Note to Readers: This a preliminary draft and, as you'll see, some parts are more fleshed out than others. Some sections consist of single paragraphs outlining future work. I thank you for indulgence in reading it at this early stage, and I look forward to our discussion. -JRB

STUDENT DEBT OR STUDENT TAX?
THE CURIOUS CASE OF STUDENT LOANS

JOHN R. BROOKS[*]

ADAM J. LEVITIN[**]

Student loans have become an issue of major political, economic, legal, and personal importance. Outstanding loans now exceed $1.4 trillion per year, and grow at a rate of $100 billion a year, exceeding credit card debt and auto loans. But student loans differ from the other kinds of debt in profound ways. The federal government make 90% of all loans, and all borrowers can opt in to programs where they can pay only a percentage of their income and have the possibility of future loan forgiveness. These and other features of student loans reveal that student loans have evolved over time to become something much more akin to a tax-funded grant program, merely masquerading as debt. Yet the legacy legal, financial, and institutional structures of debt persist, even though they are wholly inadequate to fit the financial realities and public policy goals of the current student loan program. Student debt exists it its own category, unlike any other form of debt, yet we still attempt to use these traditional structures.

Nearly all of the problems with the current student loan system—including unnecessarily high levels of default, fears of crippling personal tax consequences, and moralistic anti-student rhetoric—derive from this misapplication of traditional legal notions of "debt." The United States could go a long way to solving the problems with the student loan program if it removed the debt label and identified the program by its real character—a tuition grant plus an income surtax on students. This Article explores precisely that.

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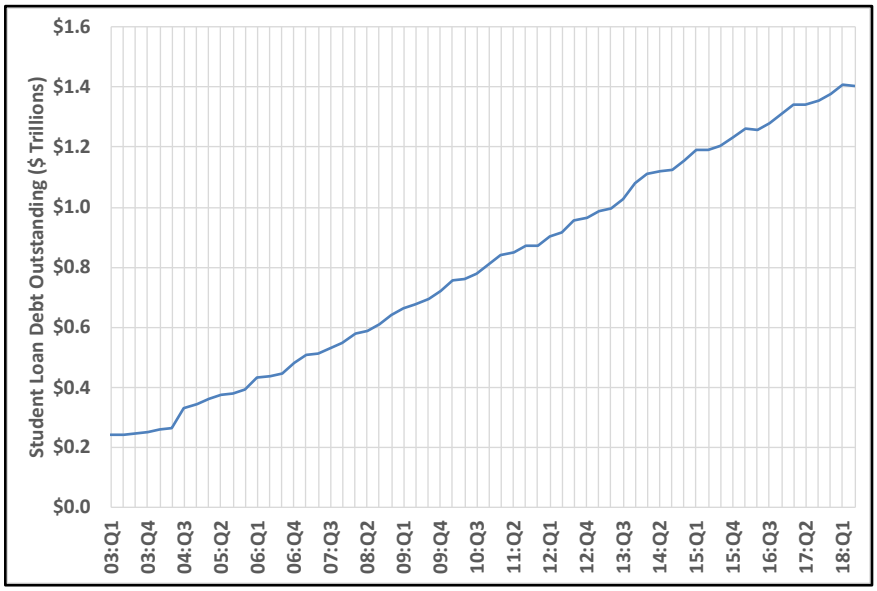
[*] Professor of Law, Georgetown University Law Center.

[**] Agnes N. Williams Research Professor and Professor of Law, Georgetown University Law Center. This Article has benefitted from a presentation at [.].

INTRODUCTION

Americans finance higher education through debt. Education debt has ballooned in recent years to become the largest category of consumer debt other than home mortgages.[1] Americans owe some $1.4 trillion in student loan debt, but this debt burden is heavily concentrated on some 45 million people,[2] roughly 14% of the population,[3] with over half of it owed by consumers under age 40.[4] (See Figure 1.) Almost all of this student loan debt is owed to the federal government, mainly in the form of direct loans, but with a substantial minority owed as part of legacy indirect lending programs.

Figure 1. Outstanding U.S. Student Loan Debt[5]



The rise in student debt burdens is particularly concerning from a policy perspective because it delays and reduces households' ability to save and accumulate wealth, including through home purchases.[6] This

[1] Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit, Aug. 2018.

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[5] Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit, Aug. 2018.

[6] https://onlinelibrary.wiley.com/doi/pdf/10.1111/joca.12143; https://www.urban.org/urban-wire/state-millennial-homeownership; https://www.urban.org/urban-wire/student-debt-hindering-homeownership;

is harmful to those consumers with student loan debt, as homeownership is an important wealth building and financial security tool;[7] homeownership contains a built-in hedge against being priced out of a community by gentrification or inflation.[8]

Moreover, nearly 8.5 million borrowers are in default on their loans, meaning that they have not made regular loan payments for nearly a year. Borrowers in default can face severe financial consequences, as fees and accrued interest cause loan principal to balloon. Bankruptcy is often unavailable for these borrowers, and in some states defaulted borrowers are further punished through suspension of professional licenses and other forms of modern debtors' prison. Some of these borrowers may be permanently financially crippled.

Not as obviously, however, increased levels of student loan debt are also harmful to consumers who do *not* have student loan debt. Put another way, there is a negative externality from increased student loan debt. To the extent that student loan debt delays household formation and home purchases, it puts downward pressure on home prices, which harms existing homeowners by reducing what for many households is the value of their main asset—home equity.[9] Moreover, to the extent that student loan debt impairs consumers' ability to save for retirement, it threatens to impose a greater burden on public resources.

The reasons for the increase in student loan debt are complex and relate both to rises in the cost of education and the cost-insensitive

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https://www.journals.uchicago.edu/doi/10.1086/684587; https://www.urban.org/sites/default/files/brown_caldwell_sutherland_youngstudentborrowers-2_0.pdf;

http://www.appam.org/assets/1/7/Is_Student_Loan_Debt_Discouraging_Home_Buying_Among_Young_Adults.pdf

https://www.urban.org/sites/default/files/effects-of-student-loans-on-long-term-household-financial-stability.pdf

http://www.jchs.harvard.edu/blog/will-student-loan-debt-keep-young-people-from-buying-homes/`

[7] https://www.urban.org/urban-wire/homeownership-still-financially-better-renting; https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.32.1.31

[8] Todd Sinai & Nicholas Souleles, *Owner-Occupied Housing as a Hedge Against Rent Risk*, 120 Q. J. ECON. 763 (2005); Todd Sinai & Nicholas Souleles, *Can Owning a Home Hedge the Risk of Moving?*, 5 AM. ECON. J: ECON. POL'Y 282 (2013).

[9] Jesse Bricker et al., *Changes in U.S. Family Finances from 2013 to 2016: Evidence from the Survey of Consumer Finances*, 103 FED. RESERVE BULL. 1, 18 (2017). A higher percentage of households have home equity than any other type of asset excluding bank accounts and vehicles, and the median value of that home equity ($185,000) is higher than that of any other type of asset. *Id.*

nature of education financing. In this Article, however, we argue that the student loan debt problem is fundamentally a function of treating education finance transactions as *loans*, that is as *debt obligations* that must be repaid. Instead, we argue, education financing transactions should be seen as a combination of transfer payments (i.e., grants) (the funding leg) and taxes (the repayment leg), or which we refer to through the shorthand of *grant and tax*. This description more accurately captures the economic reality of education finance transactions; although education finance is clothed in the language of debt, student loans scarcely resemble any other type of debt product.

In particular, for borrowers using one of the Department of Education's Income-Driven Repayment Programs, the borrower only has the obligation to pay a percentage of her income for a fixed number of years, and often with substantial interest relief as well. These terms are unlike any other debt in the marketplace, and they reflect the substantial public policy reasons behind education finance. They incorporate ideas of progressivity, insurance, and ability to pay that are actually more akin to taxation.

The insistence in treating education financing as debt, rather than as grants and taxes is a symptom of a political culture that is averse to transfers and taxes and prefers framing policies in terms of arm's-length contracting. Yet federal student loans—the majority of the market—hardly resemble any sort of arm's length transaction.[11]

Ironically, despite the political culture's aversion to taxes and transfers, it is precisely the framing of education financing as a matter of contractual debt arrangements that has created the student debt "crisis" because of the different ways consumers and voters are likely to view debt obligations versus tax obligations. Consumers view debt obligations in terms of the amount of principal—the entire amount to be repaid over time. Thus, a consumer with $100,000 of student loan debt feels a heavy stone weighing down her future.

In contrast, tax obligations are viewed in terms of annual flows. The sum of annual tax payments may be equal, to the dollar, to the sum of student loan debt payments, yet because there is no "principal" owed on taxes, the borrower does not feel weighed down by an insurmountably large obligation, nor does the marketplace treat her as having a balance sheet liability. Moreover, the terms on which consumers are able to obtain other forms of consumer credit depend on the borrower's credit report and credit score, not tax liability. If

[11] [Example, postal banking proposals rather than just transfer payments to the poor…]

education finance were a tax liability—a flow—rather than a debt obligation—stock—it would not appear on consumer credit reports as a liability. In such a situation, tax obligations related to education financing would create less of a drag on consumers' ability to borrow for other purchases, such as mortgages.

In addition the typical institutional structure of debt—including notions like interest, loan servicing, default, rehabilitation, and more—is poorly designed to manage a program that is fundamentally about progressive financing of higher education. Indeed, most if not all of the problems borrowers face with student loans are a result of these features, rather than the affordability of the loan payments themselves. Ironically, if the loan program instead adopted the institutional features of taxation, students' well-being—and the financial stability of the loan program itself—would be substantially improved.

This Article makes several contributions. First, we present a concise history of student loans that holds out important lessons about the nature of education financing and why it is presented as a matter of debt, rather than tax and transfer. We show that the United States' reliance on student loans as a main financing instrument was a historically contingent choice made for political expedience, but that once that choice was made, the loan system became a vehicle for the delivery of benefits to students. These gradual changes over time ended up fundamentally transforming student loans.

Second, we show the full extent of the differences between student loans and typical debt. The literature thus far has yet to fully absorb how the Income-Driven Repayment programs substantially alter the very nature of the financing instrument, and public rhetoric is even farther behind. Scholarship, policy, and advocacy needs to understand better the nature of this transformation, and we hope this Article helps that conversation.

Third, we present a novel policy proposal that keeps the core features of the current program while shedding the label, and institutional structures, of "debt." We show how the program could be reconstituted as a combination of a tuition grant and a dedicated income surtax on grant recipients. We offer the proposal as a real alternative, but also to illustrate that we do not need to saddle ourselves with the legal and institutional structures of debt. Student loans now stand alone as a financial instrument unlike anything else, and it is time that law and policy adjust to that reality.

The Article proceeds as follows. Part I presents a brief history of student loans. Part II turns to the unusual nature of student loan debt

and how it does not resemble other types of debt obligations. Part III addresses the problems that arise from treating education finance as a matter of debt rather than tax and transfer. Part IV presents our vision of how education finance could be reframed and why it would be helpful in ameliorating the adverse consequences of the rising costs of financing education. Part V addresses complications and objections. A conclusion concludes.

I. A BRIEF HISTORY OF STUDENT LOANS

Higher education finance is a huge and rich topic with a long history—well more than we can cover here. At a first approximation, it has always been paid for with a mix of public, charitable, and individual funds, but the particular mix and choice of instruments has varied greatly over the years. Here, we focus specifically on student loans as one of those financing instruments, and in particular on how student loans have evolved over time.

