THE STUDENT LOAN REPAYMENT CRISIS AND POSSIBLE RESOLUTION THROUGH THE USE OF AN AUTOMATED PAYROLL DEDUCTION SYSTEM

by
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Access to higher education has been a priority for the federal government for many years. In effort to advance this cause, the federal government offers students loans to individuals who would not be able to secure favorable financing otherwise. In recent years, the number of borrowers who have taken out federal student loans has risen and the growing number of borrowers who are delinquent or have defaulted on student loans is a reason for the government to be concerned. Borrowers with high levels of debts may be forced to consume less in order to pay down obligations, causing macroeconomic impacts. Borrowers in delinquency or default may be ineligible for certain federal loans, and may find it more difficult to find private credit to take out loans to purchase homes or cars which can create further negative impacts on banks and financial institutions within America.

This capstone proposes and evaluates the use of an automated payroll deduction for student loans that would help reduce payment amounts for all borrowers to stimulate additional participation in the economy. It would also help borrowers avoid incessant paperwork, steer clear of delinquency and default, and it would not require payments from distressed borrowers below an income threshold. With political support from the United States House of Representatives and Senate, this proposal would help ensure that attaining an education with the use of federal loans does not come at a lifelong cost to borrowers.
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Action Forcing Event

On April 17, 2016, the Wall Street Journal reported that more than 40% of student borrowers in the United States are not making payments on their loans. The latest statistics are raising concerns over whether or not many of these borrowers will ever repay the government for their loans.¹

Statement of the Problem

As of early 2016, approximately 22 million Americans owe the federal government over $1 trillion for student loans.² While 12 million of these borrowers are considered current on their loans, over a third make no payments due to low income.³ Over 3 million borrowers are officially in deferment or forbearance, statuses which exempt borrowers from repayment for reasons such as a financial hardship including unemployment. When borrowers do not actively enter into deferment or forbearance when experiencing a financial hardship, they risk becoming delinquent after 31 days of missing a payment and defaulting on their loan obligations after 360 days of

² Ibid
delinquency. Over 6.6 million borrowers are delinquent or in default, owing the
government over $122 billion that may never be fully recovered.\textsuperscript{4}

Delinquency and default are harmful to borrowers as they limit the borrower’s chances from participating in the economy otherwise. Borrowers in default may be ineligible for certain federal loans, and may find it more difficult to find private credit to take out loans to purchase homes or cars which can create further negative impacts on banks and financial institutions.\textsuperscript{5} With the rise in number of borrowers in default, the possibility of strain on the overall economy rises, causing concerns for the government. Borrowers who are not in default but have large sums of outstanding debts are also a concern as most of their disposable income would go towards the repayment of the debt as opposed to participation in the economy.

The number of borrowers who are delinquent or in default has risen with the record number of American students that borrowed to attend universities and colleges during the last decade. Moreover, the pool of borrowers who will not be repaying their loans is growing due to a rise in the number of borrowers eligible for loan discharge due to frauds committed against them by for-profit education institutions. Borrowers owing over $100 million have already applied for discharge and the number could grow into the billions.\textsuperscript{6} When loans are unpaid by borrowers or are discharged by the government,

\textsuperscript{4} Josh Mitchell, “More Than 40% of Student Borrowers Aren’t Making Payments”
the taxpayers are left with the burden of footing the bill, contributing to the growing national debt.

The Federal Reserve Bank of New York has reported that student loan debt is now only second to mortgage debt, overtaking auto loans and credit card debts.7 Historically, the newly skilled workers were likely to spend in the economy but due to the growing burden of the student loan debt they are less likely to purchase homes, cars, or participate further in the economy, causing ripples that slow aggregate economic growth of the nation.

Researchers at the Federal Reserve Bank in St. Louis further this observation and found that the “serious delinquency rate for student loan borrowers has increased steadily since before the recession.”8 This indicates that as more borrowers become delinquent or default on their loans, the more likely they are to experience damage to their credit scores and unlikely to receive favorable terms for home, auto, or other lines of credit. This further hinders full participation in the economy, further fueling the negative macroeconomic impacts.

The amount of borrowers making zero payments, are delinquent or in default, or are requesting loan discharges are indicators for a need to revisit the repayments system for student loans owed to the government. If this trend is to continue, it will

become a larger burden on the taxpayer, contributing to the rising national debt. Moreover, with decreased participation and consumption in the economy, the burden will only become a bigger problem.

History

In 1955, Milton Friedman introduced the concept of “equity investment” in the realm of education. In his essay, “The Role of Government in Education,” Friedman wrote that the government could help finance the training of an individual based on certain criteria and that the “individual would agree in return to pay to the government in each future year x per cent of his earnings in excess of y dollars for each $1,000 that he gets in this way.”\(^9\) Friedman provided these ideas and recommendations to the U.S. Department of the Treasury, which began the lending direct loans under the National Defense Education Act (NDEA) of 1958.\(^10\)

The NDEA’s objective was to help the growing number of adolescents wishing to enroll in colleges and universities gain access to the education they desired. However, due to budgetary restrictions, the government was unable to expand direct lending initiatives so it opted to partner with private banks and non-profit lenders to guarantee these loans under the Higher Education Act (HEA) of 1965. Title IV of the HEA established the Federal Family Education Loan (FFEL) program in 1965 which “embodied the first explicit federal commitment to equalizing college opportunities for needy

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The FFEL program enabled the government to further its higher education initiatives without having to incur all of the costs. However, since the government guaranteed the loan, it had to absorb any default costs which were not accounted for in the budgets.

