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COLLEGE CREDIT: Repairing America's Unhealthy Relationship with Student Debt

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INTRODUCTION

Sallie Mae, the largest private lender of student loans, recently announced that it will split into two entities. The first company will manage nearly all of Sallie Mae's assets—$118.1 billion worth of federal loans and $31.6 billion worth of private loans—and the second will continue to lend to students.[1] This development underscores a disquieting truth: Americans have a healthy attitude toward higher education but an unhealthy relationship with student debt. While household debt comes in many forms, only student debt grew during the Great Recession. Federal policy has encouraged this habit. In the two years following the financial crisis, spending on student loans grew 19 percent and 18 percent, respectively.

Though students and families are borrowing more to cope with the ever-growing cost of college, the loans that they are taking out may actually be a cause, as well as a result, of the problem. Many studies suggest that colleges are capturing part of this increase in federal loan funds and using it to pay for high-cost expenditures—such as research labs, student amenities, and administrators—that are then passed on to students in the form of higher tuition and fees. Since colleges are guaranteed funding for students who demonstrate need, they are insulated from the consequences of raising prices. Therefore, student loan reform needs to introduce competitive pressure into the student loan system. De-linking the cost of specific colleges from decisions on loan awards is one way of achieving this goal. Instead, colleges

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could offer every eligible student four possible loan awards based on financial need and the median cost of college. This reform would force colleges to compete for students' loan money by demonstrating the actual value that their education provides. And since colleges would no longer be shielded from market pressures, they would be forced to become more cost-conscious.

BACKGROUND

Though the growth of student debt has received considerable attention of late, the problem has been mounting for decades. Indeed, both the amount of debt owed and the share of households owing debt have steadily increased over the past 20 years.[2] However, recent debates over the value of a college degree have inspired a new focus.

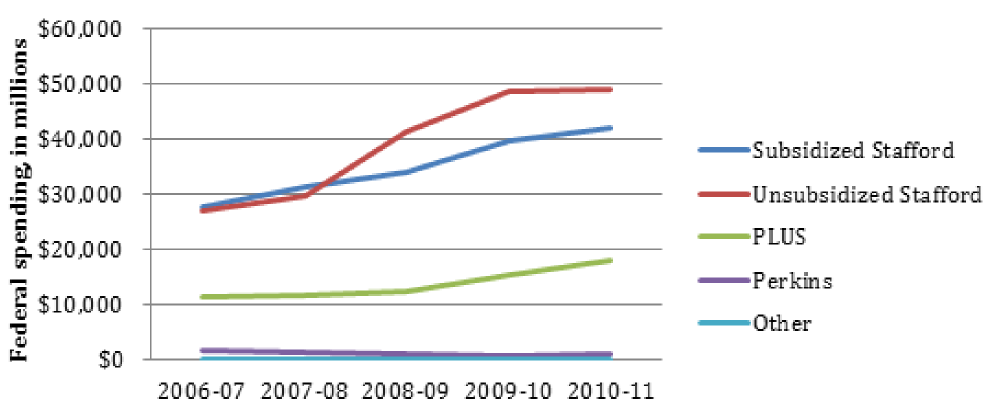
The federal government offers direct and indirect loans for college and university students. There are four types of direct student loans:

1) Direct subsidized Stafford loans, for undergraduates who attend college or vocational school and have "financial need."
2) Direct unsubsidized Stafford loans, for which all undergraduate, graduate, and professional students are eligible.
3) Direct PLUS loans, which graduate and professional students as well as the parents of undergraduates can use to pay for any educational expenses that other forms of financial aid do not cover.
4) Direct consolidation loans, which allow students to consolidate all their loans into a single loan with one lender.