In the review that follows, we show several important points. First, we note that the United States came to rely on student loans for particular political and historical reasons. While the U.S. was willing to make direct grants to veterans and, to a lesser extent, for national security purposes, the budget politics of general education aid was more challenging, forcing Congress to rely on less generous and more hidden guaranteed loans.

Second, once the loan programs were in place, they became attractive vehicles for delivering benefits to students. As tuition costs kept rising, and thus needs of students kept growing, Congress made incremental changes to student loans to try to lower financial barriers to higher education. Other changes to the program were because student loans themselves suffered from market failures that necessitated an active government role to maintain the system. Fifty years of tinkering and expansion of the program led to the enormous levels of student debt we see today.

Third, that incremental evolution of student loans caused them to transform over time in an ad hoc way from being largely private, traditional debt instruments, to being essentially a federal transfer program that incorporates notions of progressivity, insurance, and ability to pay, while also shedding many of the traditional features of debt. It is that transformation that argues for the new approach we put forward below.

A. Early Years of Federal Higher Education Finance

Although national government involvement and financial support for higher education pre-dates the Constitution,[12] federal involvement in higher education is generally treated as beginning with the Morrill Land Grant Acts of 1862 and 1890. These Acts provided federal land for the establishment of new public universities, administered by the state governments. But even with that generous subsidy, higher education was still largely paid for out of individual and charitable (including church) funds, and partly as a result higher education served only a small percentage of the population. In 1910, only 9 percent of Americans aged 18-24 attended college; by 1940, the percentage had barely risen, to 13%.[13] In 1940, student tuition and fees were about one-third of total revenue for higher education institutions (60% for private schools and 19% for public).[14] In 1947 the President's Commission on Higher Education (the "Truman Commission") pinpointed high student fees as one of the major barriers to higher education and focused much of its attention on ways to bring the fees down—just as we still are today.

In the pre- and immediate post-war years charitable contributions (especially for the private schools) provided some aid to families who could not afford college fees, but there were relatively few options beyond that. Some institutions offered loans to their students to make up the difference, but they do not appear to be heavily used.[15] The Truman Commission reported that in 1946-47, $23.6 million of loan funds were available, but only $3.7 million was actually borrowed.[16] Private lenders and philanthropists also tried to get some loan programs off the ground, but with only limited success.[17] Ten years

[12] The College of William and Mary, a public institution, was founded by Royal Charter in 1693. *See* CLAUDIA GOLDIN & LAWRENCE F. KATZ, THE RACE BETWEEN EDUCATION AND TECHNOLOGY 255 (2008). The Northwest Ordinance of 1787 contained an early version of federal land grants to establish state colleges. *See* WILLIAM ZUMETA, DAVID W. BRENEMAN, PATRICK M. CALLAN & JONI E. FINNEY, FINANCING AMERICAN HIGHER EDUCATION IN THE ERA OF GLOBALIZATION 60 (2012)

[13] THE PRESIDENT'S COMMISSION ON HIGHER EDUCATION, 2 HIGHER EDUCATION FOR AMERICAN DEMOCRACY 4 (1947) [hereinafter, TRUMAN COMMISSION REPORT].

[14] 6 TRUMAN COMMISSION REPORT, *supra*, at 33.

[15] BETH AKERS & MATTHEW M. CHINGOS, GAME OF LOANS 45 (2016).

[16] 2 TRUMAN COMMISSION REPORT, *supra* note 13, at 46.

[17] AKERS & CHINGOS, *supra* note 15, at 45-46.

later, on the eve of the passage of the National Defense Education Act in 1957, roughly 83,000 students borrowed a total of $13.5 million.[18]

The lack of privately provided educational financing relative to demand was an indication of the well-known market failure in student lending. Part of the reason private financing was not readily available for education was that it is generally done through unsecured loans—borrowers tend to be young and with few pledgable assets. Prior to the advent of credit cards, unsecured private consumer lending was extremely limited; even today it remains so because of the difficulty in collecting unsecured debt. Yet these young borrowers also have no certain future income; indeed for the first few years of the debt, borrowers are proposing being students without income. Moreover, young borrowers have little if any credit history. All this meant that lenders have little basis for gauging a borrower's future ability to repay. Rather than try to price this uncertainty, traditional lenders simply did not lend prior to the government's intervention, and the market relied instead on lenders with philanthropic motives. This market failure underlay, and still underlies, the federal government's involvement in higher education financing.

The experience of the two World Wars underscored to the government the importance of higher education—particularly languages and applied sciences—to national defense,[19] a commitment reinforced by the Cold War. Policymakers also understood the role of higher education in addressing issues of income, race, and gender inequality,[20] and the need to plan for the explosion of college attendance for the oncoming baby boom generation. This led to a series of important interventions by the federal government into higher education, each of which had important implications for the creation and growth of the student loan program.

The first of these, the Servicemen's Readjustment Act of 1944 (the "GI Bill"),[21] did not have any significant loan provisions. Instead, it provided direct grants for returning servicemembers to cover student tuition and fees (among other benefits). But the bill and its justifications set the stage for the expansions to come. Early interventions like the GI Bill and (as we'll see) the National Defense

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[18] Pamela Ebert Flatteu, et al., Institute for Defense Analysis, *The National Defense Education Act of 1958: Selected Outcomes*, at II-7.

[19] HUGH DAVIS GRAHAM, THE UNCERTAIN TRIUMPH: FEDERAL EDUCATION POLICY IN THE KENNEDY AND JOHNSON YEARS xviii (noting "the discovery during the two world wars of widespread illiteracy among the conscripts").

[20] *Id.*; 2 TRUMAN COMMISSION REPORT, *supra* note 13, at 3.

[21] Pub. L. No. 78-346, 58 Stat. 284.

Education Act of 1958 were rooted in particular constituencies (e.g., veterans) or particular policy goals (e.g., national defense). In contrast, much of the work in subsequent decades was focused on expanding federal support for higher education to all citizens with the broader and more amorphous goal of general social welfare. But because this broader goal entailed potentially more money going to groups less politically favored than veterans and for policy reasons less specific than national security, large grants were pushed aside in favor of less generous and more budgetarily opaque guaranteed loan programs.

B. The First Federal Loans: The National Defense Education Act of 1958

Fourteen years after the GI Bill, Congress enacted the National Defense Education Act of 1958 ("NDEA"). As its title suggests, the justification for the bill was a need to invest in higher education, especially science, due to the perceived threat of the Soviet Union, which had launched the first satellite, Sputnik I, 1957, setting off the Space Race. Unlike the GI Bill, however, the NDEA's benefits were available to anyone (including women), not just veterans. It stated that "no student of ability will be denied an opportunity for higher education because of financial need."[22]

The NDEA introduced the first major federal student loan program, the National Defense Student Loan (NDSL) Program, the predecessor to the Perkins Loan program that was phased out in 2017.[23] The bill, as originally proposed in the House, included a direct grant program, perhaps modeled after the GI Bill.[24] It proposed to give an average grant of $750 per year to 23,000 students selected by state scholarship commissions on the basis of "objective criteria," but not requiring any particular type of student or course of study.[25] At this point the U.S. was spending $587 million a year on veteran's education and training through the GI Bill,[26] but for non-veterans, this $17.5

[22] National Defense Education Act of 1958, Pub. L. No. 85-864, 72 Stat. 1580, 1581.

[23] The NDSL Program was renamed the National Direct Student Loan Program in 1972, and the 1986 HEA reauthorization renamed it Perkins.

[24] *See* H. Rep. No. 85-2157, at 6 (1958). The grants would have been a base amount of $500 plus an additional amount up to $500 based on need. *Id.* That grant structure is similar to the G.I. Bill education grants. *See* G.I. Bill § 400(b).

[25] H. Rep. No. 85-2157, at 6.

[26] The Budget of the United States Government, Fiscal Year 1956, H.R. Doc. No. 84-16, at M47.

million per year was determined to be too generous.[27] The scholarship provisions were eliminated, and the loan appropriation expanded in the final bill; the special favor given to veterans was not extended even to needy non-veteran students.

Rather than being structured as direct loans to consumers, the NDSL Program operated as a loan to higher education institutions, which in turn loaned the money out to students.[28] Formally, the creditors on NDSL loans were the schools, not the federal government. But the NDEA governed the terms of the institutional loans to students.

The NDEA stated that loans could not exceed $1,000 per year and $5,000 total per student, were to be given to students on the basis of need, and at interest rates not to exceed 3% per year.[29] The federal money was divvied out by state and then by institution, with no institution receiving more than $250,000 each fiscal year (later increased to $800,000 in 1964). Schools were also supposed to provide 10% of the loan funds themselves, with the hope that the schools would build capacity for more direct support of students.[30]

Setting the stage for later developments, the NDEA also provided for a loan forgiveness program for teachers, cancelling 10% of the loan balance for each year of service, up to a maximum of 50% of the loan balance.[31] Some states had already instituted similar programs, especially for medical students that agreed to practice in under-served (typically rural) areas.[32] Loan forgiveness raises tax issues, since in general cancellation of debt creates taxable income for the debtor.[33] As we will see, the tax question is particularly acute for modern income-driven repayment programs. At the time, the issue was resolved by treating the forgiven loans as "scholarships" excluded from gross

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[27] *See, e.g.,* 104 Cong. Rec. 19612 (1958); H. Rep. No. 85-2688 (1958) (Conf. Rep.).

[28] NDEA §§ 201, 203 (on repayment).

[29] NDEA § 205(b). The law also provided that interest would not accrue before repayment began.

[30] *See* NDEA § 201 (stating that the purpose of the loans was to "stimulate and assist in the establishment at institutions of higher education of funds for the making of low-interest loans to students in need"); Flatteu et al., *supra* note 18, at II-4-5. Half of the institutions participating in NDSL in 1962 had never offered loans prior to NDEA. *Id.* at II-7.

[31] NDEA § 205(b)(3).

[32] *See, e.g.,* I.R.S. Priv. Ltr. Rul. 5604265200A (April 26, 1956).

[33] IRC § 61(a)(12).

income under Section 117 of the Internal Revenue Code,[34] though the IRS would reverse this position in 1973.[35]

Although needy students relied heavily on the loans, there is some evidence that the loans were still short of what was needed to substantially reduce financial barriers to higher education. In 1963-64, right before the passage of the Higher Education Act, average tuition, fees, room, and board at all four-year institutions was $1,286, and at public four-year institutions it was $929.[36] The maximum $1,000 loan would have been nearly sufficient, except that because the total and per-school appropriations were capped, the funds ended up getting spread more widely, with average loans of between $400 and $500 per student.[37] By 1964, Congress and the Department of Housing, Education, and Welfare found that NDSL was falling short of meeting student need.[38]

Moreover, many students simply did not qualify for NDSL, whether because of higher family income, grades below required minimums, or studies outside of the supported fields.[39] Some of these students and their families turned to loans from banks and other private lenders, which varied greatly in their terms depending on perceptions of risk. By 1964, at a time when the risk-free rate was at 3.5%,[40] the interest rates on private student loans were often in the range of 11 to 14%, and sometimes as high as 26%, reflecting in part the inability for private lenders to secure themselves by attaching

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[34] *See* I.R.S. Priv. Ltr. Ruls. 5604265200A (medical school loans), 6004275330A (teaching loans); Richard C.E. Beck, *Loan Repayment Assistance Programs for Public-Interest Loans: Why Does Everyone Think They Are Taxable?*, 50 N.Y.L. SCH. L. REV. 251, 261-63 (1996); John R. Brooks, *Treasury Should Exclude Income from Discharge of Student Loans,* 152 TAX NOTES 751, 754 (Aug. 1, 2016).