While the HEA continued to be reauthorized with few amendments, a major change came in 1990 with the passage of the Federal Credit Reform Act (FCRA). The FCRA accounted for the subsidy costs of all loan programs to ensure that the government was transparent, setting aside appropriate funding, and realizing the actual costs of the transactions occurring.\(^\text{12}\)

The 1992 reauthorization process of the HEA resulted in more major changes. Congress created an unsubsidized loan option to capture the middle-income students who did not qualify for subsidized loans. Congress also raised the dollar ceiling on borrowing student loans.\(^\text{13}\)

Concerned with the cost of funding higher education, President George H.W. Bush authorized the creation of a direct lending pilot program in 1992 to test the feasibility and associated costs of the government directly lending to borrowers. Under President Bill Clinton, the pilot was expanded into a program with the passage of the Student Loan Reform Act (SLRA) in 1993. Under the Direct Loan program, the government would originate the capital while the loan origination and collections process would be handled by private institutions which would have reduced the cost of


\(^{12}\) New America Foundation, “Federal Student Loan History”

\(^{13}\) Lawrence E. Gladieux, “Federal Student Aid Policy: A History and an Assessment”
the student loan program. The SLRA required that “at least 60 percent conversion of federal student loan volume from guaranteed to direct lending over a five-year period.” The SLRA also introduced the first Income Contingent Repayment (ICR) plan which gave borrowers flexibility in repayment by setting “monthly payments to a percentage of the borrower’s income for up to 25 years.”

Despite the original law requiring 60% of guaranteed loans to be converted to direct lending, Congress passed a law soon after, in 1994 that “prohibited the Education Department from encouraging or requiring colleges to switch to the Direct Loan program.” As a result, by 2007, the “new volume in the direct loan program had reached the lowest share of total federal student loan volume since it began in the 1990s.” Colleges and universities preferred the FFEL program to direct lending because the favors and benefits they received. The guarantee system was based on private institutions that could use their resources to attract more colleges and universities and the Direct Loan program did not have such incentives. Disruptions from the financial crisis in 2008 reduced the number of lenders in the guarantee program resulting in increased participation in the Direct Loans program.

Between 1994 and 2007, two repayment options were available for direct loans: (1) Standard Repayment plan: a fixed repayment amount of at least $50 each month.
and for up to 10 years\textsuperscript{19} or (2) ICR plan: “lesser of the following: 20 percent of your discretionary income or what you would pay on a repayment plan with a fixed payment over the course of 12 years, adjusted according to your income.”\textsuperscript{20}

Starting in the 2000’s, government efforts toward student loans focused more towards repayment and ensuring borrowers could and were repaying. After the enactment of College Cost Reduction and Access Act in 2007, borrowers were given the option of the Income Based Repayment (IBR), another type of Income Driven (IDR) plan which was similar to the ICR. Under the IBR which became available in 2009, borrowers would pay “generally 15 percent of discretionary income, but never more than the 10 year Standard Repayment Plan amount. Repayment period is 25 years and any remaining loan balance is forgiven if federal student loans are not fully repaid at the end of the repayment period.”\textsuperscript{21} The IBR also introduced the option for borrowers working in public service to have their loans forgiven after 10 years of payment.

Around 2010, there was surmounting concern over how the FFEL program “enabled private lenders to profit by charging far higher interest rates [which] represented a subsidy to private financial institutions and their investors rather than a benefit to students or taxpayers.”\textsuperscript{22} In 2010, the government eliminated the FFEL

\textsuperscript{21} FinAid.org, “Income-Based Repayment Calculator”, FinAid.org, 2016, http://www.finaid.org/calculators/ibr.phtml
programs and focused only on direct lending. The Congressional Budget Office (CBO) estimated that the termination of the FFEL program would result in savings of $68.7 billion over the course of 10 years that could be used toward Pell Grants.\(^\text{23}\) The FFEL program provided $889 billion in student loans from its inception to the end of the program in June 2010.\(^\text{24}\)

As the height of the financial crisis was impacting Americans, President Barack Obama’s administration revisited the IBR plan in 2010. It created a new IBR plan for borrowers “who have at least one federal student loan in 2012 or a later year and no loans prior to 2008.”\(^\text{25}\) The new plan also cut the monthly loan amount from 15% to 10% and sped up the loan forgiveness eligibility from 25 years to 20 years. This plan was created to assist the borrowers that were in school during the years with high unemployment to ensure their participation in the economy.

In 2011, President Obama announced the Pay As You Earn (PAYE) plan which capped “payments for federal direct student loans at 10 percent of discretionary income for eligible borrowers.”\(^\text{26}\) The plan was expanded in 2015 under the name REPAYE plan to include all borrowers, regardless of when the loans were obtained.\(^\text{27}\)

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\(^\text{23}\) New America Foundation, “Federal Student Loan History”
\(^\text{24}\) Department of Education Student Loan Overview, “Fiscal Year 2013 Budget Request”
Background

In the last three years, a variety of plans and ideas have been considered at various levels of government to mollify the impending repayment crisis and alleviate the stress on borrowers. Among these ideas includes linking aid to affordability, allowing borrowers to refinance loans at better interest rates, proposals for making tuition free at community colleges and increasing the Pell grant, reforming bankruptcy stipulations, better educating borrowers, and making college completely free for students. The next section discusses these plans in greater detail.

The Obama administration made several changes to the income-based repayment options available to help distressed borrowers and help link aid to affordability. In 2013, the President and Congress enacted the Bipartisan Student Loan Certainty Act which tied interest rates for direct loans to financial markets.28 Previously the interest rate ranged closer to 6.8% and was now a little under 4%.29 Subsequently, in 2014, Senator Elizabeth Warren proposed legislation in Congress to allow students with old government loans to refinance them at the new, lower rate.30 The CBO found that this proposal would cost the government $51 billion over 10 years and the legislation did not survive beyond Congress.31 There was also concern regarding how borrowers with older government loans had already gotten a great deal and allowing them to refinance would create concerns over equity.

