

A Better Way to Borrow

Australia shows how the U.S. could reform its student loan system to be based on income, without burdens or uncertainty placed on colleges or borrowers, write Bruce Chapman and Yael Shavit.

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By now, most prospective college freshmen have already found out which colleges they've been admitted to, and the grueling process of refreshing e-mail accounts and camping out by the mailbox has ended. But for many of these students, the worst anxiety begins now, as the reality of paying for college sets in. The U.S. college loan system has recently undergone important changes, with the goal of easing the burden on graduates, but serious problems remain. Those facing high debts may still find themselves struggling to make payments, and confused about their options.

It is of great interest to note that this predicament was addressed and solved in Australia in 1989 – through income-contingent repayment systems that go beyond anything in the United States. The system has been effectively copied in many other countries. The U.S. system remains fraught with problems even though the solution has been transparent for over 20 years.

To finance the staggering costs of education, students in the United States have increasingly relied on both federal and private loans. The debt burden facing recent graduates during what are often their least financially fruitful years has serious consequences. For those students who make it to graduation, the reality of impending repayment obligations may cause them to choose higher paying jobs instead of lower paying jobs with high social value, such as teaching and social work. Students who find themselves overwhelmed by their debt burden or unable to make payments may default on their loans, harming their credit and fueling the need for government-funded collection costs.

Recently, policies have been enacted in the hopes of alleviating some of the debt burden facing graduates. A 2007 law created a new repayment method for federal loans, Income Based Repayment (IBR), which in theory allows graduates facing economic hardship to tie their loan repayments to their future income and allows borrowers to defer payment during years in which their incomes fall below a certain threshold. IBR caps graduates' repayment obligations at 15 percent of their discretionary income, in theory, and forgives remaining debt after 25 years of consistent repayment. The Reconciliation Act of 2010 made IBR more generous for students taking out federal loans after 2014.

These developments are encouraging, but this new approach does not go far enough to relieve the incapacitating debt burden experienced by many graduates. The convoluted nature of the federal lending system and the limitations of these reforms call into question the extent to which people will

make good use of IBR. As such, it is very likely that the expected improvements in college access and loan default reduction will not be fully realized.

The process of qualifying for IBR requires substantial administrative effort to prove economic hardship. Navigating this process and understanding the multiple repayment options that exist is very complicated, and will prove unworkable for some borrowers. IBR cannot offer the greatest comfort to graduates concerned about sudden changes in post-graduation income, as the period of time in which a borrower can apply for IBR is only 45 days at the beginning of each year. Consider what has to be done by graduate debtors with respect to IBR when events in their lives change. IBR allows for lower payments than a standard repayment plan when the borrower's income is above a certain level. Eligibility is determined by calculations that consider both a measure of the borrower's tax liability, called "Adjusted Gross Income" (AGI), and 150 percent of the poverty line. Both AGI and poverty line calculations can be affected by many different factors, meaning that IBR eligibility calculations can also vary considerably over time.

For example, the AGI changes if a debtor experiences an income change (for example, through promotion, salary cut, or job loss). The poverty line calculation is affected if a debtor gets married or separated, has a spouse whose income changes, or experiences a change in the size of his or her household (eg, from having a child). When each of these (commonplace) changes occurs, graduates must provide their lender(s) with convincing income documentation (payslip, letter from employer, bank statement, etc). Each year, lenders will assess income and family size to adjust the IBR repayment accordingly. A typical person moving, changing jobs, getting married or having children will have to do this each time, and separately for each of their lenders.

Perhaps even more problematic is the fact that although debt remaining after 25 years of loan repayment is meant to be forgiven, the amount of this remaining debt is still treated as taxable income, undermining the goal of assisting those borrowers who face the most difficult economic situations. Additionally, while IBR is a more reasonable repayment method in concept, its implementation may do little to address the expensive inefficiencies associated with the complicated federal lending system. The creation of a more efficient lending system devoid of unnecessary complications and expensive collection agencies could create even more cost savings and free up more funds to help those students with the greatest financial need realize their professional goals.

The data on the incomes of American college graduates suggest strongly that a significant proportion of students with debt will be in a position that requires IBR action. For example, we have calculated that 40-70 percent of those who attend college can expect to have the relevant income and poverty level sometime in the 10 years following graduation. If, as expected, college graduates find the income-based repayment process confusing and daunting, they may remain in a standard repayment plan in which those with relatively poor financial circumstances will find themselves allocating substantial proportions of their incomes to loan repayment. We have calculated, for example, that those ending up in the bottom quarter of young graduate income earners with average student debt of \$20,000 would need to devote around 30 percent of their incomes to service the debt. A significant proportion of

college dropouts with debts of just \$10,000 will have to allocate over 25 percent of their incomes towards this end. For many, this will lead to significant burdens and even default.

This important U.S. problem seems very odd to outsiders. In Australia, for example, student loans do not cause these sorts of collection problems because they are repaid not on the basis of regular set amounts, but instead depend directly and automatically on a graduate's income as recorded by income tax authorities. This is an example of an automatic income contingent loan, a concept which was thought up, independently, by two Nobel winners in economics, Milton Friedman and James Tobin.

Australia led the world by introducing automatic student loan repayment in 1989, paid through the income tax system. The policy was designed to achieve all the protections inherent in the current U.S. moves toward income-based repayment, and to do so without the complicated administrative arrangements or detailed planning that characterize IBR. Student borrowers don't have to clear any hurdles when they experience low incomes.

The Australian system is known as the Higher Education Contribution Scheme (HECS) and it works as follows: when students enroll in college they may elect to pay their tuition later in a way that depends on their future incomes. Eighty-five percent of students take up this option. The debt is recorded with the Australian Internal Revenue Service and is taken from a graduate's income, at a maximum of 8 percent of incomes, but only when incomes exceed about U.S. \$35,000 a year. If the former student is in poor circumstances, for example from being unemployed or in a low-paying job, no payments are required, and no action is needed by the debtor to prove these circumstances. There are no poverty line recalculations, no need to adjust repayments with marriage or separation or the birth of a child; it is all automatic and simple. When Australian college debtors' incomes recover, their repayment amounts increase, yet never to more than 8 percent of incomes.

The very simple facts about the Australian versus the U.S. loan systems are that in Australia there is no default because of low income, people with debts face no repayment hardships and graduates do not have to take high income jobs in order to be able to afford repaying their loans. And all this happens with no action needed by Australian graduates, and with no required expertise or information needed on how to master complex and demanding administrative arrangements.

The success of HECS has encouraged a quiet international revolution in college loans, away from the U.S.-style and toward the Australian. New Zealand adopted a similar plan in 1991, South Africa in 1991, the UK (partially at first in 1997 and now in full swing), Hungary in 2003, and similar efforts are planned for Malaysia, Ireland and other countries in the near future. All the evidence is that these systems have worked well and the government gets back the vast majority (85 percent) of the debt without defaults or repayment hardships from low incomes.

It seems that U.S. college students are being left behind in terms of international reforms of loan arrangements. Automatic loan collection offers distinct advantages over current U.S. approaches, and

given the demonstrated success and fairness of these systems in other countries, the time seems right to debate the issue in earnest in the United States.

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