[35] Rev. Rul 73-256, 1973-1 C.B. 56. *See infra* Section III.E.

[36] U.S. Dep't of Educ., Nat'l Ctr. for Educ. Statistics, Digest of Education Statistics, Table 330.10 (Average undergraduate tuition and fees and room and board rates charged for full-time students in degree-granting postsecondary institutions, by level and control of institution: Selected years, 1963-64 through 2016-17), https://nces.ed.gov/programs/digest/d17/tables/dt17_330.10.asp.

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[38] Flatteu et al., *supra* note 18, at II-6 & II-4; Jonathan D. Glater, *The Other Big Test: Why Congress Should Allow College Students to Borrow More Through Federal Aid Programs*, 14 N.Y.U. J. LEGIS & PUB. POL'Y 11, 36 (2011).

[39] SUSAN METTLER, DEGREES OF INEQUALITY: HOW THE POLITICS OF HIGHER EDUCATION SABOTAGED THE AMERICAN DREAM 61 (2014) [hereinafter, DEGREES OF INEQUALITY].

[40] FRED.

collateral.[41] By 1962, even Milton Friedman was pointing out the market failure around private student lending and the need for more government intervention.[42]

C. Guaranteed Loans: The Higher Education Act of 1965

By the time of the Kennedy and Johnson administrations, the focus and goals of national higher education policy had shifted somewhat. While the Cold War was of course still a concern, there was also a renewed focus on domestic concerns, particularly social welfare and economic concerns as embodied in the Great Society programs. Moreover, the baby boom generation was entering college, driving a boom of growth in higher education, but also putting strain on the NDSL program to meet the country's needs. Just like today, college costs were rising rapidly, and many families who did not qualify for NDSL could still not afford to pay out of pocket.

The Higher Education Act of 1965 (HEA) included many provisions to expand the federal role in higher education, but in particular for our purposes it also created the Guaranteed Student Loan (GSL) Program, the predecessor of the Stafford Loan Program.[43] The GSL Program was modeled off some more limited state "loan insurance" programs[44] and, unlike the NDSL program, it was designed to stimulate lending from private lenders rather than educational institutions. Also in contrast to the NDSL, it did not technically require the federal government to put up any capital, since the government would instead just be guaranteeing private loans. The government also subsidized interest on the loans by paying the interest during the years the borrower was still enrolled in college.

The GSL Program greatly increased the amount of debt available, authorizing as much as $700 million in its first year and $1.4 billion by 1968 (contrast with ___ under NDSL). There was also no income cap

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[41] *President's Consumer Panel Studies High Interest Rates on Student Loans*, WASH. POST (Feb. 29, 1964) at A3; *cf.* Glater, *supra* note 38. at 36.

[42] MILTON FRIEDMAN, CAPITALISM AND FREEDOM 104 (1962) ("Whatever the reason, an imperfection of the market has led to underinvestment in human capital. Government intervention might therefore be rationalized on grounds both of 'technical monopoly,' insofar as the obstacle to the development of such investment has been administrative costs, and of improving the operation of the market, insofar as it has been simply market frictions and rigidities.").

[43] The program was renamed in 1987. AKERS & CHINGOS, *supra* note 15, at 47; *see also* SUSAN METTLER, THE SUBMERGED STATE: HOW INVISIBLE GOVERNMENT POLICIES UNDERMINE AMERICAN DEMOCRACY 10 (2010) [hereinafter, SUBMERGED STATE].

[44] *See* Glater, *supra* note 38, at 37-38.

under the GSL Program to determine eligibility for the loans. But because subsidized interest was available only to families with income under $15,000 (or roughly $120,000 in 2018 dollars), lenders would only lend to families below that income threshold. The Higher Education Act also included a direct grant to the neediest students, but the funds involved were a fraction of the dollars devoted to loans.

It is likely that the particular choice to use loan guarantees—as opposed to direct loans or even direct grants—was more about politics, optics, and budget effects than a fundamental belief in the policy instrument itself. First, the precedent of the NDSL program (and also the state insurance schemes) created a model to follow. This was still a very new era in federal financing for higher education and the NDEA was essentially the first major federal intervention in general aid to higher education since the Morrill Land Grant Acts (the GI Bill being limited to veterans). Given this background, policymakers may have understandably wanted to step carefully and incrementally, relying on models (like the NDSL) already being used.

Likewise, earlier federal forays into consumer financial markets had generally relied on the provision of indirect support through loan guaranties and secondary market activities. Thus, in housing finance markets, the federal government guaranteed or insured mortgage loans through the Veterans' Administration and the Federal Housing Administration, and provided a secondary market in mortgages through the Federal National Mortgage Association (Fannie Mae), then a wholly-owned government corporation.[45] Indirect support of markets was already well-established as the federal government's *modus operandi*.

Second, although a loan guarantee appears to have a lighter fiscal footprint than a direct loan, that is a fiction. All of the credit risk is still on the federal government, making it the financial equivalent of a creditor. The only difference is the source of the original capital, and since the federal government has essentially unfettered access to cheap capital, private lenders were not doing any favors by lending it directly themselves. This choice to use an instrument that is financially equivalent to direct loans, but more expensive and complicated, suggests that policymakers went out of their way to create a more opaque and off-budget structure.

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[45] *See* Adam J. Levitin & Susan M. Wachter, *The Public Option in Housing Finance*, U.C. DAVIS L. REV. (2013).

Third, and pointing to budget concerns, there was a push during the NEA debates by some Republicans to offer benefits in the form of tax credits instead of loans or loan guarantees.[46] But President Johnson and the Democratic leadership refused, in part because of the effects credits would have had on tax revenue.[47] Loans instead provided a way to get substantial amounts of money in the hands of students without directly affecting the national budget.

The GSL Program was thus a product of compromise and the particular politics of the Higher Education Act, and the post-war period in general. It provided a way to meet the goals of the 1947 Truman Commission—expanded access to higher education for economic, national security, and equity reasons—while navigating the challenging politics of trying to provide broadly available, general aid for higher education, as opposed to aid for particular favored constituencies or for particular favored purposes. And in the background was the beginnings of the conservative anti-tax response to the Great Society. As with much of the growth of the American welfare state, the GSL Program relied on a relatively opaque, quasi-public arrangement to partially mask the extent of government involvement.[48]

D. Solidifying the Federal Role: 1970s-1980s

Student loans become a major element of higher education finance for particular and historically-contingent reasons, but once created they became an important vehicle for delivery of support and benefits. Although new funding programs—most notably the Pell Grant—were created along the way, policymakers also continued to tinker with the student loan program as a way to deliver benefits. Over the next few decades, the student loan program had several important changes, which we briefly summarize here.

The 1972 Amendments to the HEA were a major piece of legislation that, among other things, created the aforementioned Pell Grants, but its only major effect on the student loan program was the creation of the Student Loan Marketing Association, better known as Sallie Mae, a government-owned corporation that purchased student loans that it financed with the sale of bonds. Sallie Mae was intended to bring in more capital to the student loan market in order to bring down interest rates and lower the government's costs.

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[46] *See* METTLER, DEGREES OF INEQUALITY, *supra* note 39, at 61.
[47] *Id.* Add cites.
[48] Hacker etc.

The 1976 reauthorization of the HEA continued the push to get more private capital into the student loan market by providing federal incentives to states to set up their own loan guarantee agencies. It also increased the income threshold for subsidized loans from $15,000 to $25,000 (which, because of inflation, was really just a reset to the same real income level it had been in 1965). These 1972 and 1976 changes showed that policymakers were still facing some degree of market failure in private student loan lending. Increases in federal support, subsidies, and guarantees were designed to address the market failure and ensure financing to meet student needs.

A bigger change came in 1978, and not through a reauthorization of the HEA. By this time, inflation and economic stagnation were taking a toll on middle-income families trying to afford still-rising college tuitions. A partial solution from Congress was to remove the income cap on subsidized loans. Congress had found that, as a practical matter, lenders were often not willing to lend to students through the GSL Program unless the interest was covered by the government while the student was in school and during the nine-month post-graduation grace period.[49] As a result, many students found themselves shut out of the GSL Program, or paying higher costs if they were not. The Middle Income Student Assistance Act of 1978, expanded eligibility for interest subsidies to all borrowers regardless of family income.[50] The change greatly expanding the pool of students that could rely on guaranteed loans, and guaranteed student loan volume about doubled as a result.[51]

The no-cap era was brief, however. In 1981, under the Reagan administration, Congress re-introduced a family income cap of $30,000 to be eligible for subsidized guaranteed loans.[52] But while loan volume dipped a bit as a result, it largely maintained its higher post-1978 levels until the more dramatic changes to the student loan program in 1992.[53]

This period also saw developments in the tax treatment of forgiven debt. In 1973, the IRS revoked its earlier position and ruled that loan forgiveness through programs that required a particular type or field of work were not "scholarships," because they had a quid-pro-quo

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[49] H.R. Rep. 95-561.

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[51] *See* AKERS & CHINGOS, *supra* note 15, at 43, ZUMETA ET AL., *supra* note 12, at 79.

[52] Omnibus Budget Reconciliation Act of 1981, § 532(a), Pub. L. No. 97-34, 95 Stat. 357.

[53] *See* Akers & Chingos, *supra* note 15, at 43, fig. 3.2.

element more akin to employment.[54] As a result, the debt cancellation could have led to a tax bill. Congress responded with some temporary exclusions before finally adding Section 108(f) to the Internal Revenue Code, which states that amounts forgiven through a program requiring that the borrower work "for a certain period of time in certain professions for any of a broad class of employers" are not gross income for tax purposes.[55]

An interesting historical quirk in this period was the development of Yale University's Tuition Postponement Option (TPO), perhaps the first major experiment with making payments for tuition contingent on future income. Offered from 1971 to 1978, the TPO program allowed Yale undergraduates to borrow the amount of their tuition and to pay it back at the rate of 0.4% of their income for each $1,000 borrowed (*e.g.*, a student who borrowed $5,000 would pay 2% of their income annually). Borrowers would continue to make payments until the entire class cohort had paid off its debt or 35 years, whichever came first. (Individual borrower payments were also capped at 150% of the original amount borrowed). The program was designed in part of Nobel Prize-winning economist (and Yale faculty member) James Tobin, who explicitly modeled the plan after group insurance models.

For the most part, TPO was a failure. A major reason was the expansion of the GSL program during the 1970s; federal subsidized loans were a good enough deal that TPO did not get the broad uptake that it needed to function well as a group insurance scheme. Moral hazard and adverse selection problems existed as well. The program stopped being offered in 1978, and when the program was finally canceled in 1999 (forgiving all remaining debts) no class had fully paid off its debt. That said, the notion of incorporating income insurance into the loan program is compelling. Tobin himself advocated for a national version of the program when he was on the Council of Economic Advisors.[56]

Finally, in 1978, the first limitations on discharge of student debts in bankruptcy were added to the Bankruptcy Code. Instead of allowing discharge on the same terms as other consumer debt, the new rules required that the borrower had to have had five years of repayment first, or show "undue hardship.

