Rising Student Loan Burdens and What to Do about Them*

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Student loans help many individuals obtain higher education that they otherwise could not fund, but concerns have arisen in recent years about the large number of borrowers that appear to be struggling to make their payments. This article considers the economic consequences of excessive student debt. It then turns to policy options for relieving excessive debt burdens – most notably, the debate over student debt forgiveness and ways to change the federal student loan program to limit the number of new borrowers that will struggle to make debt payments.

Key words: Student loans, household debt, financial policy

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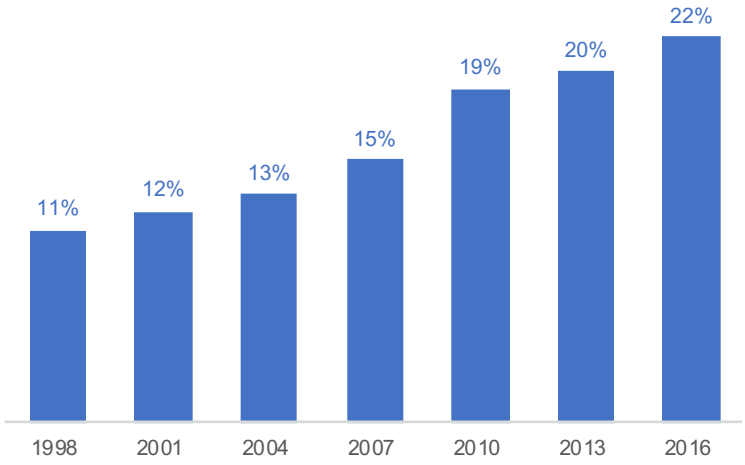
Introduction

Student loans help many individuals obtain higher education that they otherwise could not fund, yielding important benefits in terms of future income and economic mobility. Greenstone and Looney (2011) show that, even considering the typically high cost of higher education today, the lifetime yield on a college degree for the typical student will greatly outstrip that on other types of investments such as home purchases and stock holdings. Among children born into the bottom income quintile, 41% of those who obtain a college degree end up in the top two income quintiles as adults, compared with 14% of those who do not obtain a degree (Haskins, 2008). Student loans also benefit the economy as a whole by facilitating more human capital growth and, in turn, resulting in higher output.

The federal student loan program, which funds more than 90% of student loans, is essential to these outcomes. Federal student loans have low interest rates (less than 5 percent on new loans for undergraduates in 2020) and access depends not on one's own financial background or that of one's family, but rather on whether one attends an accredited institution.
It would be prohibitively expensive or just impossible for many people to fully fund their college educations through the private lending market given that borrowers with little income and limited credit histories tend to face much higher interest rates, if they can get a loan at all.

Notwithstanding these benefits, concerns have arisen in recent years about the large amount of borrowing that has occurred through the federal student loan program. Figure 1 shows that the share of U.S. households with student debt had risen to 22% by 2016, doubling over the last two decades, with most of the increase occurring after the financial crisis. Outstanding student debt per borrower has also increased substantially. In 2016, median student debt for households with student debt stood at $19,000, up from about $10,000 (in inflation-adjusted terms) in the late 1990s. Unsurprisingly, younger households tend to have the most student debt. For households under the age of 35, nearly half of households had student debt in 2016 (although there are also material debt holdings in older age groups, with about a quarter of households in their late 40s and early 50s having student debt in 2016).

Figure 1: Share of Households with Student Debt



Source: Survey of Consumer Finances.

