of recent graduates carry student loans, and their average debt has increased by more than 50 percent over the past decade after accounting for inflation. Even if tuition levels rise more slowly than they have in recent years, borrowing will continue to expand. In addition, interest rates are now rising, adding significantly to the size and duration of borrower payments. In 2004-05, recent college graduates could consolidate their federal loans at low, fixed rates, which served as a safety net for those struggling to make their payments. That low-interest option is gone, and the new interest rate scheduled for July 2006 will result in payments that are 20 percent higher than the 2004-05 rates, more than doubling the total interest paid over the life of the loan.

Effective student loan policies. In general, the economic returns to a college education have proved to be high. But for individual college graduates, the financial benefits are both variable and unpredictable. One important role of government is to provide some protection against those risks so that qualified citizens, regardless of wealth, can and will advance their education. Toward that end, well-designed student loan repayment policies should aim to ensure that borrowers with low post-college earnings do not face unmanageable payment expectations, and that those who are responsible and make manageable payments are not burdened with indefinite repayment obligations.

Such policies would help limit the risks of student loan debt for teachers, public health workers, members of the clergy, and others in lower paying but important jobs that

require higher education, as well as borrowers faced with family medical crises and other unanticipated circumstances that contribute to unmanageable repayment burdens. However, the protections should not be so generous that they give borrowers an incentive to work less, earn less, or avoid repaying their loans.

U.S. policies fall short. The student loan system in the United States includes a number of provisions that aim to ease repayment burdens. However, the protections are inconsistent and sometimes irrational, highly complex, and too narrow in scope when compared to legitimate needs. The analysis finds that:

- Many borrowers who clearly should qualify for assistance do not.
- Some provisions counter-productively reward borrowers for working less or earning less, or for borrowing more.
- Some programs fail to consider family size in assessing the amount the borrower can afford to repay.
- There is insufficient assistance for borrowers who have low incomes relative to their debt over a long period of time.
- Even when formulas for repayment assistance are designed appropriately, borrowers often are not informed that the assistance is available.

Policy options. Significantly improving loan repayment policies in the U.S. does not require a radical overhaul of our student loan system. The building blocks are there, but need to be assembled in ways that makes sense and that reach out to those who are eligible. Some improvements could be implemented through regulatory changes; others would require congressional action. Some of the options identified in this white paper include:

Expanded “economic hardship” provisions. Some federal loans offer interest subsidies for periods of “economic hardship.” However, the current formulas and processes fail to reach borrowers who should qualify, and lead to situations in which borrowers in similar situations receive vastly different treatment. These provisions could be improved by establishing a more uniform definition of hardship, and phasing out the benefits as borrower incomes rise. Other potential improvements include adjusting the benefits for family size, eliminating the three-year limit, and making other loans eligible for interest assistance. In addition, information about the assistance needs to be more readily available and the process for applying less burdensome.

Tax credit for student loan interest. This proposal would provide taxpayers with incomes below a certain threshold with a refundable credit for their actual interest payments on student loans. The income threshold would take family size into account. Borrowers with incomes above the threshold would receive a partial

credit. A tax credit gives borrowers a financial incentive to make payments on their loans. By using a sliding scale linked to repayment burdens, borrowers would also have a financial incentive to earn more.

The credit could replace the current interest deduction, under which lenders already provide taxpayers and the IRS with information on student loan interest paid. Providing relief through a tax provision could also be more effective than other programs in reaching qualified borrowers and would be simpler to administer, since lenders do not need to become involved in confirming borrower's incomes.

Simplify income-based repayment. Some borrowers with federal loans have a repayment option called “income-contingent repayment,” or ICR. It is the only current plan that allows for eventual forgiveness of remaining loan balances, after 25 years of income-based payments. This program could be improved by making it available to all borrowers, reducing the maximum repayment period, and ensuring that amounts forgiven are not treated as taxable income.

The purpose of this white paper is to prompt discussion among analysts, higher education and industry leaders, and policy makers about ways to improve student loan repayment policies. The Project on Student Debt welcomes feedback and commentary on these and other policy improvements that could provide more consistent and meaningful protections for borrowers.