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[54] Rev. Rul. 73-256, 1971-1 C.B. 56.
[55] I.R.C. § 108(f).
[56] Curran.

E. Watershed Changes: 1992 & 1993

The student loan program faced probably its biggest change since the establishment of the GSL Program during the 1992 reauthorization of the HEA and the following year's Student Loan Reform Act. These bills made several important changes. First, the 1992 bill created a new category of unsubsidized Stafford Loan (which the GSL Loan Program had been renamed in 1987). Subsidized Stafford Loans retained income eligibility requirements, but the new Unsubsidized Stafford Loans had no income limits.

Second, the 1992 Amendments removed the borrowing cap on PLUS (Parent Loans for Undergraduate Students) Loans, a loan type created back in 1980. Prior to 1992, parents could only borrow up to $4,000 per year, but after 1992, parents could borrow up to the full "cost of attendance" of a college or university. The cost of attendance is a defined term, but the amount is set by each school and includes living expenses in addition to tuition, fees, room, and board. While the measure is not perfect,[57] this change did mean that for the first time a student could be assured of having sufficient funds to cover all of the costs of education. The bill also increased the loan limits on Stafford Loans.[58]

Third, the 1992 Amendments also created a pilot Direct Loan Program (while also consolidating the Stafford and PLUS loans under the renamed Federal Family Education Loan (FFEL) Program)), and the 1993 bill greatly expanded Direct Loans. In contrast to FFEL loans, Direct Loans were directly from the government and held on its balance sheet. As noted above, whether the government is making the loan or merely subsidizing and guaranteeing it is immaterial from a financial standpoint. But Direct Loans would be considerably cheaper, because the federal government would not need to subsidize banks' high rates. The 1993 bill aimed to have 60% of all lending come from Direct Loans within the next five years.

Fourth, the 1993 bill created the Income-Contingent Repayment (ICR) program, which allowed borrowers to, instead of paying a fixed, standardized loan service payment, pay based on a measurement of income, and even receive debt forgiveness after a period of time. As it was designed, ICR had very little uptake, but it set an important stage

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[57] *See* SARA GOLDRICK-RAB, PAYING THE PRICE: COLLEGE COSTS, FINANCIAL AID, AND THE BETRAYAL OF THE AMERICAN DREAM 42-45 (2016) (discussing how some components of cost of attendance are undervalued).

[58] Limits were also raised in 1986.

in terms of both policy design and regulatory process for the post-2010 changes that will be discussed below.

In sum, the 1992 and 1993 legislation were a major step forward for the government's direct role in higher education finance, and a major shift in the loan terms themselves. Loans could now, in one way or another, fully finance higher education for any student, regardless of income. The loans themselves were increasingly made directly by the federal government, rather than private lenders. And, with ICR, the stage was set the massive change in repayment terms that would follow the 2010s-era changes.

Not surprisingly, loan volume exploded after 1993, again nearly doubling over the next few years, and beginning the steep upward climb that we still see today.

F. The Old System Breaking Down: 1990s and 2000s

Recall where federal student loans began: with the NDSL Program providing funds for colleges themselves to make relatively small, low-interest loans. By the late 1990s, however, student loans had become big business for private lenders, with government-guaranteed profits and, as Susan Mettler especially has documented, major lobbying activities.[59] Banks and other private lenders also started aggressively marketing to colleges themselves.[60]

Moreover, as tuitions continued to increase, private lenders began offering nonfederal, truly private loans, that is, loans outside the FFEL Program, to fill the gap between college costs and existing aid and loan packages. These nonfederal loans had none of the protections, guarantees, and subsidies of the FFEL loans, and so became a particular source of risk (to students) and profit (to banks).[61] Nonfederal loans went from being almost 0% of loan volume in 1994[62] to 25% by 2007-08.[63] The late 1990s and early 2000s saw a number of loan-related scandals and investigations, likely souring the taste of many lawmakers for continuing to subsidize private lenders.[64]

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[59] Mettler, Submerged State, *supra* note 43, at 34-35. 71-79.

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[61] Note that some private loans may even have been designed to fail under the 90/10 rule.

[62] AKERS & CHINGOS, *supra* note 15, at at 43.

[63] Trends in Student Aid 2017, fig. 4.

[64] Glater. Cuomo investigation.

The pain for many borrowers during this period was exacerbated by the further toughening of the rules for discharge of student loans in bankruptcy. Prior to 1976 all student loan debt was dischargeable in bankruptcy. In 1976 Congress amended the HEA to prohibit a discharge unless the borrower had made at least five years of repayments or the loan imposed an "undue hardship" on the borrower.[65] In 1990 the five-year repayment period was extended to seven years, and in 1998, the rule was changed to make discharge available only in cases of undue hardship—student loans were no longer dischargeable under normal circumstances.[66] In some ways, this set the stage for the income-driven repayment programs. For most debts, bankruptcy is the backstop insurance program to address severe financial distress.[67] But with that safety value largely gone after 1998, the need for another form of insurance became more pressing.

Another important development in this period was the extension of PLUS loans to graduate students in 2005 (thus creating a split between Parent PLUS loans taken out by a student's parents, and Grad PLUS loans, taken out by the graduate or professional student herself). Because PLUS loans had essentially no borrowing cap after 1992, this meant that a graduate student could directly borrow up to the full cost of attendance for very expensive graduate programs, including law and medical school. As we will see, this also had major implications for the later Income-Driven Repayment (IDR) programs, and thus the overall progression of student loans toward becoming essentially a progressive government transfer program.

The financial crisis of 2008 caused credit to dry up across the whole economy, and that was no less true in the student debt market, even with its government subsidies and guarantees. With the Ensuring Continued Access to Student Loans Act (ECASLA) of 2008, Congress authorized the Department of Education to buy up outstanding FFEL debt held on private lenders' balance sheets as a way to infuse cash into those lenders (much as the Federal Reserve and other agencies did for other asset classes).[68]

Later in 2008, Congress also created Public Service Loan Forgiveness ("PSLF") and the first iteration of Income-Based Repayment ("Old IBR"), both major steps in the move toward more

[65] 20 U.S.C. § 1087-3 (1976); 11 U.S.C. § 523(a)(8) (1978).

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redistribution and insurance through the federal government.[69] PSLF provided that borrowers working in public sector jobs could have the balance of their loan forgiven after 10 years of regular payments.[70] Old IBR—which was available to everyone, not just those working in public service—allowed borrowers to cap their monthly payments at 15% of discretionary income, with loan forgiveness after 25 years of regular payments.[71] Importantly, the still relatively new Grad PLUS loans were made eligible for IBR, but the original Parent PLUS loans were not.[72]

G. A New Era: 2009 to Present

When President Obama and a Democratic Congress entered office in 2009, the stage was set for some major changes. The FFEL system of subsidizing private lenders had proven itself to be expensive and a source of corruption, the credit crisis had proven that ultimately the federal government was bearing the credit risk anyway, and the Direct Loan program started in 1992-93 had proven itself to be an effective alternative. Moreover, after a slow start with ICR in the 1990s, the more generous Income-Based Repayment and PSLF programs pointed the way to further reforms to make student loans a vehicle for more generous and progressive support for students.

The Student Aid and Fiscal Responsibility Act (SAFRA) finally got rid of the FFEL program, ending subsidized private student lending altogether.[73] The Direct Loan program would be the only source of federal student loans going forward. This alone was a massive change, ending the fiction of private student lending and making clear that the federal government was the real source of funds.[74] Student loans immediately become the biggest single government loan program, dwarfing the next largest category, loans from the Department of Agriculture, by a factor of almost ten.

SAFRA also made IBR more generous ("New IBR"), allowing those who would be "new borrowers" after July 1, 2014, to pay 10% of their discretionary income (rather than 15%) and receive forgiveness

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73 SAFRA was formally an amendment to the Health Care and Education Reconciliation Act of 201, the bill that completed the passage of the Affordable Care Act. Savings mostly going to expanded Pell Grants, but also a little bit used as a payfor for the ACA.

74 Mettler.

after 20 years (rather than 25).[75] IBR had some problems, however. Old IBR was not particularly generous, and New IBR would take a while to come into effect. And both Old and New IBR had little relief for interest accrual. This meant that for borrowers who were not making payments sufficient to cover any interest currently due, the interest that accrued would be capitalized into the principal balance of the loan and be fully payable whenever a borrower's income became high enough that IBR was no longer necessary.

The Obama Administration almost immediately turned to regulation to fix these problems and in 2012 created the Pay As You Earn (PAYE) program. PAYE took the New IBR payment terms—10% of discretionary income, forgiveness after 20 years—and extended it earlier, to loans taken out after October 1, 2011.[76] Less obviously, but perhaps more important financially, PAYE capped the amount of unpaid interest that could be capitalized into the loan balance, thus slowing the growth of a borrower's balance.[77]

Both of these regulatory moves were clearly not authorized by the IBR statute, so the administration actually relied on the Income-*Contingent* Repayment portions of the HEA, which gave more leeway to the Department of Education to set the repayment terms.[78] So, while ICR itself was never heavily used, it became the basis for much of the growth in income-contingent loans after 2012.

Finally, in 2015, the Obama Administration created yet another program, Revised Pay As You Earn (REPAYE), which added some important new terms. It was open to all borrowers, not just post-2011 borrowers, it had even more generous (though complicated) rules on interest accrual and capitalization, and it had somewhat less generous terms for graduate borrowers. But most significantly for our story of the progress of student loans, it removed any monthly cap on the income-contingent payments.[79] In all the other plans—ICR, IBR, PAYE—a borrower reverts to paying a flat, standard loan service payment once her income gets high enough. For REPAYE, however, the borrower continues to pay 10% of her discretionary income no matter how high her income is.[80]

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The unlimited 10% amount was intended as a way to make the program less generous to borrowers who eventually have high incomes. In financial terms, however, it actually has the opposite effect. Instead of making a high-income borrower pay *more*, it just makes the borrower pay *faster*. And since the loans still carry a fairly high interest rate, paying it off faster is beneficial in the long term.

II. STUDENT DEBT IS NOT LIKE OTHER DEBT

In the previous Part, we laid out how the government's involvement in higher education finance was a response to a market failure—the failure of the private market to provide adequate funding for student borrowers because of the difficulty in pricing unsecured loans for unemployed borrowers with little or no credit history. We also explained why path dependency and political considerations led the government to use the form of loans, rather than tax-funded grants, to finance higher education. And we also showed how student loans evolved over time, from being financial instruments with fairly standard terms from private lenders (though still with deep government involvement) to being a direct loan from the government with the option of income-contingent payments, interest relief, and potential loan cancellation.

In this Part, we break down in detail why this current structure of student loans is so unlike other forms of debt. To be clear, many forms of debt feature one or more of these features; what makes student debt different is the totality of these features—they go well beyond even most forms of contingent debt. At some point the accrual of non-debt features require us to look beyond the form of an instrument and consider better ways to describe its substance.

