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Vice President Biden's Student Loan Plan

Introduction

Former Vice President Joe Biden has proposed a comprehensive plan to address the nation's student debt crisis and to improve the affordability of higher education. His plan includes free community college and increased funding for historically black colleges and universities. On student loans, he significantly expands existing programs for income-based repayment and loan forgiveness, particularly for public servants. His plan also makes it easier for borrowers to refinance their student loans and discharge their debt in bankruptcy. The plan is costly but is paid for by higher taxes on those with high incomes and wealth. This analysis focuses on the student loan component of the plan, which will meaningfully ease the financial pressure on those who take out a student loan and thereby support stronger economic growth over the long term.

Vice President Biden's Student Loan Plan

BY MARK ZANDI

Former Vice President Joe Biden has proposed a comprehensive plan to address the nation's student debt crisis and to improve the affordability of higher education. His plan includes free community college and increased funding for historically black colleges and universities. On student loans, he significantly expands existing programs for income-based repayment and loan forgiveness, particularly for public servants. His plan also makes it easier for borrowers to refinance their student loans and discharge their debt in bankruptcy. The plan is costly but is paid for by higher taxes on those with high incomes and wealth. This analysis focuses on the student loan component of the plan, which will meaningfully ease the financial pressure on those who take out a student loan and thereby support stronger economic growth over the long term.

The crisis

The level of student debt outstanding is reaching staggering levels. More than 46 million Americans together owe nearly $1.5 trillion in student loan debt.[1] That is a nearly threefold increase in just over a decade and 2½ times the size of our national credit card debt (see Chart 1).

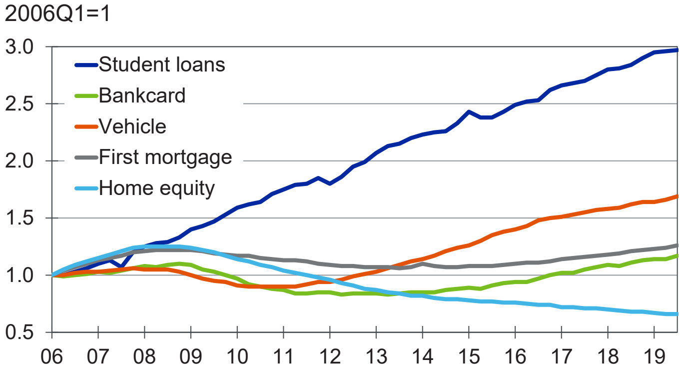
Close to $1.2 trillion of the student loan debt outstanding is owed directly to the federal government, while the rest is owed to private lenders with a government guarantee. Only half of those who owe the federal government are making monthly payments, with the others either still in school or in a grace period, deferment or arrears. Most disconcerting is that 5 million borrowers with government loans have not made a payment in more than a year. That represents 16% of loans outstanding, or $105 billion.

And the numbers are getting worse. More than 2% of those who took out a loan less than three years ago have already gone into default by not making a payment in more than a year (see Chart 2), almost double the rate for those who took out a loan nine years ago at the same point in the life of their loans.

Student loans weigh most heavily on young people, with about half of all student debt owed by those in their 20s and early 30s and one-tenth by those just entering college. However, older Americans also owe an increasing amount of student loan debt. About one-third of student loans are owed by people in their late 30s and 40s, and an increasing number of baby boomers and their parents are taking out loans to help children and grandchildren. Several hundred thousand retired Americans have their Social Security or other federal government sup-

