Making Loans Work for Today's College Students

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College debts and defaults on college loans are a hot topic these days. Forty million people in the United States hold student debt totaling $1 trillion. Apart from mortgages, student loans are now the largest source of household debt, outstripping credit cards and auto loans. Student borrowing continued its upward trend even during the recent Great Recession – and so did defaults. According to the U.S. Department of Education, seven million student borrowers are now in default, and more are behind on their payments.

What can be done to address so much debt and rising defaults? Many call for boosting public subsidies to college-going students. Decades ago, U.S. governments, especially state governments, heavily subsidized almost all of the cost of college attendance. But that support has faltered in the face of tax revolts and many other pressures on state budgets. A major increase in public funding is not immediately a prospect. The reality is that college-going students are going to continue to take out loans, and designing a federal loan program that works for students and families coping with stagnant or falling real incomes is critical if the United States is to keep delivering advanced educational opportunities to rising cohorts of young adults.

Federal college loans should be reformed, I argue, to include repayment requirements for all borrowers that are automatically adjusted in tandem with ups and downs in post-college earnings. A well-structured repayment program would insure borrowers against risks from both national economic downturns and personal setbacks in the job market. In such a system, interest rates could be set to cover default risks and the government's borrowing and administrative costs, making the improved federal college loan program self-sustaining for decades to come.

The Economic Rationale and Current Realities of Government College Loans

Education is an investment. Like all investments, it involves costs in the present to increase potential benefits in the future. While students are in school, expenses include both foregone earnings and payments for tuition, books, and other costs. The potential future benefits include increased earnings, improved health and longer life. To pay the current costs of their education, students need cash. In a business deal, a borrower would put up collateral in order to fund a potentially profitable investment. But of course students cannot put themselves up for collateral: they cannot contractually commit to hand over their future labor to a lender in exchange for upfront cash. Because private indentured servitude is illegal in the modern world, the public sector of most developed (and many developing) countries steps in to provide grants and loans.

College loans are not necessarily overburdening. Even now, U.S. student loan debt is typically lower than it appears from screaming media headlines. Consider students who first enrolled in college in 2003-04. Six years later, in 2009, 44 percent had no student debt and another 25 percent had borrowed $10,000 or less; and another 29 percent had borrowed between $10,001 and $50,000. Only two percent of these students are severely burdened after borrowing $50,001 or more. Based on limited data, today's entering college students appear to be on a similar path.

In addition, most defaults on repayments do not occur among former students struggling with the largest loans. In the entire student loan portfolio, including graduate students, the average loan in default is about $14,000, while the average loan not in default is $22,000.

Designing an Improved Repayment Plan

Under the current federal student loan program, most borrowers have to repay in fixed increments over ten years, even though a college education pays off over many decades through higher earnings and better health and productivity. The mismatch between the timing of the costs and benefits is especially problematic right after people leave college. Default rates decline for older borrowers, but fully 28 percent of student borrowers under age 21 default on their loans.

Income-based repayment systems that include automatic adjustments in bills and the length of the repayment schedule can reduce pressures on borrowers when they first graduate from college or experience joblessness or low earnings. Countries as diverse as Australia, Chile, New Zealand, Thailand, and the United Kingdom have workable versions of such systems. In the United Kingdom, for instance, borrowers contribute 9 percent of any income that exceeds £21,000; any remaining student-loan balance is forgiven after thirty years.

To be sure, the United States has already started down this road, with its recently expanded Pay As You Earn program. In principle, this income-based plan holds college debt payments to ten percent of the borrower’s annual income. But this and other U.S. income-based plans are not the typical route for all student borrowers – and the U.S. approach does not currently work very well, because the repayments owed by borrowers are not automatically adjusted in tandem with their yearly earnings. If a borrower has unusually low wages or faces a spell of joblessness, he or she must go through a year-by-year bureaucratic process to demonstrate financial distress and qualify for a payment reduction. This backward-looking approach does not deal immediately with shocks to income, leaving many in the program stuck paying more than ten percent of their earnings in certain years. What is more, the cumbersomeness of the system discourages many student borrowers from applying at all. As the theory and evidence of behavioral economics shows, even small administrative hurdles can keep people from making beneficial choices.

The United States can easily design an improved income-based college loan system. Social Security is a good model, because it involves very little paperwork for participants and officials. Workers fill out an initial form and then the employer and government adjust payroll contributions automatically to rise and fall with yearly earnings. Repayments for college loans could be handled the same way – and appropriate legislation is already pending. If Congress acts, college loans and debt repayments can become much less burdensome for America’s students and young workers today and tomorrow. Students, families, and the nation as a whole all stand to reap large benefits from this modest reform.

Research and data for this brief were drawn from “Trends in Student Aid,” College Board Advocacy & Policy Center, 2012; Jason Delisle, “The Graduate Student Debt Review,” New America Foundation, 2014; Susan Dynarski and Daniel Kreisman, “Loans for Educational Opportunity: Making Borrowing Work for Today’s Students,” The Hamilton Project, October 2013; Alisa F. Cunningham and Gregory S. Kienzl, “Delinquency: The Untold Story of Student Loan Borrowing,” Institute for Higher Education Policy, March 2011; Donghoon Lee, “Household Debt and Credit: Student Debt,” February 2013; and the National Student Loan Data System.

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