Perhaps the central difference between most student loan debt and other types of debt obligations is that the federal government is the direct lender. A range of structural features of student loan debt flow from the government serving as lender because the government has very different goals, incentives, and economics than a private lender. Whereas a private lender's goal is profit, that is not the objective of the federal government. Instead, federal student lending has a social goal of improving access to and affordability of higher education. Additionally, the federal government has a much higher capacity to absorb and spread risk, especially across time and generations, and has access to taxing power to manage issues of moral hazard.[81]

[81] DAVID MOSS, WHEN ALL ELSE FAILS

The federal government's lack of profit motive combined with its superior ability to absorb risk enables federal student loans to differ from other types of loans in a number of material ways. These differences include a lack of underwriting, income-contingent payments, debt forgiveness, lack of interest accrual in some circumstances, favorable tax treatment, and other pro-debtor features, but also sharp limitations on bankruptcy discharge.

One theme in the points below is that some of the features and terms of student loans were introduced while the student loans were federally guaranteed loans nominally owned by private lenders. For example, interest subsidization, the tax treatment of forgiven debt, and private loan servicing may have had a logic when the loans were held by non-governmental entities, but the concepts and rules have carried over to the Direct Loan era with little change. As we show, however, the federal role in student loans requires a much more profound rethinking of the underlying structure of the program.

A. Lack of Underwriting

[Most lending is underwritten to reflect the borrower's risk over a risk-free rate. Student loans (other than those guaranteed by parents) have no underwriting, but are one-size fits all products in terms of loan eligibility, rates, and maximum loan size irrespective of whether a student is a computer science major at CalTech or a poetry major at Upper Vermont Community College. This, combined with the difficulty in predicting effective interest rates, makes it near impossible for student borrowers to know if their borrowing is within their ability to repay.]

B. Income-Contingent Payments

Borrowers in one of the Income-Driven Repayment programs are not required to pay a fixed monthly amount based on their principal and interest rate, but instead may make payments that are only a function of their income. This is especially true for REPAYE, where borrowers pay 10% of their discretionary income no matter what their income is. (In the other Income-Drive Repayment programs, a borrower may revert to paying the standard loan amount when their income gets high enough.) Moreover, the complicated rules on interest accrual and capitalization mean that for many borrowers there is little connection between typical debt terms—principal and interest rate—and what they actually pay, even if they never have their loans forgiven.

Contingent debt is a product that is virtually absent from the world of consumer finance. Concepts such as formal income-contingent

repayment arrangements simply do not exist for products other than student loans. Instead, to the extent that any income-contingent repayment occurs, it is in the context of loan workouts, bespoke arrangements made when a debtor has fallen behind on a loan. But there is no consumer finance product other than student loans that has a standing option of income-contingent repayment.

To illustrate, the tax law often requires a determination of whether a purported debt instrument is truly debt for tax purposes (and thus whether interest payments are deductible). The same is true for bankruptcy law and federal consumer credit regulation. Loan payments that are this variable and based directly on revenue or profit of the borrower, with no relation to the stated interest rate or some other rate index, raise a serious risk of being classified as equity instead of debt for tax, bankruptcy, or consumer credit purposes. Of course, the concerns of tax law—i.e., protecting the tax base against excessive earnings stripping through interest deductions—and the concerns of bankruptcy law—i.e., determining the priority of claims or interests in the debtor—are not the same concerns as consumer credit law—i.e., ensuring smooth functioning of debt markets by protecting creditor and borrower rights. But in the case of federal loans to fund higher education, it is not clear whether *any* of these concerns is present.

C. Forgiveness of Unpaid Balances

All borrowers in Income-Driven Repayment are entitled to forgiveness of any unpaid balances—principal and interest—after being in a repayment program for some set amount of time (10, 20, or 25 years, depending on the plan). The forgiveness is contractual, not discretionary, and is based only on objective factors, like the borrower's income and length of time in repayment. As one of us has written, this raises the question of whether the forgiveness should really be thought of like most debt cancellation.[82] If the terms of the loan require only payment for a fixed number of years, and with no discretion for the lender on whether payments will continue after that, the typical notion of forgiveness does not fit as well.

Student loan forgiveness can also occur outside the income-driven repayment plans, such as in cases of death and disability, school closure, false certification of loan eligibility, and fraud-like situations that provide borrowers a "defense to repayment."[83] While these rules were written to apply to private lenders under the guaranteed loan

[82] Brooks, *supra* note 34.

[83]

program, they also apply to Direct Loans, meaning that the lender—the federal government—has provided in the terms of the loan for a number of situations where the borrower simply does not have to pay the government back. While some commercial law bankruptcy remedies provide for cancellation or subordination of a debt in the case of lender malfeasance,[84] student loan forgiveness for federal Direct Loans applies where the *lender* has done nothing wrong, and at most perhaps a *school* has behaved badly. These are terms one would rarely expect to see in a typical debt instrument.

D. Interest Accrual

The rules on origination fees (essentially points), interest forbearance, deferral, accrual, compounding, and capitalization are highly complex, with the result that it is almost impossible for a borrower to understand ex ante how much interest she will actually pay or what her effective interest rate is. Federal student loans are not subject to the Truth in Lending Act disclosure regime,[85] so there is no disclosure of the finance charge—the expected borrowing cost on the loan if paid off according to its terms. Moreover, federal student loans have automatic rights to deferment and forbearance, unlike any other type of debt. And that is before we get to the Income-Driven Repayment programs. It is not an exaggeration to say that a student borrower cannot know ex ante how much the borrowing will ultimately cost.

To illustrate this, we briefly summarize the interest terms of the various Income-Driven Repayment programs. To help in this, we first define a few terms. Interest *accrues* monthly based on the unpaid principal and stated interest rate. Sometimes the borrower has to pay this interest in the current monthly period, sometimes it is paid by the government, and sometimes it is simply unpaid. In some cases, any unpaid accrued interest is *capitalized* into the loan principal, meaning that it becomes part of the principal balance of the loan on which further interest will compound. If accrued but unpaid interest is not capitalized, it is still owed, but interest will not compound on it.

First, for all Direct Loans, whether in Income-Drive Repayment or not, there is a distinction between unsubsidized and subsidized loans.[86] Subsidized loans are available for families and students below

[84] Cite some state usury statutes that void the loan; *Pepper v. Litton*, 308 U.S. 295 (1939) (equitable disallowance in bankruptcy); 11 U.S.C. § 510(c) (equitable subordination in bankruptcy).

[85] 15 U.S.C. § 1603(7).

[86] Cross-ref to history discussion

an income threshold and provide that the government will pay the accrued interest while the student is enrolled in higher education, and for a six-month period after leaving school (and also during any period of deferment).

For unsubsidized loans, however, all interest accrues and is owed by the borrower, unless an Income-Drive Repayment provision provides otherwise. As noted in Part C, the interest subsidies were first put in place under the system of federal loan guarantees, so that the federal government was literally paying the interest subsidy over to a private lender. But under the current Direct Loan system, the government's "payment" of the interest is simply a decision not to charge or collect interest as it is due because the government would merely be "paying" itself.

For tax purposes, we would think that either of these situations would generate gross income for the borrower—either the government is paying a debt on behalf of the borrower, or is forgiving part of the debt to itself. This issue does not appear to have been ever raised, and there is no authority on point. That this has never even been broached suggest that all parties understand that interest obligations are a fiction, or at a minimum that stated interest on student loans is not comparable to interest on typical debt.

Second, for loans with Income-Driven Repayment plans, the interest accrual rules differ somewhat based on the particular plan. There are four types of Income-Driven Repayment plans: Income-Contingent Repayment, Income-Based Repayment, Pay-As-You-Earn, and Revised-Pay-As-You-Earn.

1. Income-Contingent Repayment.

For a borrower in Income-Contingent Repayment (other than PAYE and REPAYE), unpaid accrued interest is capitalized into the loan only for an amount up to 10% of the original loan balance. Unpaid accrued interest beyond that is still owed, but does not grow and compound over time, i.e., it is essentially an additional interest-free loan. Because the debt is very long term (Income-Contingent Repayment forgiveness is at 25 years), the present value of some early unpaid interest would be substantially discounted in present value terms. For example, if we assume a discount rate equal to the long-term Treasury rate (roughly 3% at the time of this writing), a debt of $100 in Year 1 that charges no interest would have a present value of

about $48 in Year 25.[87] If we assume that the present value should be discounted by the student loan interest rate that would otherwise be charged, the present value of that $100 could be as little as $16 (for Grad PLUS debt).[88]

2. Income-Based Repayment.

If the payment of a borrower in Income-Based Repayment (old or new) is not sufficient to cover the interest otherwise due, the government will pay the unpaid interest during the first three years of repayment (for both subsidized and unsubsidized Direct Loans). After that, however, any unpaid interest accrues and is fully capitalized into the loan if the borrower's income gets high enough that they no longer need income-based payments, or if they simply leave the program. Contrast that with Income-Contingent Repayment, which does not reduce the interest payments for any period, but on the other hand caps the amount of unpaid interest that would be capitalized.

3. Pay As You Earn (PAYE).

Pay As You Earn combines the terms of Income-Contingent Repayment and Income-Based Repayment. The government will cover unpaid interest during the first three years of repayment, and will also cap the capitalization of any interest after that at 10% of the original loan. As with Income-Contingent Repayment, uncapitalized interest still accrues—it just does not bear an interest charge of its own.

4. Revised Pay As You Earn (REPAYE).

We have yet another treatment of interest. Under this plan, the government will pay all the interest in the first three years only for subsidized loans. For unsubsidized loans, the government only covers half of the interest (the rest is either paid or accrued and unpaid). *However*, after the first three years, the government will continue to cover half of the unpaid interest for all loans, subsidized and unsubsidized. Moreover, none of the leftover unpaid accrued interest is capitalized into the loan principal unless the borrower leaves REPAYE (which is not required, even for a person with high income).

We describe these interest accrual rules in detail to illustrate their complexity and variety. When a borrower takes out a loan, the borrower may not know which repayment plan she will eventually

[87] That is, $48 in Year 1, invested at a 3% return, would generate $100 in Year 25.

[88] 2018 interest on Grad PLUS loans is 7.6%.

utilize. The borrower may select a repayment plan only years after the actual borrowing. As a result, the borrower cannot know how interest accrual will work, and thus her total cost of borrowing. The amount of interest a borrower will ever actually pay, or even have forgiven in a formal sense, is a complex function of both the type of underlying loan, the choice of repayment plan, and unforeseeable future income fluctuations. It is literally unknowable ex ante—to both the borrower and the lender—which distinguishes student loans from all other types of consumer borrowing, wherein the centerpiece of the disclosure regime is the ex ante disclosure of the costs of borrowing.

E. Tax Treatment of Debt Forgiveness

In typical circumstances, forgiven debt creates gross income for tax purposes, because the release of the liability delivers a benefit to the borrower equivalent to having earned the money to pay off the debt.[89] Relieving someone of that debt burden is an accrual to the person's net wealth, and thus something that the tax system takes account of in normal circumstances. As should be clear by now, student loans are not such a normal circumstance.

The tax treatment of student debt varies depending on the repayment program and the reasons for the forgiveness. And that varied treatment is also in flux, subject to ad hoc rulings by the Treasury. The tax code has long provided that debt forgiven under PSLF (or its predecessors) was excluded from gross income for tax purposes. The 2018 tax reform bill added an additional exclusion, for debt forgiven due to death and disability (at least through 2025).[90] Moreover, the Higher Education Act also states that debt forgiven because of school closure is also excluded from gross income for tax purposes.[91] (Notably, it seems that Treasury was unaware of this last exclusion for at least a period, likely because the exclusion was never codified in the tax law or regulations.[92])

The tax treatment of student debt discharged from other reasons is less clear. There is no explicit statutory exclusion for debt forgiven under any of the IDR plans, or for false certification or defense to repayment, and Treasury's position seems to be that the forgiven debt

[89] IRC § 61(a)(12); *Old Colony*.