Chart 1: Student Loans Surge

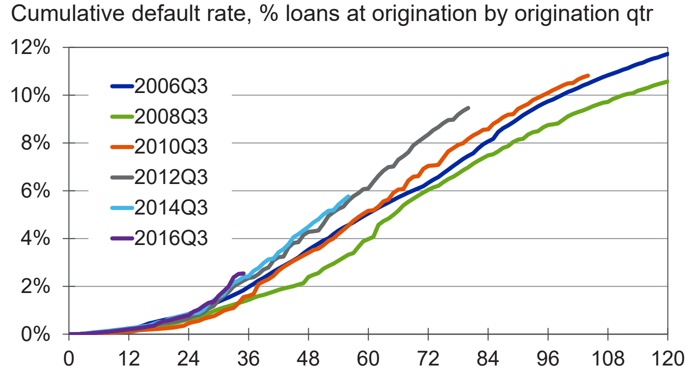
2006Q1=1



Sources: Equifax, Moody's Analytics

Chart 2: Recent Student Loans Are Struggling

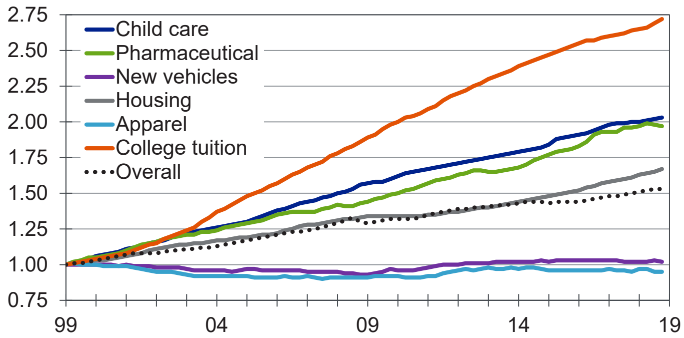
Cumulative default rate, % loans at origination by origination qtr



Sources: Equifax, Moody's Analytics

Chart 3: College Tuition Costs Skyrocket

Consumer prices, 1999Q1=1



Sources: BLS, Moody's Analytics

port payments garnished to pay on their defaulted loans.

As in other areas of economic distress, minorities bear a disproportionate burden. Almost 80% of African American students have to take out a student loan to get a college education, compared with less than 60% of white students. Worse, a disproportionate number of African Americans pursue their higher education at a for-profit college, where less than half of attendees ever get a degree. So, a disturbing share of African Americans are taking on debt with little hope of ever paying it back.

Note the similarity here to other pathways into the middle class for African Americans. Finding the traditional path of higher education unavailable to them, many African Americans turn to for-profit colleges. For most this leads to overwhelming debt, not opportunity. It is eerily similar to what they have faced elsewhere in the economy. For example, unable to take out the kind of safe mortgages that have helped so many before them build wealth through homeownership, many African Americans prior to the recent housing crisis were steered into unsustainable subprime loans, leaving them with debt and damaged credit instead of increased wealth. Or, unable to take out the kind of bank loan that has long helped many get from one job or paycheck to the next, many African Americans are steered into so-called payday loans that leave them in even deeper holes.

The implications of the student debt crisis are becoming ever more serious. Increasing evidence shows it is slowing new business start-ups and causing younger Americans to delay marriage, children and homeownership. And while more borrowers default on their mortgages, the effects will ripple through the economy as damaged credit slows further borrowing and economic activity.

Historical context

The origins of the federal student loan program extend back to the National Defense Education Act of 1958. This law was an attempt to help those returning from World War II integrate back into the economy and to prepare for the increasing threat posed by Russia. The legislation focused primarily on improved school funding but also contained a provision authorizing the Department of Education to provide loans directly to borrowers.

In 1965, the government shifted its role in the program from providing lending to providing a guarantee for banks to do the lending. In part by providing banks with generous origination fees and no risk, the Federal Family Education Loan program took off. By 2010, there were well over $500 billion in FFEL loans outstanding.

Then, in 2010, lawmakers returned the federal program to a direct loan program to reduce the fees paid to private student loan originators and more easily deliver the subsidy involved. Under this program, still in effect, a qualifying student can borrow up to $30,000 for a bachelor's degree program. Students may apply for new loans each year or semester, with the interest rate determined each June as a spread over the 10-year Treasury rate. Rates are fixed for the following year, with no interest charged while students are in school. Once students graduate, they get a six-month interest-free grace period to secure a job and begin paying back their loans. Graduates who continue their studies at graduate or professional schools may extend the deferment period until they complete their programs.