In terms of indirect loans, the government offers the Federal Perkins Loan Program, which enables schools to lend to undergraduate and graduate students with "exceptional" need.[3] The federal government spends by far the most on subsidized and unsubsidized Stafford loans: in 2010–11, it spent $42,133 million on subsidized loans and $49,018 million on unsubsidized loans.[4]

The student loan process begins when a college determines the cost of attendance (COA) for each student seeking federal aid. The COA includes tuition, room, board, and all other expenses. The college's financial aid staff then determines a student's expected family contribution (EFC)—the amount of aid that a student's parents are expected to provide, given the financial information that a student lists on the Free Application for Federal Student Aid (FAFSA). Then the staff determines a student's

Federal Spending on Student Loans



Source: College Board Advocacy and Policy Center financial need by subtracting the EFC from the COA. This figure sets the maximum amount that a student can receive in need-based aid.[5] Non-need-based aid awards, such as unsubsidized loans, are calculated by subtracting the financial aid package initially received from the COA.[6] The school then tallies up the overall need of its students and makes a request to the federal government.[7]

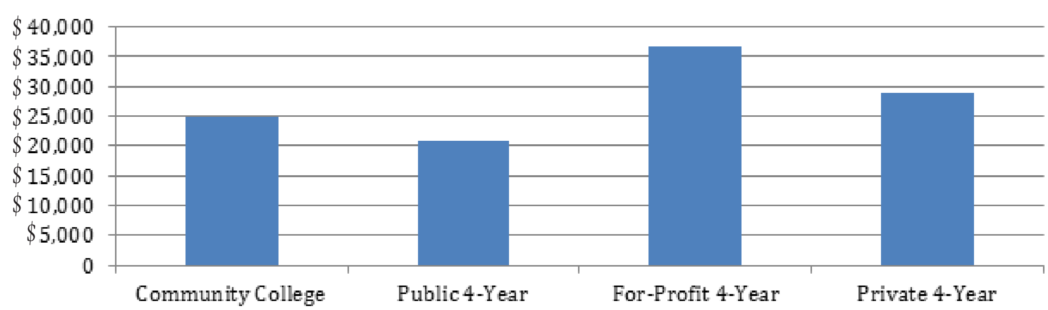
After requesting funding for students, schools receive funds for loans through the Department of Education's G5 grants management system. A school requests as much funding as it needs for its students and families, and the Department of Education transfers the funding electronically to a bank account that the school creates for the sole purpose of receiving these funds.[8] There is no limit to the amount of aid that schools can receive, provided that their students are eligible.[9] Schools must send disbursement records to the Department of Education, which then compares the amount of money it authorized with the amount of money that was disbursed to the students. If the school has disbursed more money than was authorized, the department makes up the difference.[10] The school must disburse all federal funding within three days of receiving it.[11]

There are limits to the amount of federal government money that a student can borrow. For first-year undergraduates, the limit per year is $5,500 for dependent students and $9,500 for independent students. For second-year undergraduates, the limit is $6,500 for dependents and $10,500 for independents; for third-year undergraduates and "beyond undergraduates," the respective limits are $7,500 and $12,500. For graduate or professional degree students, there are no limits for dependent students and a $20,500 limit for independent students. The maximum amount of federal dollars that students can borrow over their academic career is $31,000, no more than $23,000 of which can be subsidized loans. The maximum amount of federal funds that independent students can borrow is $57,000 for undergraduates, no more than $23,000 of which can be subsidized loans. The lifetime limit on federal funds borrowed by independent graduate or professional students is $138,500, no more than $65,500 of which can be subsidized loans.[12]

PROBLEMS

Total student loan debt has grown dramatically in the past decade: from 2007 to 2012, total student debt nearly doubled, from $548 billion to $966 billion.[13] Recent graduates hold the most debt: the total loan debt of individuals under the age of 30 increased from $220 billion to $322 billion from 2007 to 2012, and their average loan balances increased from $16,425 to $21,402.[14] However, total debt and average balances grew for each group.[15] One recent study suggests that the average student debt for graduates in the class of 2011 was $26,500, a 5 percent rise from the previous year.[16]

2008 Average Student Debt Among First-Time Bachelor's Degree Recipients, by Sector



Source: 2008-09 Baccalaureate and Beyond Longitudinal Study,National Center for Education Statistics