[90] IRC § 108(f)(5).

[91] 20 U.S.C. §§ 1087ee(a)(5) (PSLF loans), 1087(c)(4) (incorporating section 1087ee(a)(5) for FFEL loans), and 1087e(a)(1) (incorporating FFEL terms for Direct Loans).

[92] *See* Brooks, *supra* note 34.

does create taxable income in those situations.[93] Yet on at least two occasions, Treasury has ruled that debt forgiven under the defense to repayment theory could also be excluded. In 2015, the Department of Education forced Corinthian Colleges, a for-profit chain, to close, and discharged any remaining debt held by its students, applying both closed school (for recent students) and defense to repayment theories. But even though only closed school discharge had a statutory exclusion from being taxed, Treasury announced that they would not assert that gross income had been created for any borrower.[94] Their reasoning was that many borrowers with defense to repayment discharge were either victims of fraudulent misrepresentation or insolvent, both of which provide an exclusion under the tax code. But because it would be too hard to determine which borrowers actually qualified, they simply applied those theories to everyone.

In 2017, Treasury extended that same ruling to former students of American Career Institutes, who had their debt discharged in similar circumstances.[95] These two examples may be enough to assume a pattern and a precedent, but the result still relies on Treasury issuing a formal ruling, and it is not clear whether future discharges under defense to repayment would get similar tax treatment.

Neither of these rulings apply to IDR discharges (which are still several years away). At this time, Treasury's position is that those discharges will be taxable, since no clear statutory exclusion applies. However, as alluded to above, and as one of us has argued elsewhere, the history of how student loan discharges are taxed suggests that IDR discharges should also be excluded.[96] Recall that Section 108(f) of the tax code was added because of an adverse IRS ruling for a PSLF-like program.[97] In 1973 the IRS reversed its earlier position and ruled that debt forgiveness under that program did not qualify as an excluded scholarship under Section 117 because there was a quid pro quo.[98] Congress enacted section 108(f) to plug that hole.[99] But there is no quid pro quo for IDR—the borrower is not required to work in a particular

[93] Solomon Letter.
[94] Rev. Proc. 2015-57.
[95] Rev. Proc. 2017-24
[96] *See* Brooks, *supra* note 34.
[97] *See supra* notes 54-55 and accompanying text.
[98] Rev. Rul. 73-256, 1973-1 C.B. 56.
[99] *See* Joint Committee on Taxation, "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," JCS-41-84, at 1199-1201 (Dec. 1984).

field or geographic region, or anything else. Thus, the scholarship exclusion should still apply in principal.

At any rate, the take-away is that there is inconsistent and fluctuating tax treatment of the forgiven debt, and a lack of clarity for even what the theory or law is for including or excluding any discharge from gross income. At a minimum, this illustrates a weak commitment to treating student debt like other forms of debt.

F. Nondischargeability in Bankruptcy

[There are sharp limitations on the dischargeability of student loan debt in bankruptcy. Conventional wisdom is that student loan debt is entirely non-dischargeable in bankruptcy. Recent scholarship has shown that the restriction is not as absolute in practice,[100] but the limitation on the discharge of student loan debt still prevents many borrowers from obtaining debt relief, and the mistaken belief in its absolute scope likely chills many other consumers from even seeking to address their debt burdens through bankruptcy.

In a sense non-dischargeability makes the debt *even more* like debt in that it tightens the obligation to repay. But dischargeability is a feature of most debt, including consumer debt. Debt is generally not an absolute obligation to pay, but an obligation to pay *or file for bankruptcy*.[101] Moreover, the IDR programs function more like a sliding-scale discharge, without having to actually declare bankruptcy. In other words, one can get similar benefits as discharge, but without having to be declared insolvent and without affecting other debt—student loans, and IDR loans in particular, exist largely in their own category.]

G. Fewer Rights and Minimal Oversight

Lack of bankruptcy discharge is not the only way in which student debt is actually *tougher* than other consumer debt. Borrowers often have fewer federal statutory protections. The Federal Truth in Lending Act,

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[100] Jason Iuliano, *An Empirical Assessment of Student Loan Discharges and the Bankruptcy Undue Hardship Standard*, 86 AM. BANKR. L.J. 495 (2012).

[101] *Cf.* OLIVER WENDELL HOLMES, JR., THE PATH OF THE LAW (1897) ("The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it – and nothing else."). Holmes famous dictum was made at a time when there was no bankruptcy law in the United States. Had he made the statement a year later, it would have required an asterisk indicating a third possibility—bankruptcy discharge.

for example, does not apply to federal student loans.[102] Likewise, federal student loans are exempt from state law disclosure regimes.[103] This has four important implications.

First, the Truth in Lending Act has an ex ante disclosure regime, designed to promote an "informed use of credit."[104] The Truth in Lending disclosure regime is based around the pre-borrowing disclosure of a standardized all-in representation of the cost of credit in the forms of a "finance charge" and an "annual percentage rate."[105] The HEA has its own disclosure requirements, but it does not require pre-borrowing disclosures of credit costs nor does it use the standardized "finance charge" and "annual percentage rate" for disclosures.[106] Instead, disclosures must merely disclose the "actual interest rate," an undefined term.[107] The lack of definition is particularly notable because the Truth in Lending Act's definition of "finance charge" and "annual percentage rate" were adopted precisely because of the ability of lenders to deceive or confuse consumers through different manipulation of the presentation of the interest rate. Even more significantly, HEA disclosures are not made prior to lending. Instead, they must be made between 30 and 150 days before payment is first due, which means that they are made only after the borrower has committed to the deal.[108]

Second, failure to comply with HEA loan disclosure requirements does not create civil liability for the Department of Education,[109] or relieve the borrower of the obligation to repay the loan.[110] In contrast, failure to provide TILA disclosures for typical debt results in civil liability, including statutory damages of two times the finance charge and attorneys' fees.[111]

Third, the Truth in Lending Act also contains an important consumer protection in the form of a "billing error" resolution regime that enables consumer borrowers to obtain information and require

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[102] 15 U.S.C. § 1603(7).
[103] 20 U.S.C. § 1098g
[104] 15 U.S.C. § 1601(a).
[105] 15 U.S.C. § 1637.
[106] 34 C.F.R. §§ 682.205(a)(1), (2). The Department of Education regulations are for FFEL loans, but pursuant to 20 U.S.C. § 1087e, the regulations governing FFEL loans apply to Direct loans unless otherwise specified.
[107] 34 C.F.R. § 682.205(a)(1)(iv).
[108] 20 U.S.C. § 1083(a), (b); 34 C.F.R. § 682.205(a)(1).
[109] 20 U.S.C. § 1083(f).
[110] *Id.*
[111] 15 U.S.C. § 1640.

lenders to undertake a good faith investigation into disputed charges while the consumer withholds payment without triggering collection activity or negative credit reporting.[112] Given the high costs of litigation relative to consumer debt amounts, this is an important consumer protection that encourages consensual resolution of disputes.

And fourth, the Truth in Lending Act also prohibits lenders from engaging in collection activity through offsets of consumer debts against amounts the lender owes to the consumer unless the lender has first obtained a judgment against the consumer.[113] The HEA, in contrast, specifically authorizes the Department of Education to engage in "administrative offset."

What all of this means is that the due process and borrower protections that Congress thinks should exist in the context of private loans does not exist in the context of federal loans. But because student loans are treated as loans, rather than as government benefits, they also lack the sort of due process provisions that govern Social Security and disability payments, or even tax payments themselves.

H. Other Assorted Oddities

[Students loans differ from typical consumer debt in other, smaller ways. For example, default after 270 days of nonpayment is more generous than the typical 180 days. Student loans are freely prepayable. And the federal government has extraordinary collection ability (approaching the strength of its taxing power).]

I. Pro-Debt Features

[Some features of student loans are still in line with traditional debt. In particular, that the total lifetime cap on what a person will pay is based on the original amount borrowed. (The interest rules make the actual function complicated, but the original principal is still a key variable.) A person may be making an income-contingent payment, but only until the loan is paid off (or the point of forgiveness is reached). This is in contrast to an income tax, which is perpetual.]

III. THE PROBLEMS WITH STUDENT DEBT ARE BECAUSE WE STILL TREAT IT LIKE OTHER DEBT

One of the claims of this paper is that most, if not all, of the problems with how student debt in general, and Income-Driven

[112] 15 U.S.C. § 1666.
[113] 15 U.S.C. § 1640(h).

Repayment debt in particular, works today are because we try to force the square peg of income-contingent federal loans for higher education into the round hole of traditional consumer law and institutional arrangements. This often means that we treat student loans like traditional debt when we shouldn't, and not like traditional debt when we should.

A. Rhetoric and Framing

Using debt as the policy instrument for income-contingent payments for higher education distorts public discussions, policy debates, and individual decisions. Politicians, writers, and students focus on the top-line "debt" label to imply excessive financial burden and risk, both for the government and on the economy, without looking at the deeper fundamentals. Calling this particular system of government payments and receipts "debt" leads to simplistic comparisons to other types of debt, like home mortgage debt, car loans, and credit card debt, despite huge differences.

For example, the headline $1.4 trillion number is sometimes cited as evidence of a "crisis," along with the fact that it exceeds the amount of outstanding credit card debt. But we need to remember that the $1.4 trillion is just an estimate of how funds are flowing to and from the federal government to pay for an important public good. We rarely think of other government spending programs in this way. For example, the present value of federal government expenditures over the same time period as the loans is on the order of $100 trillion—that's the number that student loan debt should be compared to, not outstanding revolving credit card debt.

Similarly, making an income-based payment to the government is analogous to paying an income tax, yet we would never treat 25 years of future income taxes as a "debt" that would show up on an individual's balance sheet or affect their credit score. This is not to minimize the obligation of course—not paying required taxes is a serious offense. The point instead is that in both cases, ex ante all a person has promised is to a pay a percentage of their income to the government in some future years. Indeed, student debt is in some ways less of an obligation, since it may cease at some point (at forgiveness or when loan balance is paid), while taxes continue until death (and beyond).

The excessive focus on the top-line "debt" numbers also fuels misguided policy responses, from both the right and the left. For example, a recent proposed bill from Republicans in Congress to re-authorize the Higher Education Act would have scaled back

dramatically on the amount of debt that a graduate or professional student could borrow from the federal government, capping it at $28,500 per year. Graduate students currently can borrow a lot of money—$100,000 per year or more—and so it is understandable that policymakers would focus on graduate students if the goal is to reduce the overall debt level. But the consequence of doing so would be to make the loan program less financial stable and potentially increase the burden on taxpayers. Graduate student borrowers have the lowest default rates and pay the highest interest rates. While the news sometimes features dramatic stories of huge, unpayable debts, the vast majority of borrower will have high-paying careers and pay back their loans. Grad PLUS Loans are the most profitable class of loan for the government, and thus help to cover the IDR relief for lower-income borrowers. Without those payments to subsidize the weaker performing loans, overall subsidy rates for the loan program will increase.

At the same time on the left, there are calls for loan cancellation, which alone would do little for managing the costs of higher education going forward. Moreover, because IDR is already available, the incremental benefit of outright cancellation would fall disproportionately on higher-income graduates. The loan system is far from perfect (as we try to make clear here), but policy solutions that just focus on the existence or nominal amount of debt miss the larger issues.