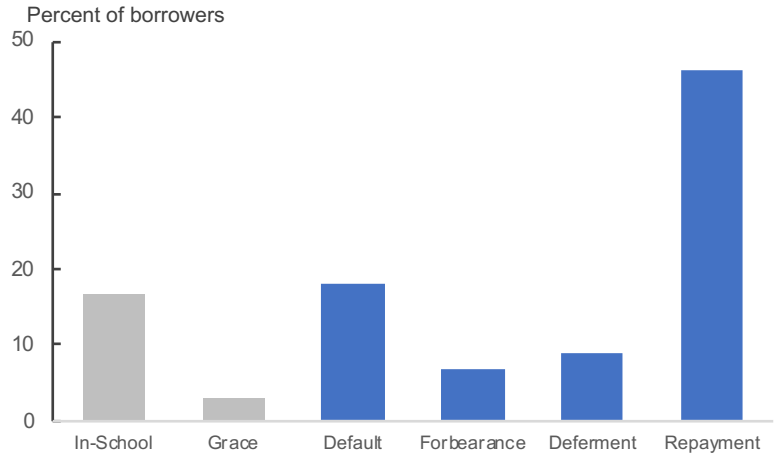
Student Borrower Struggles and their Implications

Data on the repayment status of the Federal Student Loan Portfolio provide concrete evidence of the struggles that some borrowers are having paying off their student debt. Figure 2 shows that 17% of individuals with federal student debt were in default as of mid-2019. However, traditional default rates greatly understate the challenges facing these individuals. A better denominator for the calculation would remove the 21% of borrowers that are still in school or in the 6-month grace period that follows leaving school (represented by the lighter gray bars in the figure) as those borrowers are not expected to be paying off their loans. One should also recognize that borrowers facing hardship may be put into deferment or forbearance. About 42% of the federal student loan program borrowers that have entered the period when they are scheduled to be repaying their loans (represented by the darker blue bars in the figure) were in default, forbearance, or deferral as of mid-2019.

Moreover, some student borrowers who are repaying are only able to do so because they are in the government's income-driven-repayment (IDR) program. The IDR program allows people having trouble managing their full loan payments to pay just a given fraction of their income

(typically 10%). Nearly one-third of student loan borrowers are in IDR. While borrowers in IDR are avoiding the negative consequences of default, the reduced payments result in extended loan terms and the accumulation of more interest over time.

Figure 2: Repayment Status of Federal Student Loans in 2019:Q2

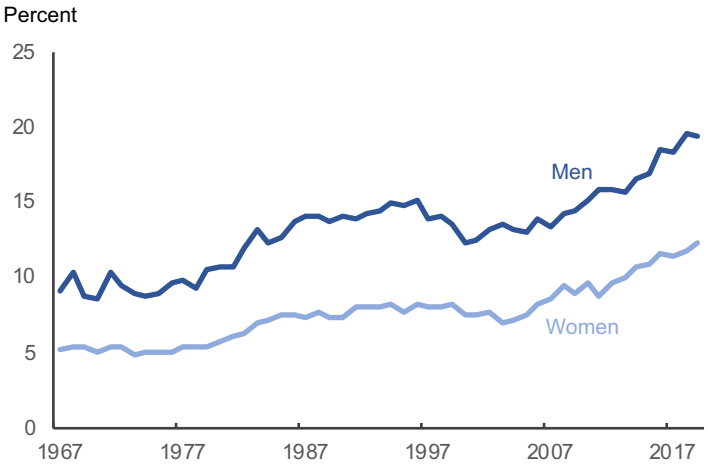


Source: College Board.

Various trends among young adults have raised concerns about the degree to which higher student debt burdens may be impairing their economic circumstances. Figure 3 shows the share of individuals between ages 25 and 34 (older than the age of the typical college student) who are living with their parents. The figure shows pronounced uptrends for both men (the darker line) and women (the lighter line) since the early 2000s, with almost 20% of young men in this age group now living with their parents. What is especially striking is that trends did not turn around with the strong labor market of the late 2010s.