Surging debt

Student loan debt has surged for several reasons. First, the financial crisis that struck over a decade ago has had a devastating and long-lasting effect on this sector of the economy. State-supported public colleges and universities have seen their public funding slashed, the values of the private endowments to fund grants and scholarships have fallen, and it has become much more difficult to use home equity loans to finance tuition and other educational expenses. Also, large contributions that once went to scholarships and grants are increasingly going to capital improvements instead.

However, the overwhelming reason for the increased demand for student loans has been the rapid rise in tuition and fees at both public and private schools. The price of education has gone up tenfold over the past 16 years, 30 times faster than overall inflation (see Chart 3). While some of this increase is because of rising costs of faculty salaries and benefits, an increase in non-faculty administrators, and increased maintenance costs, a significant portion of the increase in tuition is because of the availability of student loans. Institutions of higher education have not felt pressure to rein in costs given how easy it is for students to cover higher tuition with a loan from the federal government. In the absence of the downward pressure from falling demand, prices keep rising.

The Biden plan

The student loan crisis is prompting many policy proposals to address it. Among the most comprehensive is the plan recently put forward by Biden. It would significantly reduce the financial burden on existing and future student loan borrowers.

Specifically, the plan substantially expands the current Revised Pay As You Earn, or REPAYE, income-based repayment program. Under the current REPAYE program, borrowers pay 10% of their discretionary income, which is defined as income minus

150% of the poverty line, for 20 years, and 25 years if a graduate student. Any remaining balance after that is forgiven but may be subject to income tax.[2]

The Biden plan would expand REPAYE significantly. Under Biden's proposal, anyone earning less than $25,000 per year would make no student loan payments at all, and those making more would have their payments capped at 5% of their discretionary income of more than $25,000. The $25,000 is per individual, so a married couple, each with student loan debt, would make no student loan payments if their total combined income was less than $50,000 per year. As in the current program, student loan debt owed after 20 years of payments is forgiven, but the forgiven debt is not taxable. To streamline the program and increase participation, those with new or existing loans would be automatically enrolled in REPAYE, unless they opt out.

The Biden plan also significantly increases the amount of student loan debt forgiveness afforded to those working in government, schools, and other non-profits under the Public Service Loan Forgiveness Program. Under the current PSLF program, qualifying borrowers' student loan debt is forgiven after 10 years of monthly payments under the REPAYE plan. Biden's plan would supplement this forgiveness with $10,000 of debt relief for every year of national or community service, up to five years. Qualifying workers would be automatically enrolled. Anyone with up to five years of prior national or community service would also qualify for the forgiveness.

For those who take out a private student loan, Biden would push to enact an Obama-era legislative proposal to make it easier to discharge such loans in bankruptcy. And he would empower the Consumer Financial Protection Bureau to increase its oversight of private lenders who are not providing financially stressed borrowers affordable payment plan options.

Budget costs

The static budget cost of the Biden student loan plan over the 10-year budget horizon of 2021-2030 is expected to be $301 billion.[3] The bulk of the cost—an estimated $286 billion—is because of the expansion of the baseline REPAYE program. The government subsidy for those in REPAYE is substantial, with a subsidy rate—the cost to the government as a percent of loans in the program—of close to 55%. That is, the cost to the government is $55 per every $100 in loans extended.[4]

The cost of increased student loan forgiveness under the new Public Service Loan Forgiveness Program would cost an estimated $15 billion over the 10-year budget horizon.

Tax increase

The cost of the Biden plan will be paid by capping itemized deductions taken by high-income Americans at a 28% tax rate and eliminating what is known as the stepped-up basis loophole, which largely benefits the very wealthy.[5] The Obama administration put forward similar tax proposals in 2015.

Taxpayers benefit from itemizing when the value of their deductions exceeds the amount of the standard deduction.[6] High-income taxpayers in particular benefit from itemization, since they have more expenses that can be deducted, and because the per-dollar tax benefit of those deductions depends on a taxpayer's marginal tax rate, which rises with income. Well more than three-fourths of the tax benefit resulting from the three largest itemized deductions accrue to households with income in the highest 20% of the population, with about one-third going to households in the top 1%.