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30 Ibid
31 Ibid
Another major proposal which did not become law was President Obama’s initiatives to make community college free. The proposal was aimed at making a college education accessible to those who worked for it while also promoting economic growth and training needed to maintain a talented workforce.³² The plan would have been a joint effort with federal and state funds but with insufficient cost information and concerns over the high levels of spending, Republicans in Congress did not allow the proposal to become law.

Several attempts at avoiding the repayment crisis have involved reviewing the Pell Grant and expanding coverage to allow for more low-income students. Since the grants “haven't kept pace with inflation, let alone increases in tuition” many of the low-income students make up the difference by borrowing.³³ Increases to the Pell Grant could reduce the dependency of low-income borrowers on loans, thus reducing their likelihood of defaulting. Alternatively, many proposals have considered slashing the Pell Grant and other forms of federal aid.

Another proposal for helping resolve the repayment crisis is to reform bankruptcy laws. Currently, government student loans are not dischargeable through bankruptcy except in the rare cases of undue hardship. Several bills have been proposed

in the Senate but concerns over the negative impacts it would create on future private loans have slowed the proposal’s pace.34

A growing number of studies indicate that borrowers need more education and information on how much they are borrowing. The government of Indiana passed a bill which “requires higher education institutions to provide students with information estimating: a) the total amount of loans taken out, b) total payoff amount, c) monthly repayment amount and d) how close the student is to reaching the maximum federal borrowing limit.”35 The implementation of the bill at the state level resulted in a positive correlation between level of information students had and a reduction in over borrowing.

Next, during the 2016 presidential election cycle, Senator Bernie Sanders emerged as the champion of making college completely free for students. His plan involved “using federal tax revenues to pay two-thirds of the current in-state tuition if the state will contribute the other third from increased state appropriations.”36 His plan would require increasing federal tax revenue as well as at the state level in order to successfully fund it and many states are unlikely to participate as they would have to increase their funding more toward higher education than they currently allocate.

The dramatic rise in number and revisions to repayment options in the last decade is an indication of the troubles borrowers face in repaying student loans.

34 Ibid
Economist and policy makers began recognizing the severe threats posed to the economy if delinquencies and defaults were not remedied for borrowers. Representative Carolyn Maloney wrote, ‘‘Americans have an average debt exceeding $27,000, and some end up paying back loans well into their 30s, 40s and even 50s. As debt levels increase, young people are forced to delay starting a family, purchasing a home, starting a small business and saving for retirement. This not only affects their lives, it impacts the overall economy.’’

To narrow in on the problem, Susan Dynarski finds that ‘‘the risk of default does not rise as debt balances rise. In fact, research shows the opposite: defaults are highest among those with the smallest loan balances.’’ Dynarski finds that among students who borrowed under $5,000 for an undergraduate education, the default rate is 34% whereas for students borrowing over $100,000 or taking out loans for graduate school, the default rates are 18% and 7%, respectively. Additionally, she notes that the most distressed borrowers are also likely patching together several sources of income to make payments and the bureaucratic process requires a new form to adjust the loan payment for every change in income.

The second part of the student loan repayment crisis stems from the lending done to borrowers who attend for-profit schools and the increased likelihood of delinquency and default for these borrowers. Adam Looney and Constantine Yannelis

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39 Ibid
have found that “increased enrollment in for-profit schools and increased borrowing rates among community college students account for much of the recent doubling in default rates.”\textsuperscript{40} They found that between 2009 and 2011, almost half (45\%) of all new federal loans were made to students borrowing to attend a for-profit or 2-year school.

The research also finds that borrowers who attended for-profit institutions tend to be older than the traditional college student, are from lower-income families in poorer neighborhoods, and are likely to be first generation borrowers. They enroll in programs they are less likely to complete and generally experience fewer employment opportunities, and are worst impacted by any economic downturns. By way of comparison, 70\% of students at traditional schools (public and private colleges and universities) complete their program while only 49\% of students at for-profits complete their programs.\textsuperscript{41}

In April 2015, a large conglomerate of for-profit schools operating under the banner of Corinthian Colleges was fined by the Department of Education for misleading its current and prospective students regarding job placements rates. The school ultimately shut down, leaving students with unfinished degrees and the burden of debt. Since many of these borrowers were victims of fraud, the federal government allowed for affected borrowers to apply for relief and have some to all of their qualifying loans


forgiven. Estimates showed that if all qualified borrowers were to apply for relief, the government would bear a cost of $3.5 billion.  

Around the same time, a number of for-profit institutions announced they would be closing or selling off schools. Among these include Art Institutes and Le Cordon Bleu Colleges of Culinary Arts. Many of the schools began facing stricter requirements from the Obama administration to have higher rates of gainful employment for students after graduation which pressured these schools to close or to be sold. The next major school closure announcement was of ITT Tech which left over 35,000 students without degrees and the burden of debt. Similar to the Corinthians borrowers, qualifying student attending ITT schools were eligible for loan forgiveness. Early estimates show that if eligible borrowers apply for relief, it could cost the government over $500 million. As more large for-profit schools close operations, the burden to relieving borrowers grows for the taxpayers, creating an unsustainable structure.

**Actors**

Given the macroeconomic impact of the repayment crisis, there are many actors with varying opinions. The following section describes the actor and their general stance.