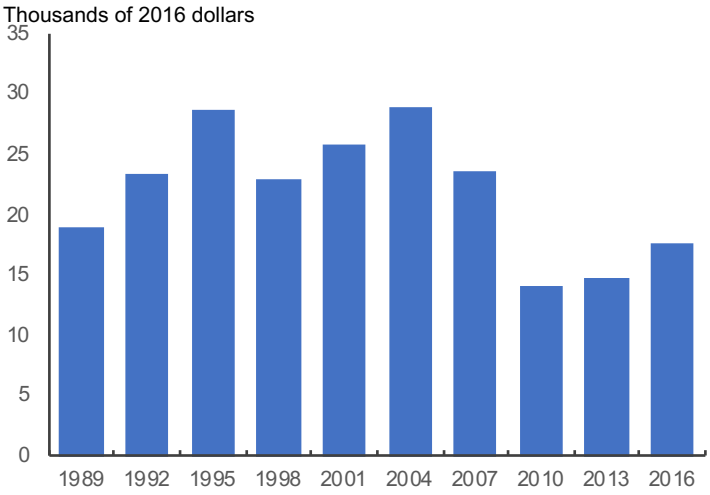
Figure 4 shows median inflation-adjusted net worth for households in the same age group. As of 2016, their net worth was significantly behind that of their counterparts a generation ago. In a mechanical sense, the greater student debt of the more recent cohort is clearly weighing on its net worth. Of course, the greater education facilitated by the student debt is likely to raise the incomes of many within the cohort, leading to higher net worth growth over time than would otherwise be the case. Still, their lower net worth early in life may hinder other types of economic opportunities.

Figure 3: Individuals 25-34 Living with Parents



Source: U.S. Census Bureau.

Figure 4: Median Net Worth for Households 25-34



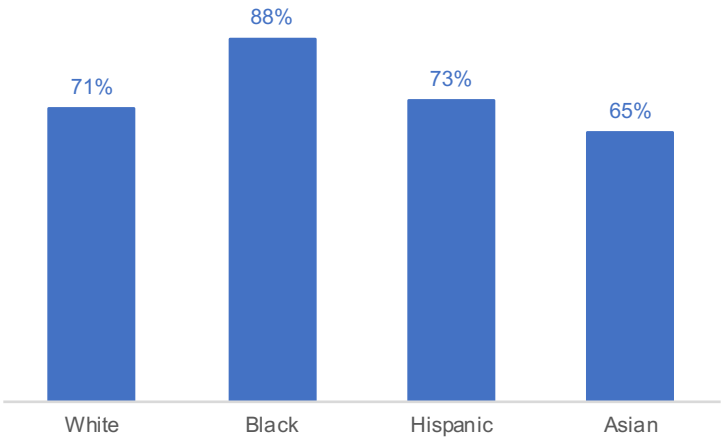
Source. Survey of Consumer Finances.

The potential for student debt to suppress economic mobility is of particular concern for some groups. A long literature documents persistent racial wealth disparities in the United States (see, for example, Gale, Gelfond, and Fichtner, 2019), and patterns of student borrowing by race raise questions about whether student loans may be one mechanism through which these disparities are transmitted from one generation to the next. Figure 5 shows results from Scott-Clayton and Li (2016) documenting that blacks are more likely to have student debt than individuals in other race groups; the same study showed that average student debt per borrower is also much higher for Blacks, at around $53,000, compared with less than $30,000 for other groups.

Of course, rigorous academic research is needed to definitively link greater student borrowing to trends in household formation, wealth accumulation, economic mobility, or any other economic outcome. The existing body of research of this type is fairly small but the available studies have, if anything, yielded reassuring results. For example, a particularly well-identified study by Mezza, Ringo, Sherlund, and Sommer (2020) finds that having student debt delays homeownership but that the magnitude of the delay is small -- about 4 months on average. Likewise, Cooper and Luengo-Prado (2018) do not find greater student debt to be among the main factors explaining why more recent cohorts of young adults are less likely to form

households than earlier cohorts; they conclude that most of the change is explained by different demographics, higher housing costs, and macroeconomic conditions.[1]

Figure 5: Share of 2008 Grads with Student Debt in 2012



Source: Scott-Clayton and Li (2016).