The average debt loads are different for students in each higher-education sector. In 2008, students in the for-profit sector had the largest average debt loads, while students in public four-year programs had the lowest debt loads.[17] Notably, the two sectors whose students owed the lowest amount of debt—community colleges and public four-year colleges—were, at the time, the two largest sectors of the higher-education industry.[18]

STUDENTS ARE FAILING TO REPAY

The overall picture bodes poorly for students. Debt levels are growing across the board while increasing numbers of students are running into trouble with loan repayment. Of all the forms of household debt, student loans are associated with the highest delinquency rates: 90 days or more—a rise of more than 7 percent from 2004 to 2012.[19] These delinquencies seem likely to persist because subprime borrowers, whose loan repayment delinquency rates are much higher than those of the rest of the borrowing population, hold a large and growing share of student debt.[20]

Default rates, which measure the percentage of borrowers who fail to pay back their loans by an agreed-upon time, are also growing.[21] The Department of Education reported that in 2011–12, two-year cohort default rates (CDR) for borrowers of student loans grew in both public and private nonprofit schools, and while they decreased in for-profit institutions, these schools still have the highest default rates. When the department calculated the three-year CDR, they found that students at private nonprofit institutions had a 7.5 default rate; at public nonprofits, 11 percent; and at for-profit institutions, 22.7 percent.[22]

The growing regularity of delinquency and default will have serious consequences for recent graduates. Ninety days after a borrower first fails to make a payment, loan servicers report this delinquency to the major credit bureaus, which likely leads to a negative credit score. The ramifications are worse in default: defaulting borrowers become ineligible for additional federal student aid and loan repayment plans, the IRS can withhold their tax refund to repay the loans, their debt will increase because of additional fees, and the federal government can ask the borrower's employer to garnish the borrower's wages.[23]

Borrowers who fall behind on their loans will find it extremely difficult to escape their debt burdens. Even if borrowers wish to discharge their student loans in bankruptcy, they must first sue their creditor to demonstrate that repaying their loans would cause them "undue hardship."[24] Judges can discharge a borrower's loan debt only if repaying those loans would make the borrower unable to maintain a basic standard of living, if the circumstances preventing the borrower's repayment would persist throughout the time they must repay their loans, and if the borrower has made a "good faith" effort to repay.[25] Because of this high standard of proof, only 40 percent of borrowers who file this claim have their loan debts discharged.[26] Moreover, only 0.1 percent of borrowers who file for bankruptcy try to discharge their loans.[27] The rest must continue repaying their loans despite their financial straits. Even though students who obtain bachelor's degrees can expect to earn $2.4 million on average over their lifetime, student debt can have lasting negative effects.[28]

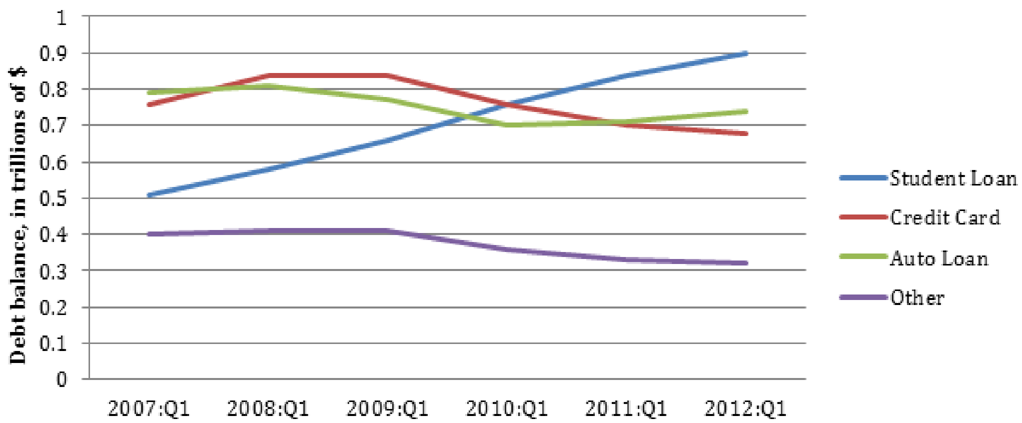
Notably, these problems are confined mostly to public student loans. In 2010–11, less than 7 percent of all student loans originated in the private market; in January 2012, private loans made up less than 15 percent of all outstanding student debt.[29]

WHY IS THIS HAPPENING?