The increase in tax revenues from limiting deductions will rise sharply after most changes to the individual income tax system made by the 2017 tax act expire under current law at the end of 2025. The expiration of those changes will substantially increase the number of taxpayers who itemize and the amount of deductions they claim. Consequently, the increase in revenues from eliminating deductions would be much larger in later years. Moreover, marginal tax rates are generally higher after 2025 than under the 2017 tax act.

Capital gains resulting from the sale of inherited assets are taxed differently than the capital gains that are typically taken. To calculate the gains on inherited assets, taxpayers generally use the asset's fair-market value at the time of the owner's death—often referred to as stepped-up basis—instead of the adjusted basis derived from the asset's value when the decedent initially acquired it. As a result, when the heir sells the asset, capital gains taxes are assessed only on the change in the asset's value after the owner's death. Any appreciation in value that occurred while the decedent owned the asset is not included in taxable income and therefore is not subject to capital gains taxation. Under Biden's plan this tax benefit would be eliminated, and those inheriting assets will face the same tax treatment on their capital gains as everyone else.

Financial benefits

Biden's student loan plan provides significant financial relief to existing and future student loan borrowers. The expansion of REPAYE under the plan will help an estimated 14.7 million student loan borrowers lower their loan payments in the first year of the program alone. Given the demographics of those using REPAYE, expanding it would be particularly helpful to those groups the economy most often underserves: minorities and those who are lower-income, younger or less educated. The typical borrower in the expanded REPAYE program will save almost $2,000 per year in student loan payments.

Allowing those with government student loans to refinance into lower-cost government loans will provide more modest but still-meaningful help. Approximately 8 million borrowers will see average savings of $375 in annual interest payments.

The Biden plan also provides some macroeconomic benefits. The plan provides a near-term boost to economic growth as most student loan borrowers enjoy lower payments. That frees up cash to fund more spending, home purchases and other investments. Partially offsetting these near-term benefits to growth are less spending and investment by high-income and wealthy households who pay more taxes. The wealthy reduce their spending by less than students increase theirs, since the wealthy have substantial financial resources to support their spending.[7] Overall, however, the plan is a net gain over the 10-year budget window. Assuming the plan is implemented in 2021, the nation's GDP is expected to be $120 billion larger in 2030 than it would be in the absence of the plan, an increase of 0.35%.[8]

But most of the economic benefits of the lighter student debt loads take significant time to develop, with the biggest impacts coming after the 10-year horizon of this analysis. These benefits include higher homeownership; increased mobility of the workforce, which allows the economy to adjust more quickly to adverse shocks; and greater business formations, which support increased innovation and stronger long-term productivity growth. These macroeconomic benefits will be considerable, but will play out over decades.

Policy challenges

There are three principal problems inherent to any policy addressing the student loan crisis. They are moral hazard, spending money to help those who financially do not need it, and driving up the cost of education.

Moral hazard is a problem for student loan plans that include significant debt forgiveness, particularly if future students will need to use loans to finance their education. These future students may have an incentive to take on too much debt and will be less willing to pay it back if they think there will be future rounds of debt forgiveness to bail them out. The Biden plan does well in addressing moral hazard, because students receive debt forgiveness only after making their loan payments on time for years or working as public servants.

Some proposals to address the student loan crisis also provide substantial support to students who do not need the financial support. This includes students from high-income and wealthy families and graduate students who are training for highly lucrative jobs. The Biden plan does well in targeting the lion's share of assistance to those who most need it, those of modest income or who commit to public service. Under his expanded REPAYE plan, many borrowers in the bottom half of the income distribution will make no loan payments at all, while those in the top quintile of the distribution will pay several thousand dollars a year.

The third problem is arguably the most difficult. Any government subsidy for higher education runs the risk of being captured, at least in part, by colleges and universities through higher education costs.[9] The tuition subsidy increases the demand for higher education, which, when it bumps up against the fixed supply of those services, causes tuitions to increase more significantly. The Biden plan does increase funding for community colleges and historically black colleges and universities, which addresses this concern, but some portion of the subsidy may still be captured by colleges and universities through additional tuition rate hikes. If so, future students may need to take on more debt to finance their educations, limiting the plan's benefit.