Important caveats apply, however. The first is that research on the many ways in which student debt might affect economic outcomes has been limited by data availability and identification struggles. To date, the research has focused on questions that can be tackled because the right data exist. There are all sorts of ways that student debt may be affecting individuals and the economy, and, for many of these channels, researchers have found it hard to parse out the role of student loans versus other factors.

The other major caveat is that the problems associated with greater student debt load may take years or decades to fully emerge. Factors that weigh on the economic opportunities in ways that are not very evident when a person is young can compound to be a much bigger deal later on in life. For example, a student borrower prevented from starting a business because of insufficient capital (and access to credit) may see little difference income at first but might have substantially lower income over her lifetime because of the constraint.

[1] The thought experiment underlying nearly all studies to date of how student loans bear on economic outcomes is how the world might look different if student debt disappeared but the higher education financed by the debt remained. For policy purposes, the results thus speak to the debate over student loan forgiveness rather than the

The Debate over Student Loan Forgiveness

Turning now to policy issues, a key area of debate going into the 2020 Presidential elections has been forgiveness of student debt. The starting point for any consideration of this issue is what arguments might justify the forgiveness of student debt. One set of arguments concerns the direct effect of high student debt on economic outcomes for individuals and the macroeconomy. As summarized in the previous section, the research to date has yielded reassuring results, but a more negative view may emerge as more outcomes are studied and more years of data accumulate.

Another set of arguments concerns fairness. An important and growing body of literature has documented systematic patterns by type of school regarding which borrowers tend to have problems paying off their student debt (see, for example, Chou, Looney, and Watson, 2017a). In particular, many for-profit colleges fall in this category. Broadly speaking, for-profit higher education institutions tend to charge tuitions that are quite high relative to community colleges, their main competitors as non-selective institutions. In terms of what students gain from this investment, a burgeoning set of research papers documents that value-added from for-profit higher education is low or negative in many (though by no means all) cases. This literature has found that for-profit schools tend to be associated with more student debt, much higher default rates on that debt, slower repayment of student loans, lower graduation rates, and worse labor market outcomes.[2] The finding of worse labor market outcomes holds up even after controlling for the more disadvantaged backgrounds of their students. Given these outcomes, it hardly surprising that many who took on large loans to finance low-value-added educations are frustrated with the federal student loan program. Whether the government should have done more to protect students from entering these arrangements and whether it should, then, bear the cost of forgiving some of the debt is likely to be the source of debate for some time to come.

Importantly, the federal student loan program already allows for some loan forgiveness. Under the IDR program discussed earlier, student loans are usually forgiven after making 20 to 25 years

effect of student lending generally, which is almost certainly positive and large on net.

[2] See Dynan (2019) for links to the relevant papers.

of on-time payments. (Borrowers who take on public service jobs can experience forgiveness after as few as 10 years of making on-time payments.) While this feature of the federal student loan program provides much-needed relief to some struggling borrowers, it has some drawbacks. The IDR program is administratively burdensome, as participants have to re-document their hardship. To the extent that student loans are impairing economic mobility, much of the damage may have been done after two decades. From a taxpayer perspective, there are concerns that a significant share of the individuals on track to experience large amounts of debt forgiveness through IDR appear to be those who have high balances -- but also high earnings -- because they borrowed to attend high-cost professional schools such as business school, school, or medical school. For example, the Congressional Budget Office (2020) projects that high-balance graduate borrowers in the top two quintiles of the income distribution will eventually see 20% to 40% of the amount they originally borrowed forgiven.

Different politicians have put forward different options for addressing excessive student loan loads. Some actions correspond to relatively small modifications of current policies. For example, IDR might become the default payment plan for student borrowers, which would relieve the administrative burden. Debt forgiven under IDR is currently taxable but it could be made exempt from taxes. Debt forgiveness for public servants might be expanded.