Student debt continues to climb despite these negative consequences, partly because Americans place such a high value on a college education. Even in a poor financial climate, students and their families continue to compile large college debts.[30]

Furthermore, federal policy encourages them to do so. In the wake of the financial crisis, the government dramatically increased its spending on federal

Non-Mortgage Household Debt After the Great Recession



Source: Federal Reserve Bank of New York

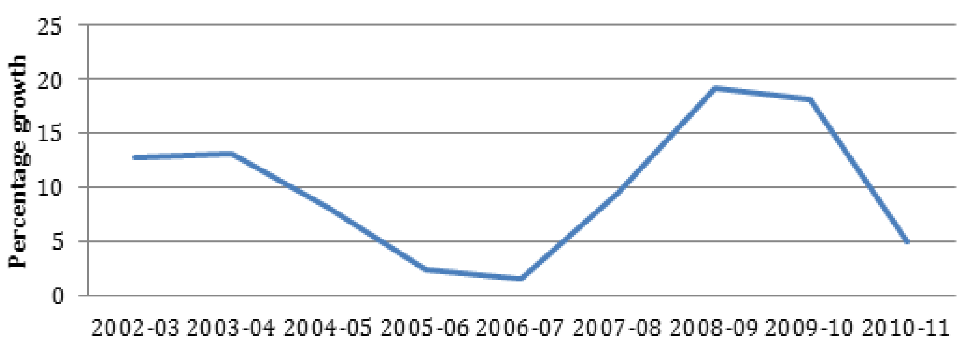
loans.[31] For the 2008–09 academic year, spending on student loans increased 19 percent; in the following year, spending increased 18 percent; and in 2010–11, spending growth returned to a more modest 5 percent.[32] Overall, federal spending on student loans grew 120 percent from 2001 to 2012.[33]

THE LARGER PROBLEM: UNCHECKED TUITION GROWTH

Federal expenditures and household borrowing patterns are symptomatic of a larger disease: the unimpeded growth of college tuition, which calls for greater borrowing.

The story of student loans is counterintuitive: students are forced to take out more loans precisely because the government makes more loans available. In an oft-cited 1987 *New York Times* op-ed, Secretary of Education William Bennett suggested that federal aid for college students provides a "cushion" for colleges that wish to raise their costs.[34] Bennett's theory—which some have dubbed the "Bennett Hypothesis"—has since been modified by Andrew Gillen, research director of Education Sector, formerly with the Center for College Affordability and Productivity. His "Bennett Hypothesis II" suggests that federal aid programs targeting low-income students are unlikely to lead to tuition increases, since these programs simply give poor

Postrecession Growth in Federal Student Loan Spending



Source: College Board Advocacy and Policy Center students the ability to pay their school's "prevailing tuition."[35] However, "universally available programs" will shift the demand curve for higher education, leading to increased enrollment and enabling schools to raise tuition.[36] Gillen argues that these tuition increases will yield more revenue for colleges and will make it possible for them to pay for additional faculty, researchers, and administrators. Since these expenses do not disappear over time, these initial purchases will raise colleges' costs in the long run and necessitate future tuition increases.[37] Gillen's argument is supported by both anecdotal and empirical research.[38]

The current structure of federal financial aid programs shields colleges from market pressure. Colleges have virtually no incentive to lower costs because the federal government bases its aid awards on the cost of attendance. Indeed, since the aid award equals the cost of attendance minus the expected family contribution, colleges can raise tuition knowing full well that the government will accept any increase and factor it into the aid award. By tailoring aid to the price of specific colleges, then, the federal aid system distorts the pricing of higher education. Moreover, since the price of any college does not necessarily reflect the value of the education that it provides, students and parents are uninformed consumers. They have almost no power to bring down prices.