Finally, at the level of the student, the psychological effects of debt for individuals can lead to stress and distorted and inefficient decisions. Stress alone can be a real cost to many, in health and other outcomes. There is also evidence that student loans many be connected to slower rates of home-buying, retirement savings, and other features of long-term personal investment. [MORE on debt overhang]

B. Default

[Roughly 8.5 million borrowers are currently in default, which is generally triggered after 270 days of non-payment. If IDR were working properly, there ought to be close to zero defaults. This illustrates several problems: 1) that enrollment in IDR is voluntary and complicated; 2) that the servicing model creates bad incentives (more on that below); 3) that default itself is a legacy tool mismatched to the current policy issues. In particular, a borrower can have at most two periods of default before becoming ineligible for IDR—a result that serves no party's interests.]

C. Servicing

[Partly as a way to appease the old FFEL lenders, and partly based on a misguided analogy to mortgage lending, SAFRA[114] provided that the Department of Education ("ED") would keep using private loan servicers even after it become the direct lender. But this just shifts all the important interactions with borrowers to private parties with the wrong incentives—private servicers are the vehicles through which individual borrower rights have to be effected (or not). The servicers themselves don't even collect the payments, which are made directly to ED—they merely do account maintenance. As a result they have no skin in the game (and no bank regulator oversight[115]), unlike, e.g., mortgage servicers.

The structure of service fee payments makes the incentives even worse. For example, the servicers get paid less if a borrower is in default or delinquency. At first glance, that appears to make sense, but in fact it just means that the servicers stop caring about someone once they're in default. As another example, often a different servicer takes over when a borrower joins PSLF—which means that the current servicer has no incentive to help a borrower get on PSLF. (The servicers complain about this too, by the way, and actually claim that they do a better job with private loans than with Direct Loans, because the incentives are better aligned.)]

D. Department of Education as Non-Regulator

[ED thinks of itself as a lender, and thus focuses on issues like safety and soundness of the loan portfolio. This makes it focus excessively on the costs of IDR and the net subsidy rate of the loan program, and also leads it to largely disclaim its role as a regulator of loan servicers, which it treats much more like contracted vendors. ED has some authority to manage the servicer problems described above, but has little political incentive to do so. (In part because Federal Student Aid (the relevant branch of ED) has a lot of independence and little political oversight.)]

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[114] The Student Aid and Fiscal Responsibility Act, passed as part of the Health Care and Education Reconciliation Act of 2010 (better known as the bill that passed the final tweaks to Obamacare). Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, §§ 2001–2303, 124 Stat. 1029, 1071 (2010).

[115] The Consumer Financial Protection Bureau has some supervisory authority over servicers, through their "larger participant" rulemaking.

E. Tax Treatment

As noted above, the Treasury Department currently takes the position that loan forgiveness through the Income-Driven Repayment programs (other than PSLF) would create taxable income for the borrower, although there is some legal uncertainty around the issue. In the typical debt context, this tax treatment makes sense—if a creditor forgives some or all of a debt, that is a net accrual to the borrower's wealth, as if the person had, say, won a lottery and used the winnings to pay down a debt. Because that is the default tax treatment, the assumption is that it applies to any forgiven debt absent an affirmation exclusion in the tax law, and there is no such exclusion for non-PSLF IDR forgiveness.

But in the context of a federal loan, particularly an income-contingent one, this logic breaks down. Here, the same party—the federal government—is both the creditor and the tax collector. Thus when the government-as-creditor forgives 100% of a loan, the government-as-tax-collector turns around and demands back a portion of the loan it just forgave, perhaps as high as 37%.

Greg Crespi has called this the "tax bomb" from IDR—it could be financially devastating to a borrower in a weak enough position to need forgiveness in the first place, particularly because the payment is due all at once.[116] The potential impact has also been a subject of media reports[117] and appears to be source of stress among borrowers who feel that they were baited and switched.[118]

The context of the forgiveness also underscores the absurdity of this tax treatment. Unlike a typical commercial or consumer debt, the availability of forgiveness is in the ex ante terms of the student loan itself—the borrower and the creditor both understand at loan grant that the borrower has the choice to only make income-based payments for 20-25 years. In forgiving the loan, the government is just following through on this promise, not granting the borrower an unanticipated windfall. Moreover, the forgiveness is for a clear public policy reason. Congress decided that a borrower who can only afford to make income-based payments for 20-25 years should be relieved of the remaining debt. To then tax that relief undermines that goal.

It is not clear that any policymaker affirmatively wanted IDR forgiveness to be taxed, and some immediately began trying to correct

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[116]

[117] NY Times.

[118] Email exchange with borrower, on file with authors.

the issue after IBR was passed in 2008.[119] Instead, this tax treatment just follows by default from labeling the program "debt," since the tax treatment is one of the legal consequences of "debt." As noted above, the problem could be solved simply be labeling the forgiveness (or, indeed, all of the loan) instead as a "scholarship," which is clearly excluded from gross income for tax purposes.

F. Outdated Rehabilitation Tool

[Prior to IDR, the main way to help distressed borrowers was through loan rehabilitation, which allowed them to get back into good standing if they made nine payments of 15% of discretionary income. In the meantime, fees and interest would fully accrue. Then the borrower goes back to the (unaffordable) full payments, but with an even higher principal amount. About 1/3 of borrowers who go through rehab default again within 24 months. A much better option for borrowers would be to consolidate them into a new loan, and then to put that loan in IDR. However, the servicer incentives and fees are overwhelmingly in favor of using rehab rather than consolidation/IDR. In an IDR world, there is no reason even to have rehab, much less to implicitly encourage servicers to use it over IDR.]

G. Fallacy of Payment Hierarchy

Much of the problems of default and IDR complexity could be alleviated if it were (a) the default program and (b) payments were collected through wage withholding, with tax return reconciliation. (This is how Australia and the UK do it, for example). Because the IDR payments are based on adjusted gross income, this would be relatively trivial. However, many student debt advocates (and likely other financial institutions) resist this because mandatory collection would upend the typical "hierarchy of payments" notion that borrowers should be able to prioritize more important payments, such as for food and shelter. Default, in this sense, is actually an important self-help option for borrowers to have if needed. But this is a legacy of pre-IDR thinking. IDR specifically provides for low, even zero, payments when income is low, and the exemption is based off of the federal poverty level—meaning that any borrower in IDR should have a reasonable amount of income for basic necessities before having to make any loan payment.

Furthermore, under current rules if a borrower defaults twice on her loans, the IDR programs are no longer available. So the self-help

[119] Kennedy? But CHECK.

option of non-payment will put a borrower in a much worse position, particularly because unpaid loans can lead to wage garnishment anyway. These rules for default and IDR should be changed regardless, but the larger point remains: if IDR continues just as an opt-in program for relatively sophisticated borrowers, it is likely to exclude those most in need of its relief.

To be clear, we do not claim that there is no cost to payment withholding. At the margin there would be some borrowers who will face cash flow and liquidity challenges. But that cost needs to be balanced against the benefit of expanded IDR and a reduction in default rates.

H. Debtor's Prison

[Under some state laws, unpaid student debts can mean frozen college credentials, suspension of state licenses, and asset seizure, making it less likely that the borrowers will be able to repay. More mundanely, debt concerns drive some students to avoid fields that require graduate degrees or professional licensing/credentialing, or to live at home and attend lower-ranked schools. And debt itself can hurt credit ratings and job prospects, ability to buy or rent homes, household formation, etc. When a "debt" really means only a promise to pay a percentage of income for a fixed number of years, the overall size of the debt is less relevant to understanding a person's financial capacity.]

I. Disclaiming Government Oversight Responsibility

[If student debt is actually like other consumer debt, then we could imagine a stronger role for banking regulators at the federal and state level, watchdog agencies, private law rights of action, and so on. But because student debt is different, these tools often fail. As noted above, federal bank regulators do not treat loan servicers as banking entities, and ED has little incentive to oversee them instead (and the CFPB has not stepped in to use its rulemaking and enforcement authority). There are also far fewer state law protections compared to, say, auto debt or payday loans. Furthermore, the loan servicers often argue at the state level that state law is preempted by federal law, like the Higher Education Act or even ED's contracting requirements (which, as noted, is not a substitute for true oversight). The confusing and irrational set of rules just creates more cracks for borrowers to fall through.]

IV. TREATING EDUCATION FINANCE AS GRANTS AND TAXES, INSTEAD OF LOANS

Taking the above objections seriously—that the biggest problems with our student debt system derive largely from the inappropriate application of typical features of "debt" to something that is fundamentally different from typical debt—we have to ask, what is the alternative? Here, we start from our main observation—that making an income-based payment to the federal government to fund the provision of a public good or service is more akin to a tax and transfer than borrowing to fund consumption. We therefore consider here a proposal to make that arrangement explicit and reshape the student loan program as an up-front grant to pay for tuition, connected to an income surtax on grant recipients.

Before exploring this proposal in detail, we should provide a few caveats. First, our main goal here is to describe a system that would work roughly the same as the existing system, while removing its worst element—the debt feature. The reframing also points to some possible incremental improvements that we discuss below, such as graduated repayment rates. But more radical changes, like tax-funded free college are also possible. We take no view on the relative merits of that sort of broader systemic change.

Second, if our proposal sounds unusual or even radical, we remind you that income-contingent loans have essentially the same financial character as what we describe—we just replace the "debt" policy instrument with a "tax and transfer" instrument. As discussed in Part II, the choice of one or the other instrument was largely about politics and optics, not fundamental differences in the fiscal or economic realities. These labels have real consequences of course—that is our whole point—and we try to lay out below the negative consequences that may flow from a tax-and-transfer label. If in the end neither choice of label and appurtenant legal and institutional structure is appealing, then we may require a hybrid legal structure, taking elements of each to construct something new. We offer some suggestions in that direction in the discussion that follows.

A. Basic Proposal

One can describe a student loan in income-driven repayment as follows: The government provides to the student annually an up-front lump sum to help pay tuition and fees. After leaving school, the student then pays 10% of their discretionary income for the lesser of 20 years or the time it takes to pay back the original funds, indexed to some interest rate (as noted above, the actual effective interest rate varies

with the plan and is complex to determine ex ante). Because we seek above all else to remove the negative rhetorical, psychological, political, legal, and financial baggage of "debt," let's simply put different labels on this transaction. The government has made a *grant* to the student, and the student is paying an *income tax* to the government for some period of time.

We could stop there, and simply have the existing arrangement with different labels. In theory that alone could address some of the primary problems with the current system, like default, the tax treatment of forgiveness, and individual financial stress from debt overhang. But the different labels free us from some of the constraints of the debt model, such as charging interest, and also point to a different set of legal and administrative institutions that present opportunities for further reform.

We therefore propose the following additional reforms: 1) making income-based payments the automatic (indeed, the only) option; 2) collecting payments through the tax withholding and return filing system; 3) having students pay the tax until the original grant amount, adjusted for inflation, is repaid (i.e., removing both market interest and loan forgiveness); and 4) imposing a graduated schedule of marginal tax rates. We elaborate on these proposals below.

B. Proposal Details

[Note to Readers: These are preliminary proposals offered for discussion. They may change as we do scenario modeling and receive feedback.]