Conclusions

High student loan debt is having a corrosive effect on the nation's economy, one that is getting worse by the year. Borrowers struggling with their student loan payments are unable to start families, become homeowners, or establish new companies as quickly as previous generations. And the very prospect of the heavy burden of this debt is beginning to make it less attractive for many to attain the education and skills critical to the nation's long-term economic success.

Biden has put forth a comprehensive plan to address the student loan crisis. The plan significantly expands existing programs to ease the financial burden on lower-income borrowers and public servants. These programs have proven to be effective. Thus, scaling them up should provide substantial and quick relief to millions of current and future student loan borrowers. The student loan crisis will almost certainly require even more attention, but the Biden plan goes a long way to addressing it.

Endnotes

1 Basic statistics on government student loan programs are provided by the Department of Education and Lending Tree. Metrics on private student lending are provided by Measure One.

2 A good analysis of the REPAYE program and proposals to improve its effectiveness is provided by "A Better Way to Provide Relief For Student Loan Borrowers," Adam Looney, Brookings Institution, April 2019.

3 The dynamic budget cost of the plan, after accounting for its macroeconomic impact and the resulting impact on government revenues and spending, is an estimated $297 billion over the 10-year budget horizon, 2021-2030.

4 These costs are calculated based on the net present value of lifetime estimated cash flows to and from the government associated with these loans for borrowers in the program. Cash flows from the government include loan disbursements to borrowers, while cash flows to the government include repayments of loan principal, interest and fee payments, and recoveries on defaulted loans.

5 The tax increases under the plan raise an estimated $763 billion over the 10-year budget horizon, 2021-2030. Of this, $634 billion is from the scaling back of tax deduction for high-income taxpayers and the remainder from the elimination of the stepped-up basis loophole.

6 For 2018, that amount ranged from $12,000 for a single filer to $24,000 for a married couple filing jointly.

7 Also partially offsetting the near-term benefits are somewhat higher interest rates as the Federal Reserve responds to the stronger growth in a full-employment economy by raising short-term rates, and long-term rates rise because of the reduction in national savings.

8 The Moody's Analytics structural model of the U.S. economy is used to estimate the macroeconomic impacts of Biden's student loan plan.

9 This is known as the Bennett hypothesis, which was proffered in a 1987 op-ed in the New York Times by then-Education Secretary William Bennett. The hypothesis has since generated a significant amount of debate and research.

About the Author

Mark Zandi is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools. Dr. Zandi is a cofounder of Economy.com, which Moody's purchased in 2005.

Dr. Zandi's broad research interests encompass macroeconomics, financial markets and public policy. His recent research has focused on mortgage finance reform and the determinants of mortgage foreclosure and personal bankruptcy. He has analyzed the economic impact of various tax and government spending policies and assessed the appropriate monetary policy response to bubbles in asset markets.

A trusted adviser to policymakers and an influential source of economic analysis for businesses, journalists and the public, Dr. Zandi frequently testifies before Congress on topics including the economic outlook, the nation's daunting fiscal challenges, the merits of fiscal stimulus, financial regulatory reform, and foreclosure mitigation.

Dr. Zandi conducts regular briefings on the economy for corporate boards, trade associations and policymakers at all levels. He is on the board of directors of MGIC, the nation's largest private mortgage insurance company, and The Reinvestment Fund, a large CDFI that makes investments in disadvantaged neighborhoods. He is often quoted in national and global publications and interviewed by major news media outlets, and is a frequent guest on CNBC, NPR, Meet the Press, CNN, and various other national networks and news programs.

Dr. Zandi is the author of *Paying the Price: Ending the Great Recession and Beginning a New American Century*, which provides an assessment of the monetary and fiscal policy response to the Great Recession. His other book, *Financial Shock: A 360º Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis*, is described by the New York Times as the "clearest guide" to the financial crisis.

Dr. Zandi earned his BS from the Wharton School at the University of Pennsylvania and his PhD at the University of Pennsylvania. He lives with his wife and three children in the suburbs of Philadelphia.

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