STEPS FORWARD

By insulating colleges from competitive pressure, student loans distort the incentives of colleges and universities. The problem of growing student loan debt cannot be addressed without rethinking our federal loan program. Further, to the extent that higher education represents an investment in the human capital that makes economic growth possible,[39] it remains valuable for the federal government to encourage students to attend college. In principle, the government has an interest in making college more accessible to less well-off students; however, the current loan system is making a college education a more burdensome proposition for students and their families. Student loan reform should therefore continue facilitating access to college while bringing market pressures to bear on postsecondary institutions.

To the extent possible, student aid should be de-linked from the cost of attending a specific college. The Center for College Affordability and Productivity has suggested that policymakers turn direct subsidies for colleges and universities into vouchers for students.[40] The authors argue that doing so will force colleges to compete for students, since they no longer have guaranteed public funding. Universities would be forced to work harder to meet their students' educational needs; and new, innovative institutions would enter the higher-education market.[41]

Their notion of "subsidizing students, not schools," is consistent with the goal of introducing competitive pressure into the higher-education market and should be applied at the federal level. A revamped student loan program would provide loans for students but remove colleges from the equation. The federal government would no longer grant loans on the basis of the cost of attendance at a specific college but on the basis of the *median cost* of attendance at nonprofit private, public, and community colleges as well as at for-profit colleges.

PROPOSAL: CALCULATE LOAN AWARDS BASED ON MEDIAN COST OF COLLEGE

A new federal approach to student loans would involve four steps:

1) Future borrowers will continue to use the FAFSA to report financial information to the federal government. They will list their own as well as their parents' earnings, income tax owed, current balance of cash, savings, and checking accounts, and the net worth of their investments and businesses.[42]
2) Using the FAFSA, the government will calculate each student's expected family contribution (EFC) using the current formula and produce

four possible loan awards by subtracting the EFC from the median cost of college attendance in each of the four higher-education sectors: for-profit, nonprofit public, nonprofit private, and community college.

3) The government will offer students loan awards based on the median cost of attendance in the sector that they choose to attend.
4) Students will receive the corresponding loan award from the government after choosing which type of college to attend.

These reforms will introduce greater uniformity into the student loan system. Students already face strict limits on the amount of loan funds that they can borrow every year, thus limiting the differences in loan awards. However, these reforms would ensure that students with similar financial backgrounds would receive identical loan awards regardless of the specific school that they choose within each sector.

More important, by severing the link between loan awards and a college's prevailing tuition, these reforms would force colleges to think twice before raising prices. Colleges will be forced to justify higher tuition to applicants on the basis of better academic and employment opportunities. Moreover, since the federal loans that students receive will make it easier for them to attend some colleges but not others, students will need to assess their choice of college more carefully. Indeed, these reforms would force students to become more sensitive to price because they would need to make up the difference between the sector-wide award and the tuition bills of individual colleges. Colleges will therefore have an incentive to prove that their academic offerings are both cost-effective and valuable. Schools might respond by lowering costs through a number of means: adopting cost-saving technologies, firing unnecessary administrators, or getting rid of wasteful amenities. Students are currently less sensitive to the value of their investment because the federal loan program allows them to delay paying for college for many years.

One might argue that this reform will hurt high-achieving students of modest means by preventing them from attending prestigious private colleges. However, poor students are already underrepresented at the most elite schools, and this reform will not drastically worsen what is largely a structural problem.[43] There is also a significant way in which this reform will benefit lower-income applicants. Since the most elite schools have large endowments and can offer generous need-based financial aid, middle- and lower-tier private colleges, which typically do not have large endowments, will struggle to compete for talented students.[44] These schools, more than any other, will need to prove their value to applicants by lowering costs or improving their educational offerings. These reforms will therefore improve the options available to poorer students.

It is important that the federal government differentiate among the sectors, given the large differences in both average cost of attendance[45] and median tuition costs.[46] Indeed, if the government disbursed loans based on the median cost of every college, students could more easily pay for some types of colleges than others. The goal of these reforms is not to advantage some sectors but to create competition so that in each sector, the institutions that provide high-quality education thrive. Such reforms, which both recognize and rectify the distorting effects of loans without eliminating them, will help ensure that our higher-education system is less burdensome for students.

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