1. Income-Based Payments as the Default

In the current system, borrowers have to affirmatively opt in to an Income-Driven Repayment program. This usually involves a complicated income-verification process, managed by a private loan servicer that lacks the right incentives to help the borrower into the best program. As the programs are currently designed an IDR program strictly dominates the standard loan program for every borrower.[120] They pay no more under one of the IDR programs, and perhaps less. Moreover, from the government's standpoint, the borrowers who would pay less in IDR are those that probably *should be* paying less for equity reasons. In addition, under the current rules, a borrower can default on the loan at most twice before becoming ineligible for IDR, meaning that those borrowers who most need IDR and are least able

[120] Only possible exception is a high-income, but liquidity constrained borrower in REPAYE.

to get into IDR are precisely those who are shut out of the program. If we truly have a policy commitment to IDR, there is no reason for it not to be automatic. It is only our commitment to treating a student loan as a "loan" that stops us from making IDR the default, or even the only, option.

The grant-and-tax plan would instead make income-based payments (the tax) the only option. Again, if we make no other changes to the programs, every borrower's payments would be either the same or less. We propose some further changes below that complicate this view, but the case for automatic income-based payments remains strong regardless of whatever other parameters one might choose.

2. Tax Payments and Withholding

If the student payments are a tax, then the obvious way to collect the payments are through the tax system, through wage withholding and tax return filing. This addresses several of the problems with the current system. First, it makes income calculation and verification easier and uses current-year income, rather than income from the prior year. An unfortunate feature of the current system is that a person's payments in a given year are calculated based on the person's adjusted gross income in the *prior* year, as reported on that year's tax return. For borrowers with a lot of volatility in their income, this can be painful, for example when a high-income year is followed by a low-income year. By using the tax withholding system, the payments can instead by based on a decent approximation of current-year income, with any corrections handled through tax-return filing, just like we do for our income tax.

Second, it would lessen the administrative burden of making payments, and obviate the need for a separate loan servicing system. The IRS is well-equipped to handle this task, and loan servicers already rely on IRS data to make the income eligibility determinations anyway. Eliminating the loan servicing system would be a substantial step in favor of students.

Third, it would virtually eliminate default as a problem, especially combined with the fact that income-based payments would be the only possibility. As noted above, this aspect of withholding has raised objections among borrower advocates because of a concern that a borrower would have no ability to voluntarily choose to miss a payment because of other financial demands. While we acknowledge that this could be the case for a small subset of borrowers, we think the other aspects of our proposal minimize the risk and the benefits greatly outweigh the costs. Most importantly, if the payments are

income-based, there is already a mechanism to protect the neediest borrowers. Moreover, we propose below a more graduated rate schedule that will provide even greater protection to low-income borrowers. Furthermore, our proposal does not eliminate self-help. Our current system of tax withholding allows individuals to adjust their withholding away from the default, and that would be true here as well. Students who would owe additional amounts at tax return filing could extend filing or even chose not to pay. Finally, the grant-and-tax plan could be modified to include some escape-hatch relief if necessary.

3. Interest Rates and Repayment Period

We propose that the grant-tax would be collected until the student has paid back the original grant amount (or until death), adjusted for inflation. Put another way, we would abolish both forgiveness and interest rate charges. We understand that this may appear harsh, but these two features work together to still favor the student, particularly when coupled with the graduated rate schedule we propose below.

Because the IDR system is built on top of a legacy system of guaranteed loans, the system includes interest charges on the debt. The rates are set by statute and regulation and in 2018 range from 5.05% (for undergraduate Direct Loans) to 7.6% (for Grad PLUS Loans). These relatively high interest rates are a source of revenue for the government, a source of pain for borrowers, and a source of mind-boggling complexity for everyone, as described above.[121] A virtue of shifting from a debt frame to a grant-and-tax frame is the opportunity to rethink how interest works.

We propose to abolish the interest charges, and instead index the unpaid grant amounts to inflation, following the Australia model. This would lower the amount paid by students in real terms, and also make obsolete all of the complicated and varied interest subsidies in the various IDR plans.

Lowering the interest rate to just the rate of inflation would slow the growth of the amount owed more than any of the existing IDR programs, which in turn would make it less necessary to stop the tax after a fixed number of years (the equivalent of loan forgiveness at 20 years). Furthermore, because (if we can revert to the debt frame for a moment) indexing to inflation is equivalent to an interest-free loan, having a long repayment period is not a particular hardship, since the present value of the amount paid will go down the longer the period.

[121] *See supra* Section III.D.

Moreover, extending the period allows us to use a schedule of low graduated rates, as we describe below.

We prefer for the grant-and-tax system to be mostly or entirely self-financing. The current system is close to self-financing, partly because the high interest rate payments from some borrowers can be used to subsidize those with lower, income-based payments and potential forgiveness. If we lower the interest rates to just the rate of inflation, we lose that revenue. Removing cancellation and extending the time period for repayment makes up for some of that difference, with the additional benefit of ensuring that those with higher incomes in the back half of their working lives pay their fair share.

As a final point, we should note that this also implicitly repeals the 10-year forgiveness for Public Service Loan Forgiveness. *[More to come]*

4. Graduated Repayment Rates

[The current IDR system uses a flat repayment rate—10% of "discretionary income." Whether or not the grant-and-tax plan shifts to using a taxable income base, we propose instead to use graduated rates of [ ]. The argument for graduated rates is that same as for using graduated rates for income taxes—it allows for more progressivity, since higher-income individuals pays a greater share of their income to the government.

[Still need to do some modeling and examples to work out details]

To be clear, for these graduate rates to work effectively would also require the interest and repayment period changes mentioned above. If a grant-and-tax system instead continued to use a fixed repayment period, the tax rates would have to be higher for the system to be mostly self-financing. The relationship between the tax rates, indexing, and repayment periods are tight, and the final terms of each will have to be developed in concert.]

V. ADDRESSING COMPLICATIONS AND OBJECTIONS

A. The Downsides of Tax Framing

Our proposal would reframe a debt as a tax. As we've argued, this would remove the worst features of debt, but it could introduce some new framing problems. The political and legal consequences of labeling something a "tax" are not without cost.

For example, taxes often carry a "punishment" valence in public rhetoric, and our plan could be framed as a tax on the inability to pay

for college. We reject this framing normatively—with the exception of "sin" and other Pigouvian taxes, the question is on what basis to assign tax burdens, not whether the thing taxed is "good" or "bad." But ultimately what matters is how the tax is perceived, and what behavioral effects flow from that.

In addition, we would be asking students to opt in to an additional income tax on top of the existing income tax, which could create its own psychological barrier to students using the grants. How that barrier would compare to the barrier of borrowing is an empirical question, but it would have important consequences for our proposal.

It is also possible that labeling the student payments as a "tax" moves them a step away from tuition and a step toward other tax payments in students' minds. In other words, it may introduce a disconnect between the payments and the good that's being provided. Framing the payments as "debt" may make it clearer that a person is just deciding to pay tuition now or in the future. But framing the payments as a "tax" may make the connection between the payments and tuition less salient to students. That could affect the political stability of the tax portion of the grant-and-tax program. If the grant and tax becoming disconnecting in students' minds, it may allow policymakers to tinker with one or the other, instead of managing them together.

A related objection is that if we are going to have a tax, it should not be a linked separate tax, but just a small increase in our existing income tax, thus falling on everyone, not just those who can't pay for college up front. The equity and timing issues of this are complicated, and largely beyond the scope of this paper. But if our proposal drives people instead to consider free college funded out of general revenues, so be it. Part of our argument is that from the standpoint of financial flows these choices are all more similar than headline labels like "debt" and "tax" might imply.

B. Tax Enforcement

[Using the full tax enforcement powers of the federal government may appear harsh, relative to using debt. Wage withholding would leave no options for students to avoid payments, and nonpayment could theoretically even lead to criminal sanctions.

We think that is an extreme case, however. In the typical situation, an individual under our model would not be treated all that differently than she is today. The vast majority of people who underpay taxes simply owe interest and penalties, just as those who default on loans

do. The government can already garnish wages and tax refunds for loans in default, so a person's financial exposure is not materially different. And in many cases unpaid taxes are treated as just another uncollected debt anyway. Finally, the overall advantages of this plan outweigh the few cases where a person might be harmed by having to pay the graduate tax rather than a loan payment.]

C. Budget Politics

[This proposal could create a big problem with how the federal government currently budgets. Generally the government estimates outlays and receipts over the next ten years. Because many of the grants would fall within that ten-year "budget window," while the largest tax payments would be outside the window, this plan could be "scored" as far more expensive than it really is. Moreover, even if all future tax receipts were estimated and fully offset the grants, the nominal amounts of outlays and receipts would both ratchet up, erroneously appearing to increase the overall size of the federal government. Amounts that had been off-budget credit programs would become on-budget spending, with offsetting tax revenue years away.

This is, to be sure, a substantial problem and not easily solved. But we think it is a problem more with budget politics and policy than with our plan on the merits. The same sort of thumb is on the scale for nearly any public investment—even if an investment is likely to increase future tax revenue, that revenue may be far out in time and speculative. Indeed, our proposal at least has the advantage of an identified and predictable offsetting revenue source.]

D. Education Costs

[Behind any concerns about the growth of student loans is the growth in education costs. Some observers believe that the free availability of debt (and grants) with no underwriting is at least partially responsible for the rise in tuitions. Whether or not one agrees with that claim, it should be clear that our proposal does not address that underlying cost growth. Moreover, if tuitions continue to rise, the fiscal footprint of our proposal will also continue to rise.

If there is a need for reforms to address cost growth, those may be better addressed by direct regulation and oversight of educational institutions, in order to prevent abusive practices and rent-seeking. That said, our grants would not be unlimited, and we can imagine other sorts of limitations that would at least partially prevent institutions from taking advantage of the system.]

E. Can This Be a Self-Sustaining System

[Political benefits from doing so—insulates system from budget process, which fosters stability and business planning.

But hard to know ex ante what collections will be—depends on borrower mortality and disability. Would need to price for this on an actuarial basis, but such pricing can be wrong. Would need to address risk of underpricing by actually overpricing. And would need to deal with changes in size of borrower population over time. But if a reserve were built up, it would be a tempting target for Congress.]

F. Loss of Credit Reporting

[Student loan debt is currently credit reported by the Department of Education. This is actually a substantial *benefit* to many borrowers because it is the first credit reporting they have, which helps establish a credit file for them and enables other borrowing. Even if the reporting is negative, it is better than no reporting.

Lots of liabilities are not credit reported—rent, alimony, child support. Lenders can adjust. Lenders can also request W-2s or can ask borrowers to represent if they have received federal education financing.]

G. Transition

[As with any large reform proposal, we would face the question of what to do with existing loans. A simple option would be to leave them in place, but that could mean continuing to deal with these legacy problems for another 25 years. We would prefer a way to transition everyone to the new program. A simple way would be to just issue the grants to pay off existing debt—a refinancing of the debts with grants. However, that could still leave older borrowers with higher interest payments previously accrued, plus fees and penalties. A more complicated, but still doable, plan would be to take each person's original principal (inflated to current dollars), offset it by that person's total loan payments thus far (inflated to current dollars), and then use the grant to pay off the difference. That would effectively make our new plan retroactive for all past Direct Loan borrowers (and maybe even generate refunds in some cases). (To be clear, this would exacerbate the budget politics described above.)]

CONCLUSION