Insight

Priorities for Reforming and Modernizing the Federal Financial Aid System

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The skyrocketing cost of a college education and the related debt burdens for today's students is a drag on the economy, leaving jobs unfilled and stifling growth.

With a fresh set of elected and appointed policymakers in place, hope is renewed that in the coming months Congress will move forward with the bold strokes needed to ensure that all students, regardless of background, have access to higher education financing. There are ample reforms to consider but perhaps the most important are those that will modernize the federal student aid system. Below are a few policy recommendations worth considering.

FEDERAL STUDENT LOAN REFORM

Properly Account for the FDLP – The 2009 switch to the Federal Direct Loan Program (FDLP), currently the only program for Stafford and PLUS student loans, was sold to policymakers and taxpayers as a form of savings. By eliminating the 'middleman' (private banks and lending institutions) and using the Federal Credit Reform Act (FCRA) guidelines, the change to direct lending was estimated to save $67 billion over a 10-year period. However, several changes to the program and reviews by independent agencies suggest that the FDLP is actually losing money. The Congressional Budget Office's (CBO) January 2017 Baseline Projections for the Student Loan Program show a subsidy rate swing from -13.3 percent (savings by the government) using FICRA to 10.3 percent (cost to the government) using Fair Value Accounting (FVA) guidelines. Further, the Government Accountability Office (GAO) recently estimated that FDLP's income driven repayment plans will cost the government an additional $74 billion. GAO attributes the expense to the Department of Education's (ED) costs and quality control accounting practices that have failed to ensure reliable budget estimates. If meaningful changes are to be made to federal student lending, better accounting practices must be utilized. This includes a switch to fair value accounting so that a more accurate reflection of the cost of the program is presented to policymakers on the front end. The Department of Education must also put in place quality controls in its accounting practices so that realistic assumptions are used to develop future budget estimates.

Streamline Income Driven Repayment (IDR) programs and Eliminate Public Sector Loan Forgiveness Programs – The original intent of IDR programs was to provide students with low incomes an opportunity to repay their loans at a more gradual pace, taking advantage of expected earnings increases throughout their professional careers, and reducing the potential hardship of student loan repayment. Unfortunately, with as many as six different options in four different IDR plans for borrowers to choose from, the benefits provided in the increasingly complex system often allude economically disadvantaged students. Indeed, multiple studies have pointed out that wealthier students in higher-paid professions can expect more of a benefit from these programs than low-income students. In addition, these programs do little or nothing to improve access to postsecondary education for low-income students, particularly those attending community colleges, where borrowing is lower. If the policy behind these programs is to continue, IDR plans must be simplified down to one, and stronger eligibility requirements and means-tested benefits should be implemented to make sure the programs are benefitting the neediest students. Finally, public sector loan forgiveness must be eliminated. There has been no evidence that loan forgiveness options are effective at encouraging participation in specific industries, nor has there been evidence that they improve access or affordability for enrolled students. Additionally, such programs are often redundant with private sector initiatives.

Eliminate the Perkins Loan program – The Perkins loan program is a holdover of the National Defense Student Loan program, authorized prior to the 1965 Higher Education Act, and made wholly redundant by Federal Direct Loan program. Permitting this program to expire and recalling federal capital would create additional savings of up to $12 billion.

PELL GRANT REFORM

There is growing support for policies that simplify the federal student aid system. Ideas such as reducing the Free Application for Federal Student Aid (FAFSA) form to a single page, and/or the consolidation of federal grants into one single Pell grant would certainly benefit students trying to navigate the process. Further changes to the Pell program should also be considered, specifically:

Eliminate the minimum Pell grant – Currently, the Pell grant program establishes a minimum award level equivalent to roughly 10% of the maximum award value. This year, the maximum Pell award value is $5,920, and the minimum award has been set at $592. Students eligible for a Pell grant below $592 are awarded a grant of $592, in other words a student that only qualifies for a $100 Pell award would receive $592 in assistance. This is an unnecessary extension of the Pell grant program that provides additional assistance to students who are only marginally eligible to begin with, either because of their family's expected contribution, or the low cost of the institution they attend.

Front-load the Pell grant program – Students are currently able to maintain eligibility for Pell grants for 12 semesters which may provide students a perverse incentive to extend their education by taking a reduced number of credits while receiving the maximum Pell award for longer. Readjusting this policy so students receive most of their grant funding up front, during the first two or three years of an undergraduate education would provide financial incentives for students complete their education more quickly. Such a shift would also focus loan aid on students more likely to complete a 4-year degree program meaning they are more likely to repay. Fourth year students on track for completion are also more likely to attract private sector investments such as those offered by income share agreements (discussed below).

PRIVATE SECTOR INVESTMENT

Auction Off FDLP Assets – Rather than an outright repeal and replace of the FDLP with a historically troubled guaranteed private lending program, the federal government could instead auction the assets of the FDLP to the private sector. As referenced above, FDLP assets currently cost the government money. The GAO estimates that $137 billion (39% of outstanding FDLP loan volume) will not be repaid. Any premiums from the sale of those assets could generate savings, and recover the costs of operating the federal student loan program. This transfer of existing FDLP assets, currently held by the Treasury, to the private sector would contribute to decreased total federal debt.

Establish Rules for Income Share Agreements – Income share agreements (ISA) are financial vehicles that allow a student to raise money from private sources today in return for a fractional share of the student's income in the future. Under ISAs, investors provide dollars that can be used to cover all or part of students' higher education costs. In return, the student agrees to pay back an affordable percentage of their income for a set period after graduation. Interest in this education finance option is growing; however, a lack of statutory or regulatory guidance presents a barrier to the growth of the instrument.

Student Loan Insurance – Federal student loan borrowers are required to repay loans regardless of whether they complete a degree program or receive a credential. Unfortunately, evidence has shown that many studentborrowers fail to complete a degree program or receive a credential, which often leads to non-repayment, forbearance, and eventually default. One option to reduce the growing default risk would be to require student loan insurance. Such an insurance requirement would let students and families hedge against the possibility of being unable to pay off loans down the road while letting markets dictate how much risk should be associated with any given academic program or school. For the government, a loan insurance requirement would virtually eliminate defaults and from a good public policy perspective such requirement would create a more efficient safety net than taxpayer loan forgiveness. Researchers from the Federal Reserve Bank of Philadelphia have studied the feasibility of the insurance option and found that insurance against college-failure risk can be offered while accounting for moral hazard and adverse selection. Specifically, the research found that student loan insurance reduced the risk of default while increasing enrollment and completion rates. They also found that the effects were more pronounced for underprepared students with a high failure probability, often associated with economically disadvantaged students.

Conclusion

These are just a few recommendations worth considering. The question now is whether the Congress and the administration will work together to enact the much-needed reforms to improve access to higher education.