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Statement before the Senate Committee on the Judiciary on “Student Loan Bankruptcy Reform”

Student Debt

Assessing Its Impacts on Individuals and the Potential Role for Bankruptcy as Part of a Comprehensive Safety Net

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Chair Durbin, Ranking Member Grassley, and members of the committee: Thank you for inviting me here today to share my assessment of this important issue. The volume of student loan debt in the economy has now surpassed $1.6 trillion, which is an alarming milestone. Concern about student debt was once a niche issue, but with 45 million[1] Americans now holding student debt, it has rightly become an issue of national concern. Your attention to this subject today is apt.

I am honored to be able to share the insights I have gathered about this issue throughout a number of years working in this space as a policymaker and researcher. I began working on this issue as a staff economist in the Council of Economic Advisers under the George W. Bush administration, while working toward a PhD in economics at Columbia University, and have since been researching the economics of higher education in the think tank industry, currently at the American Enterprise Institute and previously at the Brookings Institution and the Manhattan Institute. Throughout my career, my focus has been on studying the federal system of higher education finance, with a focus on student debt, with the goal of improving the efficacy of our system of higher education as a mechanism for social mobility.

The Impact of Student Loan Debt on Individual Borrower Well-Being

When considering the impact of student debt on individuals, it's important to recognize the appropriate counterfactual for the comparison. While borrowers in repayment would be unequivocally better off if they didn't have to make payments on their debt, most are better off with debt and a degree than they would be if they'd not pursued higher education. That's not only because college degree holders earn higher wages but also because they find themselves unemployed less often than peers without degrees. The act of borrowing to pay for college often lowers current wealth but will ultimately increase lifetime earnings and economic well-being.

While students completing bachelor's degrees with debt have average balances of approximately $30,000,[2] the degrees they hold will, on average, raise their lifetime earnings by $2.8 million.[3] The price tag for higher education can be high, but the returns are generally even higher. Economists from the Federal Reserve have estimated that students investing in associate and bachelor's degrees will earn a 15 percent rate of return, which is about twice the rate of return in the stock market, on the dollars spent on the cost of enrollment.[4]

The largest student loan balances, like the ones we often read about in the newspaper, are uncommon and most often held by borrowers with advanced degrees who also have access to very high earnings. Only 6 percent of borrowers owe more than $100,000.[5] A recent study authored by my two co-panelists for this hearing indicates that more than 40 percent of the outstanding student debt in this country was used to pay for graduate or professional programs, with MBAs and law schools being the largest sources of debt. These high-balance borrowers hold a surprising share—one third—of all outstanding student debt.[6]

For the typical borrower, access to student debt through the Federal Loan Program creates an opportunity for economic mobility that would otherwise be unavailable. Some students, however, are left worse off financially for having gone to college. Borrowers who find themselves in this situation often fall into two categories: those who start but don't complete a degree and those who complete a degree but find that it doesn't deliver the opportunities in terms of employment that would justify its cost.

We see that non-completers make up a disproportionate share of borrowers who struggle to repay their debt.[7] This explains why borrowers with small balances—less than $5,000—are

finding themselves in default on their loans more often than borrowers with larger balances.[8] Debt without a degree is one of the most problematic trends of the current federal policy regime.

Another problem that needs to be addressed, especially for borrowers of color, is low-quality institutions that do not effectively prepare their graduates for the employment that would justify their often-high cost of attendance. There are programs and institutions in every sector of the higher education industry that fail to prepare their graduates, but the problem of a low-quality education, which generates both worthless credentials and large numbers of indebted dropouts, has been concentrated in the for-profit sector.