Other actions would be much more dramatic. At the extreme end is forgiving all federal student debt for all individuals who have federal student debt. While appealing to many borrowers, the cost for taxpayers would be enormous. Total outstanding federal student debt amounted to $1.5 trillion in early 2020 – or about 7 percent of GDP. Moreover, any plan to forgive all debt would presumably also replace new loans going forward with grants, increasing the cost yet further. Critics have also pointed to the inefficiency of forgiving debt for borrowers who have reaped a large return on their investment in higher education, as well as the previously discussed regressivity that arises from high-balance borrowers benefiting the most but also, in many cases, having high incomes.

An alternative to blanket student loan forgiveness would be partial or selective student debt forgiveness. For example, some proposals call for forgiveness of debt up to a certain limit.

Determining what that limit should be is challenging though — low limits might do too little to relieve struggling borrowers but high limits might be expensive and also raise regressivity concerns (and, regardless of the limit, this option would probably erase debt for many individuals who are comfortably able to pay off their loans). Another option would be forgiving loans for certain groups – for example, just for low-income borrowers (although that might raise moral hazard concerns) or just Pell grant recipients (individuals coming from low-income families). Finally, policymakers could consider accelerating some of the forgiveness in the IDR program – forgiving some debt after every few years of on-time payments. Doing so would not only provide direct relief but also provide a more salient incentive for borrowers to keep making their payments.

Curbing Excessive Student Borrowing Going Forward

One component of addressing excessive student debt burdens is putting policies in place that will make them less likely to occur in the first place. A priority here is changing the federal student loan program so that it imposes more accountability on higher education institutions in the future. The idea is to better incentivize schools to provide more value for the tuition dollars they collect; they can do so by improving teaching, providing better career guidance, preventing students from dropping out, and taking other steps that would set students for higher income once they have left school.

The federal student loan program already has some components that hold colleges accountable for their performance. Most importantly, schools risk losing access to the program if student loan default rates for recent graduation cohorts exceed some threshold. This feature helps incentivize colleges to provide value to their students but, as already discussed, default rates are a very limited measure of distress and the focus on a single specific threshold could invite gaming.

Some student loan experts have crafted "risk sharing" proposals that would modify the federal student loan program such that participating institutions share some of the risk their students will not earn enough income after leaving school to comfortably pay off the loans. For example, Chou, Looney, and Watson (2017b) present a proposal whereby higher education institutions are

judged based on the progress that recent graduates have made repaying their loans, and poor performers are subjected to a continuum of penalties depending on just how badly their students do. Focusing on repayment progress overcomes some of the limitations of focusing on default rates, and the continuum of penalties means that there is no precise threshold that schools would strive to just meet. Of course, as with any type of lending, there would be concern that adding "skin in the game" for institutions standing to gain from the loan would lead those institutions to eschew higher-risk borrowers. In the case of the federal student loan program, such behavior might block access for the students from disadvantaged backgrounds that the program is most trying to serve. But, such concerns could be mitigated by, for example, rewarding schools that disproportionately serve disadvantaged students.

Conclusion

Any decision to modify the debt forgiveness that is already embedded in the federal student loan program would involve difficult trade-offs. Policymakers will need to weigh the benefits of relief for some struggling borrowers against the cost and potential for inefficiency, regressivity, and moral hazard associated with any change. The heated arguments around the fairness of mortgage debt forgiveness in the wake of the financial crisis suggest that the politics around any decision to increase student debt forgiveness are also likely to be difficult.

Making changes to the federal student loan program to reduce the growth of the student debt overhang going forward should be a less difficult decision. Student loan experts have proposed well-crafted risk-sharing proposals that would penalize schools for delivering poor value and thus incentivize them to strengthen their programs. Changing the federal student loans program along these lines would reduce costs for taxpayers and raise the value that student borrowers are getting for their tuition dollars.

Other changes to higher education policy could also improve outcomes. Expanding Pell grants to students from low-income families would reduce the need for student loans. From a budget perspective, loans have traditionally appealed over grants because of their lower expected net cost, but the economics changes when a significant share of debt is not being paid back. In

addition, more financial support for community colleges – along with broader reforms to the community college system – would create stronger set of alternatives to high-cost, non-selective, for-profit colleges.

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