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The Department of Education’s Office of Federal Student Aid is responsible for providing student loans to borrowers through the Free Application for Federal Student Aid (FAFSA). In addition, it oversees the process of student loan collection through its loan servicers and Private Collection Agencies (PCAs). The current Secretary of Education, John King has stated that “We take our enforcement responsibilities seriously. That’s why over the last seven years the Obama administration has taken a number of actions to protect students, borrowers and taxpayers from the illegal behavior of some institutions and programs.” The Department aims not to single out the for-profit establishments but is working to make the most appropriate use of federal funds while protecting borrowers from fraud.

President Obama tasked the Department of the Treasury (Treasury) to work in junction with the Department of Education on finding more affordable repayment options. Deputy Secretary Sarah Bloom Raskin has worked toward the initiatives on behalf of the Treasury and met with students of various universities and advocates to understand the best option for students. Similar to the goals outlined by King, Raskin has made it a goal to “understand the patterns that lead to delinquency and default, [so that] we may be able to predict and even preempt such outcomes to the benefit of borrowers, taxpayers, and economic growth.” Raskin also acknowledges that schools also played a role in the creation of the repayment crisis and cited the Brookings

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Institute report on for-profit schools and default written by Looney and Yannelis to advocate for greater accountability of funds.\textsuperscript{47}

With the Presidential election around the corner, it is important to acknowledge the positions of the Democratic and Republican candidates. Democrat Hillary Rodham Clinton has expressed interest in: helping borrowers refinancing at current interest rates, expanding the income-based repayment plans so that borrowers don’t pay more than 10% of disposable income, considering forgiveness options for private student loan borrowers, incentivizing employers for helping repay loans, and providing deferment opportunities for entrepreneurs.\textsuperscript{48} It is important to note that Rohit Chopra, the former senior adviser to Secretary King and an ally of Senator Warren, recently joined Clinton’s transition team. He has been an outspoken critic of ITT Tech.\textsuperscript{49}

Republican Donald Trump has proposed an “income-driven repayment plan that would cap student loan payments at 12.5 percent of a borrower’s income and then forgive the loans after 15 years.”\textsuperscript{50} Previously, Trump has stated that the student loan system should be privatized to have banks lend to borrowers and the Department of Education should be eliminated and should no longer provide grants. Trump has also mentioned that if colleges had more of a role in the process, the schools would make


\textsuperscript{48} HillaryClinton.com, “College Compact: Costs Won’t Be a Barrier”, HillaryClinton.Com, August 10, 2015, \url{https://www.hillaryclinton.com/briefing/factsheets/2015/08/10/college-compact-costs/}

\textsuperscript{49} Michael Stratford and Kimberly Hefling, “ITT Tech shutdown could cost taxpayers nearly $500M”

\textsuperscript{50} Hannah Finnie and Maggie Thompson, “Donald Trump’s higher ed ‘plan’ will explode the student debt crisis”, ThinkProgress.org, October 18, 2016, \url{https://thinkprogress.org/donald-trumps-higher-ed-plan-will-explode-the-student-debt-crisis-8b144b233ee7#.8o9v6t2tw}
loans to those borrowers that would have the greater possibility to repaying the schools, reducing delinquencies.\textsuperscript{51}

Elected officials, especially United States Senators and House Representatives have proposed significant ideas to reform the student loan program. In the current Senate, Republican Senator Lamar Alexander, the Chair of the Committee on Health, Education, Labor and Pensions, has long advocated for eliminating the Perkins loan and “consolidating all of the federal loan programs into one unsubsidized loan.”\textsuperscript{52} He has called for more simplicity to the loan programs to assist borrowers. Another Republican member of the Committee, Senator Orrin Hatch previously proposed a bipartisan bill to put more pressure on schools. The bill would narrow in on “colleges with loan repayment rates more than 10 percent below the national average over a three-year period” and make them ineligible for federal aid.\textsuperscript{53} The top Democrat in the Committee, Patty Murray has advocated for allowing borrowers with older loans to refinance, improving the Pell grants, and ensuring college provide students with an education that puts them on the path to succeed.\textsuperscript{54} Other Democratic members of the Senate Committee include Senators Bernie Sanders and Elizabeth Warren. Both Senators have

\textsuperscript{51} Grace Z. Li, “This is Trump’s stance on student loans – and it could hurt poor students”, USA Today College, une 22, 2016, http://college.usatoday.com/2016/06/22/this-is-trumps-stance-on-student-loans-and-it-could-hurt-poor-students/
advocated for various initiatives including refinancing older student loans as well as making higher education free to students.

In the House of Representatives, Republican John Kline, Chairman of the Committee on Education and the Workforce has expressed that the Department of Education is incapable of creating a loan servicing system that would be beneficial for borrowers. Another Republican member of the Committee, Representative Mike Bishop helped author successful, bipartisan legislation which extended the Perkins loan program by two years to ensure low income borrowers received the aid they needed. The top Democrat, Representative Bobby Scott worked with Senator Tammy Baldwin in support of legislation that would make community college education affordable. He has also expressed interest in increasing Pell grant eligibility to reduce dependency for borrowers on loans.

Many academics and think tanks have floated ideas regarding student loan finance reform. Susan Dynarski, a professor at the University of Michigan and fellow at the Brookings Institute recommends the solution focusing on lowering the monthly payments and extending the repayment period for borrowers who attend the non-selective schools where default rates are highest.