Low-income, first-generation, and minority students are disproportionately represented in this group. Black students, for example, make up just 13 percent of students enrolled at public colleges but comprise 21 percent of students at for-profit colleges.[9] This is an important driver of the repayment crisis these borrowers are facing. Half of Black borrowers who began a degree program in 2003–04 had defaulted on their loan 12 years later, compared to just one in five White borrowers.[10]

Student Debt and the Macro Economy

Since investments in higher education, on average, provide a net positive return (even taking into account the cost of borrowing), spending on education that is financed with federal student loans is generally a wealth-enhancing activity both individually and collectively. In other words, we are richer as a nation because of our public and individual investments in higher education. However, these benefits are not equally distributed, and some groups are being systematically made worse off by enrolling in higher education.

Many are concerned that student debt is causing borrowers to delay milestones such as homeownership, marriage, and parenthood. It does seem likely that alleviating borrowers of their debt would allow them to engage in these activities sooner (if they wish), but this does not mean that debt is causing a delay. The more apt question would be whether individuals with student debt are delaying these activities relative to what they would have done had they never gone to college in the first place. That is a much harder question to answer, but given that borrowing and college attendance are, on average, wealth-enhancing activities, how they would also be constraining these behaviors is unclear.

In this vein, many have argued that loan cancellation would provide a valuable stimulus to the economy. In theory, it could encourage borrowers in repayment to redirect their resources elsewhere, perhaps toward purchasing a home, getting married, or having children. It would likely have this affect; however, the magnitude would be small relative to the cost. This is because the benefits would be disproportionately delivered to higher-income borrowers and because the benefit would not be delivered immediately but rather through alleviating payments that were due monthly for decades into the future. There are far more effective forms of stimulus that could be immediately enacted if this were a priority.

Existing Borrower Protection and Relief Programs

The political discourse surrounding student debt would have you believe that unaffordable student loans are inescapable, but that’s pretty far from the truth for borrowers with federal student loans, which make up over 90 percent of the outstanding loan balance in the nation. Over the past decade and a half, policymakers have built a comprehensive safety net that gives

borrowers a break when their loan payments are unaffordable. The Department of Education's income-driven repayment (IDR) plans allow any student borrower to set his or her monthly payment to a percentage of his or her monthly income without penalties. Borrowers whose debt remains unaffordable over 20 years will have their remaining balance forgiven. While it can be difficult to choose from and enroll in IDRs, these plans can bring huge financial benefits for those who qualify.

Ideally, borrowers who find their loan payments unaffordable due to lack of earnings opportunities would take advantage of the existing safety nets—namely, the set of IDR programs including Public Service Loan Forgiveness—but evidence suggests that the safety net created by these programs is falling short.

Income-Driven Repayment Is Too Complex. Despite IDR's appropriateness for the policy challenge at hand, the system hasn't been working well. The reason for this is largely that IDR is administered through a complex variety of programs, each with different eligibility criteria and a range of program parameters. The amount borrowers are expected to pay is calculated differently across programs, as is the number of years before borrowers can qualify to have their balance forgiven. The result is a system that is excessively complex to navigate, with many borrowers unaware of the benefits available to them. As of 2016, only 43 percent of undergraduates with loans reported that they were aware of their eligibility for IDR.[11]

While IDR is now universal for all federal student borrowers, it became that way only after a series of legislative and executive interventions,[12] between 1992 and 2015, stitched together a patchwork of loosely related programs. Factual evidence about how IDR has been used is limited, but anecdotes about the challenges of navigating the system, even by financially savvy consumers, indicate systemic problems. This rickety policy framework desperately needs to be replaced with a single user-friendly IDR plan that can be universally marketed and better understood.

The complexity of these programs is especially problematic for economically disadvantaged borrowers. Borrowers with large balances from graduate and professional degrees, which are most often White students from middle- to high-income families, seem to be navigating the programs successfully, perhaps because they have so much to gain from loan forgiveness. Of the loans disbursed from 2020 to 2029 and repaid through IDR, the Congressional Budget Office estimates that borrowers with debt only from undergraduate studies would have $40.3 billion forgiven, while those who borrowed for graduate school would have $167.1 billion forgiven.[13]

Negative Amortization of Student Loans in IDR Is Problematic. Today's borrowers have access to a tremendous benefit in IDR that was not available to previous generations of borrowers. IDR helps protect borrowers from unaffordable payments in case they experience a negative shock to their income that is transient—a spell of unemployment between otherwise well-paying job opportunities—and in case the employment opportunities available to them aren't enough justify the price they paid for schooling and allow for affordable repayment of debt. Borrowers who are in either circumstance can have their payments reduced to an affordable amount based on their earnings. A side effect of making reduced payments that are less than the amount of accruing interest is that the loan will enter negative amortization, meaning the balance will increase even as borrowers make the prescribed payments.

