

Fixing the Federal Student Loan Programs

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The payoff to a college education has increased dramatically over the last two decades. At the same time, the cost of a college education has increased steeply. To provide all Americans with the opportunity to share in the prosperity of the knowledge-based economy, those high-school graduates who are prepared to benefit from college must have access to the financial resources needed to pursue their education.

The Hamilton Project paper by Susan Dynarski and Judith Scott-Clayton proposes improvements to the federal grant programs, but the student loan programs will also be crucial for ensuring college access. The objective of federal financial aid policy should be to get the necessary funding into the hands of students and their families to pay their college bills—but with the right amount of subsidy to balance the goals of ensuring access and preserving families' incentive to spend those resources wisely. Particularly as college costs increase, it is extraordinarily expensive to ensure access through the federal Pell Grant program alone. Each dollar in federal grants costs roughly 6 times as much as a dollar in federally subsidized loans. Some students—particularly those from low-income families—may be debt-averse. However, there are many ways the federal government could make the loan programs less burdensome and to make an investment in college less risky.

Unfortunately, the current federal programs for student loans are flawed and need rethinking:

First, current repayment schedules are unnecessarily burdensome. The standard repayment schedule asks borrowers to make a fixed monthly payment over a ten-year term. However, the real earnings of college graduates typically double during the first 15 years after graduation. The burden of student loans could be reduced simply by making the typical repayment schedule gradually increase with age to more closely mimic the expected earnings trajectories of borrowers.

Second, loan repayment schedules may be too inflexible. Although attending college is a rewarding investment for most people, the fluidity and uncertainty of the U.S. labor market mean that the return to that investment is uncertain—and it has grown more uncertain over time. The current loan system provides little insurance to borrowers whose earnings fall below expectations, even for short periods of time. The typical repayment schedule should increase age, to match the expected increase in earnings for borrowers. But when earnings fall below expectations and payments exceed some percentage of household income, borrowers ought to be able to opt into income contingent repayment and receive some relief.

Third, the borrowing limits in the federal loan programs have not kept pace with the rapid rise in the cost of attending college. Students and families are increasingly relying upon the private capital markets, credit cards and part-time work to finance college. Since

borrowers can not offer future earnings prospects as collateral, private sources of capital do not serve this market particularly well. As a result, the federal borrowing limits should be raised.

Even with higher borrowing limits, loans are the most economically efficient means for controlling college costs, by preserving families' incentive to spend their time wisely in college and to look for bargains. Over the past decade, Congress has flirted with a number of direct regulatory approaches to curbing cost increases—such as setting a cap on the rate at which universities can raise tuition. But such clumsy government price-controls can have unintended consequences. The loan programs, by setting an expectation that parents and students assume much of the cost of attending a more expensive institution, “builds in” such cost control.

Fourth, interest rates on student loans are too high. Currently, the rate paid to private banks to originate and service student loans is set by Congress—not the market. We know that the interest rates are not too low because 3500 or so private banks are eager to participate in the federal programs. It is harder to know if the rates are too high—without a market test. Adopting more of a market-based approach to setting origination and servicing fees, while keeping private providers involved, would ensure that students and the government were paying the lowest sustainable interest rates.

In a forthcoming paper for The Hamilton Project and subsequent work, we will be describing solutions to these problems—recommending changes in the schedule by which students typically repay their loans, making repayment more sensitive to students' actual income after college, raising borrowing limits to accommodate the rising cost of college, and suggesting market-based approaches to financing student loans.