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58 Maggie McGrath, “The Best Way To Fix The Student Debt Crisis (And It’s Not Free Tuition)"
As previously discussed, the Brookings Institute has also done significant research on the impacts of rising enrollment at for-profit schools on the number of defaults. Alternatively, the Heritage Foundation believes that the government is overreaching into higher education and regulations on for-profits to improve gainful employment rates after graduation will limit the educational choices for students.\textsuperscript{59} Additionally, the Heritage Foundation also advocates that an increase in Pell grants would only amplify the crisis and the government should restructure so that the funding goes directly to students.\textsuperscript{60}

The Center for American Progress advocates a new program in which states and higher education institutes play a role “to more effectively meet the needs of low- and middle-income students.”\textsuperscript{61} The plan requires states to create more reliable funding via more streams of income, making college more affordable, improving performance, and reducing barriers to transferring credits between institutions.\textsuperscript{62}

The student loan advocacy and interest groups also have a large voice in the reform of the system. Many of these groups work with distressed students and experience firsthand the problems students face with repayment. The National Consumer Law Center (NCLC) is one of the largest voices and advocates that the


\textsuperscript{60} Lindsey Burke, “Pell Grant Increase Would Not Solve the College Cost Problem”, The Heritage Foundation, November 16, 2010, \url{http://www.heritage.org/research/reports/2010/11/pell-grant-increase-would-not-solve-the-college-cost-problem?query=Pell+Grant+Increase+Would+Not+Solve+the+College+Cost+Problem}

\textsuperscript{61} David A. Bergeron, Elizabeth Baylor, and Antoinette Flores, “A Great Recession, a Great Retreat”, Center for American Progress, October 27, 2014, \url{https://www.americanprogress.org/issues/education/reports/2014/10/27/99731/a-great-recession-a-great-retreat/}

\textsuperscript{62} Ibid
Department of Education move away from its model of using PCAs (for borrowers in default) and utilize an individual counseling model.\textsuperscript{63} NCLC demands more transparency from Education and its collection agencies to ensure their techniques are not harmful to borrowers. In addition, it has proposed Education expand its repayment options online in order to support borrowers who get harassed by the harsh debt collection practices.

The Institute for College Access and Success (TICAS) is also a large voice in the industry. Executive Vice President, Pauline Abernathy has recommended that the government improve Pell grant eligibility, further simplify the FAFSA, improve the tax benefits for higher education, and increase state investment toward higher education.\textsuperscript{64}

Since many establishments of higher educations are public, state schools, it is important to note what role states are playing. States differ as they independently determine how to fund higher education and as a result, their proposals differ based on the severity of problems. Loan forgiveness is a universal theme as at least 35 states have laws in place for qualifying borrowers. Seven states have started initiatives to allow borrowers to refinance older loans. States are also focusing on affordability and ensuring there is sufficient capacity to accommodate students desiring an education. Some states are also considering offering Child Savings Accounts (529 accounts) to encourage long-term savings.\textsuperscript{65}

In recent years, many for-profit universities experienced peak enrollments but due to stricter regulations, soon began closing operations or selling schools. The

\textsuperscript{64} Institute for College Access and Success, “National Policy Agenda to Reduce the Burden of Student Debt”, TICAS, October 10, 2016, http://ticas.org/initiative/student-debt-policy-agenda
\textsuperscript{65} National Conference of State Legislatures, “Student Loan Debt”
regulations have made it harder for the schools to operate long term and an influx in competition has left the schools to “adjust to the new normal of smaller enrollments and more regulatory scrutiny.”

Policy Proposal

The proposed policy is to enact legislation that transitions all borrowers with outstanding federal student loans into an automatic payroll deduction system administered by the Department of the Treasury. Employers would require employees with outstanding federal student loans to complete a form, similar to a W4, with pertinent information. The employer would calculate 3% of the borrower’s income that is 250% above the poverty level and remit it to the Internal Revenue Service (IRS) until the entire balance is paid off. The payroll deduction would apply to all sources of income (i.e. capital gains) that is 250% above the poverty level and would be reconciled at the end of the year to ensure appropriate amounts are paid until the outstanding balance has been paid off. Borrowers with income under 250% of the poverty level in a year would be exempted from making any payments for that year. The proposal would keep the current loan programs and loan distribution system under the Department of Education and interest rates on existing loans would remain the same. Interest, fines, and penalties would stop accruing when the borrower’s income falls under 250% of the poverty level in order to protect from negative amortization of the loans.

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66 Paul Fain, “Vanishing Profit, and Campuses”
The Department of Education houses pertinent information provided by the borrower in the FAFSA. This information can be linked using the taxpayer identification number (social security number) to the databases the Treasury houses for most outstanding government obligations and most incoming and outgoing payments. At the end of the year, a reconciliation process would ensure the appropriate amount was paid based on actual income. Borrowers that underpaid would receive a notice letter from the Treasury and would be required to make the remaining balance within 30 days of receiving the notice. Borrowers that overpaid would be eligible for a refund or can apply the excess balance as a pre-payment.

Borrowers who make over 250% of the poverty level that do not declare the student loans with the employers would receive a notice from the Treasury at the end of the year informing them of the total balance they owe. If this balance is not paid within 30 days of receiving the notice or the borrower does not provided the appropriate paperwork to show undue hardship, the borrower would be considered in a delinquent state. Borrowers making over 250% of the poverty level who do not make the payment or provide documentation of the undue hardship for over 360 days would be considered in default. Once a borrower has defaulted, the borrower may face offsets of any federal payments (i.e. tax returns) they may receive.

The Department of Education would adjust its current websites to allow borrowers to continue to view and manage their account online. The portal would allow them to check the outstanding balance and payments made. It would also provide them
a method of communicating with the Department when they lose a job or would like to make a voluntary lump-sum payment toward their loan.

Under this proposal, the Department of Education would no longer utilize loan servicers or PCAs. In fiscal year 2014, Education paid over $500 million to loan servicers and over $900 billion to private collection companies. The transition to the automatic payroll deduction system would save the government roughly $1.4 billion annually. The cost of operating the new payroll deduction system would be approximately 2 - 3% of the annual revenue generated by the system.