In theory, this isn't a flaw in the program design. For borrowers temporarily unable to pay their full payments, IDR allows them the flexibility to postpone payment without facing the significant

consequences of delinquency or default. It seems to me that the additional accrued interest is a reasonable price to pay. And for borrowers who find themselves on a path to having their loans forgiven through IDR, the additional interest shouldn't be of any concern at all, since it will ultimately be forgiven (without any tax consequences).

In practice, however, it seems the notion of negative amortization is incredibly disheartening to borrowers. In economics we would say that the growing loan balance imposes a significant psychic cost on borrowers. While some IDR plans allow for interest to be waived during periods of reduced payments, this is not the case for all borrowers.

If all IDR programs were structured to prevent negative amortization (perhaps with an interest waiver), I suspect that borrowers would be more satisfied with the existing protections for unaffordable debt.

Widespread Student Loan Cancellation Is the Wrong Solution. Some might argue that these facts justify a blunt intervention, like mass loan cancellation, which would not require the borrower to jump through hoops to collect the benefit. But that's not the case. The complexity of the current safety net is not due to the income-based eligibility criteria; it is complex because of the manner in which it was created, through a combination of piecemeal, nonconforming policy changes. Borrowers who made their way through college and took out loans to do so are certainly capable of navigating an income-tested student loan relief program if it were designed with the intention of being user-friendly and accessible.

In addition to being an unnecessarily blunt fix to the problem of an inadequate safety net, widespread student loan cancellation would create additional problems. I am especially concerned about the distortion of borrower and institution incentives that would likely exacerbate the problems of ballooning loan balances and rampant tuition inflation.

Students enrolling in college after a student loan jubilee would have good reason to think that any debts they take on in pursuit of a degree would potentially be forgiven in the future. This would encourage students to borrow more than they would have otherwise, by financing a greater share of their costs or attending a more expensive institution. In response, institutions would likely be driven to raise their costs. While colleges and universities don't always act as firms would in economic models, they would likely raise their prices over time in response to the increase in demand and willingness to pay. If mass loan cancellation were implemented, we'd likely find ourselves having this same conversation again, but with larger balances to contend with.

Not only would widespread loan cancellation create moral hazard, but it would also deliver more benefits to well-off borrowers than to needy ones and would thus do little to address the inequality implicit in our economy. A comprehensive loan-forgiveness program would deliver 10 times more benefit to borrowers in the top 10 percent of earners than it would provide to borrowers in the bottom 10 percent of earners.[14]

Reconsidering Discharge in Bankruptcy

Over the past 30 years, a series of policy change have made it more difficult for borrowers to have their student loans, both federal and private, discharged in bankruptcy. The motivation for the special treatment of education debt was that investments in education could not be

transferred. The borrower would always retain the benefits acquired from their education. This exception would make sense if investments in education paid off uniformly with large dividends, but the reality is that some investments in education fall short of that mark, unpredictably offering little or no value to the borrower. In an economy that relies on largely self-financed investments in education as the primary mechanism for social mobility, it is untenable for students to risk their financial well-being without a robust safety net.

In light of the dissatisfaction with the IDR programs as an adequate safety net for borrowers, many have called on Congress to reconsider allowing for student loans to be discharged in bankruptcy. In the past I have argued that this would be unnecessary due to the more nuanced safety net that IDR now provides. However, the existing IDR policy framework has many shortcomings and is falling short of ensuring that student loan repayment is affordable. Reinstating the option to have student loans, both federal and private, discharged in bankruptcy under certain conditions would create an effective patch to the well-intentioned but inadequate IDR system.

The concern with allowing student loans to be discharged in bankruptcy is that some borrowers might use this option strategically, borrowing to pay for school and then entering bankruptcy as a less costly option to repaying their loans. The introduction of this moral hazard is inevitable but can be mitigated through restrictions like those previously in place. For example, requiring a borrower to be in repayment for a number of years before the loan becomes eligible for bankruptcy would reduce the financial reward of bankruptcy while potentially increasing the costs. It would also be reasonable to require that borrowers with larger balances, like those from professional and graduate programs, would be required to pay for a longer period of time before their loans would become eligible for discharge.

One negative consequence of allowing private student loans to be discharged in bankruptcy is that it would likely reduce the amount of credit available to students, with economically disadvantaged students being affected the most. Unlike federal student loans, private loans are underwritten, meaning that a student's ability to borrow depends on his or her creditworthiness. The fact that private loans aren't currently allowed to be discharged in bankruptcy offers a protection for lenders that makes them more willing to take a risk and lend to a less creditworthy borrower. If private loans were to become dischargeable in bankruptcy, lenders would be more careful in extending credit.

The equity implications of this change might seem concerning, but they could actually be beneficial to borrowers. If a lender required a guarantee that you couldn't discharge your debt in bankruptcy to approve your loan, then taking on the loan likely isn't in your best interest. Unfortunately, those who continue to have access to credit may also see higher interest rates. This seems a reasonable price to pay to allow for borrowers who are truly up a creek without a paddle to be able to discharge their loans, if needed, in bankruptcy.

However, there are alternatives to bankruptcy reform for federal loans that might accomplish the same objective of allowing a pathway to loan forgiveness that is less onerous for borrowers. Even if student loans were to be made dischargeable in bankruptcy, these following reforms should also be implemented to create a more complete safety net for students.

Additional Solutions to More Effectively Support Borrowers

The set of IDR programs should be replaced with a single, universal program, and the process of application and income certification should be streamlined to support borrowers.

Policymakers might also consider reforming the parameters that determine benefits to reallocate benefits or alter their generosity. For example, it would be reasonable to require high-balance borrowers (who likely attended graduate or professional school) to make payments on their loans longer than borrowers with small balances before they become eligible for forgiveness. Policymakers could also decrease the amount of disposable income that borrowers are expected to devote to repayment or raise the threshold of income below which borrowers aren't required to make payments. Reasonable people can disagree about the appropriate level of generosity of the student loan safety net, so I'll refrain from providing a specific recommendation today and instead illustrate that there are multiple ways to tweak the repayment system and make it more equitable.

A regime for higher education finance that provides a robust safety net must also require that we not let borrowers continue to take on debts that are predictably unaffordable. Constraining borrowing among graduate students and parents would be a good start. Increasing the role of student employment and financial outcomes in assessing a school's eligibility for participation in the federal student loan program would also go a long way in this effort.

Lastly, eliminating the possibility of negative loan amortization by waiving interest accumulation while a borrower is using IDR programs may go a long way in helping borrowers feel supported and having potential students believe that borrowing to pay for college does not impose on them an intolerable burden of financial risk.

Conclusion

The startling statistics in the student loan program and revelations of inequity might seem like cause for dramatic and immediate action, like student loan cancellation or the creation of a "free" college regime. However, the problems with our system of higher education finance cannot be repaired with such blunt efforts and must be addressed with more nuanced, incremental changes. I commend you for considering bankruptcy reform for student loans, knowing that it doesn't pack the same punch as the flashier proposals I just mentioned, but that it has the potential to substantially improve our system of higher education finance without exorbitant expense.

Thank you for the opportunity to give testimony in this important hearing. I look forward to presenting these comments and evidence to the subcommittee and answering questions.

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