The proposed system serves as an incentive for borrowers to participate as it will lower (or possibly eliminate) the monthly payments he/she must make toward student loans. This allows for more disposable income which he/she can use to participate in the economy. As income rises, borrowers would pay in proportion to what they earn. It also provides incentive for borrowers to participate as there would be a reduction of paperwork and levels of bureaucracy to work through. The enforcement aspect serves in the interest of the government as any borrower with an outstanding loan and sufficient income would be required to participate. Not participating would result in borrowers having to face offsets on any federal payment.

The proposed policy, once enacted by Congress would go into effect on January 1, 2018. This would allow ample time for the Departments of the Treasury and

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Education to validate a smooth transition and to identify any additional resources that would be needed, including the creation of new forms.

**Policy Analysis**

**Advantages:**

1. There is a clear benefit to borrowers in the form of increased access to higher education. By providing a clear repayment option that is directly tied to income, prospective students would no longer shy away from higher education due to fears of cost. In 1989, Australia instituted a student loan repayment system through which the Australian Taxation Office deducts “between 4 and 8 percent of [the borrower’s] income, depending on how much they take home annually.”

   69 If their take home pay falls under the earnings requirement, payment is not required and interest and penalties stop accruing. The Australians found that the system has “financed [and] expanded access to higher education.”

   70

2. There is a benefit to borrowers as their risk of delinquency and default would decrease. Under the proposed policy, the number of loans in defaults would reduce significantly and the harsh consequences of default would only affect those who try to deliberately bypass the system by not reporting income. Australia’s student loan payroll

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deduction system is slightly different that the proposed model but its system is structured so that there are no student loan defaults in Australia.\textsuperscript{71}

3. There is a benefit to borrowers in the form of lower monthly payments. Under the proposed system, borrowers benefit from lower payment amounts spread over a long period of time. On the next page are averages for current student loan repayments (for a household size of 1) from the Brookings Institute study done by Beth Akers in 2014\textsuperscript{72}:

\begin{table}[h]
\centering
\begin{tabular}{|l|c|c|c|c|}
\hline
 & Mean & 25\% Percentile & Median & 75\% Percentile \\
\hline
Monthly Payments & $242 & $90 & $242 & $300 \\
\hline
Monthly Payment to Income Ratio & 7\% & 2\% & 4\% & 7\% \\
\hline
Household Wage Income & $71,681 & $35,000 & $60,000 & $90,000 \\
\hline
Outstanding Debt & $25,721 & $5,500 & $13,000 & $29,000 \\
\hline
\end{tabular}
\end{table}

In the proposed system, borrowers with income that is 250\% above the poverty level for their family size would pay 3\% of their yearly income toward any outstanding student loans. All income 249\% below the poverty level for the household size is protected from deduction. If a borrower does not make income that is 250\% above the poverty level for their family size, they would not be required to make any payments.

The table below shows the average payment amounts under the new policy for the 25%


percentile, median, and 75% percentile assuming the income and outstanding debt are constant. The poverty level for a household size of 1 ($11,700) was used to determine the calculations.

<table>
<thead>
<tr>
<th>Monthly Payments</th>
<th>Mean</th>
<th>25% Percentile</th>
<th>Median</th>
<th>75% Percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$132</td>
<td>$59</td>
<td>$154</td>
<td>$228</td>
</tr>
<tr>
<td>Monthly Payment to Income Ratio</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>Household Wage Income</td>
<td>$71,681</td>
<td>$35,000</td>
<td>$60,000</td>
<td>$90,000</td>
</tr>
<tr>
<td>Outstanding Debt</td>
<td>$25,721</td>
<td>$5,500</td>
<td>$13,000</td>
<td>$29,000</td>
</tr>
</tbody>
</table>

Under this model, a household of one with an income of $29,250 to $52,650 would have monthly payments ranging from $29 to $88 respectively, averaging around $31 less than the current system. Borrowers earning under $29,250 would not be required to make any payments. A borrower making $58,500 to $99,450 would have monthly payments ranging from $103 to $206 respectively, averaging $88 less than the current system. A borrower making between $105,300 to $111,150 would have monthly payments ranging from $221 to $235 respectively, averaging $72 less than the current system. The biggest relief is provided to those individuals making under $29,250 and in the median income levels as those are the most likely to contribute in the economy with the additional disposable income.

Additionally, since the most distressed borrowers often have smaller balances, negative amortization is likely to further impact these borrowers, keeping them in debt. Under the proposed policy, interest, fines, and penalties would stop accruing on loans.
for borrowers who do not meet the minimum threshold income of 250% above the poverty level, protecting borrowers from negative amortization.

4. The automatic deduction system decreases the government’s dependency on private debt collection firms whose interests may be misaligned with the government’s interests. In the status quo, the Department of Education contracts with PCAs who are compensated for successfully enrolling a defaulted borrower into a repayment plan.

Borrowers who successfully rehabilitate their loans can get out of default, improve their credit score, and regain Title IV eligibility to qualify for future student aid. PCAs that successfully rehabilitate a borrower are compensated a flat fee of $1300. Starting in 2012, borrowers could “negotiate a rehabilitation payment amount that was less than a percentage of the loan balance.” The Department of Education maintained the same compensation structure, so regardless of whether the loan was rehabilitated with payments of $500 or $5, the PCA was paid the flat $1300. The NCLC found that the number of rehabilitations completed by PCAs sky rocketed and concluded that “money...drives collection agency behavior.” This trend was confirmed through a pilot program conducted by the Department of the Treasury’s Bureau of the Fiscal Service in 2016 which showed that while Treasury completed 8 rehabilitations, the PCA control group completed over 120 in the same time frame.

Under the proposed policy, PCAs can no longer push defaulted borrowers into rehabilitation agreements with payments less than a percentage of the loan balance.

73 Deanne Loonin and Persis Yu, “Pounding Student Loan Borrowers”
74 Ibid
The borrowers who make $5 monthly payments see substantial spikes in the repayment amounts when the loans were returned to the servicer. This increases their likelihood of re-defaulting. The proposed policy would eliminate the role of PCAs and any room for misaligned interests that can be detrimental to the tax payers. Furthermore, borrowers would no longer be subject to the harsh “draconian” collection tools.

5. Borrowers would benefit from fewer administrative tasks when trying to pay down student loans. One of the biggest reliefs for borrowers will be the decrease in administrative hurdles of re-certifying every year if enrolled in an income-driven plan. The proposed idea would help streamline payments without creating confusion for borrowers. When income stops, the deductions automatically stop without requiring paperwork, phone calls, and letters. Australian borrowers have described the ease of enrollment as “one little box you tick, and then it comes out like a tax”.

6. Under a payroll deduction system, borrowers may make payments they may not have otherwise made under the current options. As previously discussed, when borrowers successfully rehabilitate, the loan is considered current and is returned to a loan servicer. When the loan is transferred, the borrower must renegotiate the payment amount if the standard repayment amount is not affordable. If a borrower was making a smaller payment, the new payment amount may not be affordable. The proposed system keeps borrowers on the same payment amount unless there are proportional

76 Ibid
increases to income. This also brings stability to the borrower as they no longer have to provide documents or make phone calls to multiple entities.

7. The payroll deduction system would alleviate the current burden on taxpayers by reducing the administrative costs. The proposed system would no longer require constant documentation and management of student loans by various entities ranging from the Department of Education to its servicers and PCAs. Treasury confirmed through its pilot program that contact with defaulted borrowers is very low and in rare cases of contact, the borrowers are unaware of their options. In the status quo, borrowers cannot resolve their student loans, particularly those in default, without speaking with a human representative at a private collection agency. The proposed policy alleviates these concerns and reduces the cost and burden that the government expends in trying to locate and contact defaulted borrowers.

**Disadvantages:**

1. The biggest challenge in implementing this proposal is that it limits the choices available to borrowers. Since borrowers with outstanding loans completed a promissory note which states all of the repayment terms available, transitioning borrowers to the new system would require their consent. This means the proposed system would not truly transition all borrowers but it would come in as an option for new borrowers.

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One possible way to work around this would be to allow borrowers with outstanding loans to consolidate. This also requires changing the current restriction that limits borrowers from consolidating more than once to allow eligible borrowers to consolidate again. The borrowers with outstanding loans can consolidate into a new loan with a new interest rate (the previously accrued interest would turn into principal) and begin repayment under the new system. The complexity and confusion that can ensue from this system is a major downside.

2. For the government, the cost of the proposed policy is estimated to be only 2-3% of the revenue the system brings and the repayment period on loans would be until the entire loan is paid off. In Australia’s experience, approximately 17% of new lending does not get recovered. This is a hidden cost that the government would have to ultimately account for.81 The Australian government has considered pursuing the estates of the deceased who had a high balance. However this may not be a concern as the current system in America currently writes off most loans after 15-25 years of consistent payments and bears the loss.

3. The proposed plan requires income documents that may be old and inaccurate. Payment amounts being tied to income that can be almost 2 years old could result in monthly payment amounts being too high or too low. Additionally, since “many recent undergraduates have yet to file a tax return by the time their loans come due. Even if they have, the return likely reflects a partial-year’s income or was filed when the

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borrower was a dependent.”82 While it presents a valid concern, the impacts may not be as significant because the borrower’s income in the first few years out of college is generally lower and the proposed policy is intended to help the recent graduates from being inundated by debt so they are able to participate in the economy.

4. Since the proposal is directly tied to income, it would become difficult for those borrowers who do not file taxes or are reported as dependents. This would result in the borrower having to provide an “alternative documentation or have his payments set to $0 until his next tax return is completed, filed, and automatically retrieved.”83 This is another significant downside of the proposed policy since the payroll deduction system intends to protect those with little to no income.

5. The proposed policy requires a reconciliation process in order to ensure that borrowers are being deducted by the appropriate amounts. Even with a reconciliation process, borrowers may face a large, unexpected lump sum amount due at the end of the year.84 This can aggravate borrowers and taxpayers if it occurs frequently and can create a bureaucratic process to resolve it.

6. The policy does not account for individuals who obtain an education using federal student loans in America but choose to live abroad. Australia has found that 10% of its borrowers end up working abroad and not contributing toward their student

83 Ibid
84 Ibid
In the United Kingdom, that number is around 6% and little is done by either government to track the borrowers. This evidence suggests that American policy makers must account for an additional 6-10% of the loans not being paid due to borrowers working abroad.

**Political Analysis**

**Proponents**

The Clinton campaign is likely to be in favor of the proposed policy. Clinton outlined in her campaign that she plans for a three-month moratorium for borrowers to re-negotiate plans to lower payment amounts and ensure borrowers do not have to pay over 10% of disposable income. Her original plan was to increase loan forgiveness for borrowers with limited options which could potentially cause disagreement with the proposed policy. If she is elected President, her support is critical in implementation of the policy.

The second most substantial proponent of the system is the NCLC. It carries a significant amount of influence when it comes to student loan policy. They have frequently advocated that the repayment process is in need of reform to eliminate the draconian collection methods which hurt borrowers. The NCLC would support this proposal as it helps borrowers avoid delinquency and default which harm their future potential. Furthermore, it does away with the use of loan servicers and private

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86 HillaryClinton.com, “College Compact: Costs Won’t Be a Barrier”
collection firms who are motivated by monetary incentives rather than the law. Having
the support of the NCLC is critical since they carry great weight and often lobby
lawmakers to push them to help distressed borrowers.

The Brookings Institute and many of its scholars, including Susan Dynarski and
Beth Akers, are proponents of the payroll deduction system. As economists, they
advocate that elongating the repayment period is in the best interest of the borrowers
regardless of debt size so that they can participate in the economy. From a government
budget perspective, under the current accrual-based accounting method, outstanding
federal student loans are seen to have a positive impact on the budget. This means that
that with a longer repayment period, the longer the student loan continues to show a
positive impact on the budget. While in reality, this is not a truly accurate analysis of the
outstanding student loans and the budget as the fair-value accounting method uncovers
otherwise.87

Opponents

Congress is not likely to be in favor of this proposal for many reasons. First, the
Senate Democrats that lead the effort on student loan reforms, particularly Bernie
Sanders and Elizabeth Warren are in favor of loan forgiveness and free college. They
have argued that a college education should be free and that schools need to have skin

87 Jason Richwine, “The Unknown Cost of Federal Student Loans”, The Heritage Foundation, April 2013,
Under the proposed policy, a greater burden would not be placed on the schools. This is likely to cause influential Democrats in Congress to not be in favor of the proposal. Furthermore, since the proposed system would come in as another option for new borrowers, it would create more repayment plans and additional confusion for borrowers. This would likely further sway the Democrats to be in opposition as they have expressed how complex the repayment system currently is. A possible method to appease them would be to forgive or allow renegotiation on the interest terms for the loans of those individuals who are making under $29,250 (the minimum threshold of 250% above the poverty level).

Congressional Republicans are also likely to be in opposition to the proposal. Rattled by the rising cost of healthcare and concerns over the national debt, Republicans would fear a further rise in the national debt. Prolonging the repayment period would mean that the government would get less revenue in the short term. Concerns over rising healthcare costs due to Obamacare have previously caused gridlock over necessary student loan reforms. The best way to appease these concerns would be to conduct more studies about how borrowers would spend the disposable income that would have otherwise been used to pay down student loans. These studies can potentially show the positive multiplier effect as borrowers purchase homes or cars or

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increase their general household consumption. If this activity is able to offset the decrease in short-term revenue, they would likely support the proposal.

The Trump campaign is also unlikely to support the proposal. Between the two plans Trump has discussed, one offers loan forgiveness after 15 years. This plan is more lenient than what is proposed but takes more income from the borrower in the short-term.90 His campaign could likely be in opposition because they prefer not to reduce the current revenue from student loans and increase the national debt.

Lastly, TICAS has evaluated the payroll deduction model and found it to be theoretically beneficial but impractical to implement.91 Due to the increasing complexity of adding another plan, TICAS would not support the proposal. New America has also found that the downsides of the proposal make the implementation difficult.

**Recommendation**

It is recommended that this proposal be piloted with a small subset of new and existing borrowers. The pilot should be targeted for borrowers with varied debt levels and schools/degrees. Passing legislation to conduct pilot programs is generally easier and is a better method of determining the real impact of the proposed policy. The pilot would also allow the government to iron out any problems if it were to pursue the policy in its entirety.

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90 Hannah Finnie and Maggie Thompson, “Donald Trump’s higher ed ‘plan’ will explode the student debt crisis”
91 Lauren Asher, Diane Cheng, and Jessica Thompson, White Paper: “Should All Student Loan Payments be Income Driven?”
The strongest reason for piloting this proposal is because the student loan repayment crisis is in need of reform. The status quo is not sustainable and recently the Government Accountability Office has found that in the 2017 budget, the income-based plans will likely result in the government forgiving up to $74 billion in student loans”. If the government is already on track to lose money, a payroll deduction system could help by removing the borrowers out of a defaulted status and into a position where they can otherwise contribute in the economy to help cover the government’s costs.

Next, many borrowers do not know of their options and often feel intimidated by the large sums of paperwork. Having a wage deduction system would help ease their fears and encourage borrowers to opt in. For borrowers who do not have sufficient income, they must show proof and re-certify each year. This administrative burden is taxing on the borrower and creates a more bureaucratic process that costs tax payers. The proposed system would help resolve many of these concerns.

Moreover, the proposed system makes a leap in the direction of removing the government’s dependency on the misaligned incentives of PCAs. In the current system, the PCAs are incentivized by monetary goals rather than ensuring what is best for borrowers. In addition, the government is paying a large sum of money to its contractors for completing the work. The proposed system would also help the government save the money it has to pay the contractors by utilizing and repurposing current resources in house to accomplish the same tasks.

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While the downsides of the proposal are significant, the status quo is unsustainable and a solution is required. Piloting the proposal is in the best interest of the government. The government has taken on the responsibility of ensuring that all those desiring an education are able to obtain one and it must play some part in ensuring they are not experiencing negative financial consequences as a result of getting an education.
Curriculum Vitae

Sonali Brahmbhatt hails from Houston, Texas and currently lives in Austin, Texas with her husband. She holds a bachelor’s degree in Economics and Asian Cultures and Languages from The University of Texas at Austin. Sonali started her career with the federal government as a Program Analyst with the Department of the Treasury’s Bureau of the Fiscal Service in Austin, Texas. She spent three years in the Washington, D.C. area and held various positions within the Treasury, including her current role as a policy expert on the Treasury’s Student Loan Pilot. She played an active role in the policy decisions regarding default student loans under the pilot framework and co-authored the “Report on Initial Observations from the Fiscal-Federal Student Aid Pilot for Servicing Defaulted Student Loan Debt” as prescribed by President Obama under his Student Aid Bill of Rights initiatives.