

POLICY BRIEF 2013-05

Loans for Educational Opportunity:  
 Making Borrowing Work for Today's Students

OCTOBER 2013



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# Loans for Educational Opportunity: Making Borrowing Work for Today's Students

Borrowing for college has risen steadily for decades and student-loan debt has mounted to \$1 trillion, now surpassing credit cards as the third-largest form of consumer debt. With 7 million student loans in default and rising tuition prices, some are beginning to wonder if the costs associated with student borrowing are out of line with the value of attending college.

The evidence, however, does not support this popular narrative of overwhelming student debt exceeding the value of an education. Sixty-nine percent of students in recent cohorts borrow \$10,000 or less, and 98 percent borrow \$50,000 or less. In contrast, the typical holder of a bachelor's degree earns several hundred thousand dollars more than a high school graduate over a lifetime. Even those who start college but do not graduate experience lifetime gains of about \$100,000. This suggests that most students have not borrowed more than their education is worth.

Still, the recent spike in student-loan defaults to 21 percent is worrisome. Surprisingly, defaults are not driven by the small fraction of borrowers with large loans. Rather, it is borrowers with typical levels of student debt who struggle with their payments, especially in the first few years after college. Undergraduate borrowers who default have loans no larger than those who pay without incident. While the size of the loan does not predict default, the age of the borrower does: younger borrowers are at far greater risk of default and delinquency.

These four facts—moderate debt for the typical student borrower, the high payoff of college, high rates of default on typical loans, and higher rates of default among young borrowers—suggest we have a repayment crisis, not a student debt crisis.

Many individuals are having difficulty repaying loans because, under the existing system of federal lending, workers typically repay their loans early in their careers, when their incomes are relatively low and variable. A few missed payments, as penalties and fees accrue, can lead to rapidly rising loan balances. The damaged credit records that result from a few missed student loan payments can block young people from borrowing for other purposes, such as for cars and homes. Thus, the current system can turn reasonable levels of debt into repayment burdens that make financial independence and stability more difficult to achieve. Moreover, the current system harms taxpayers because, when delinquency and default rates on loans are high, the lender also suffers.

In a new Hamilton Project discussion paper, Susan Dynarski and Daniel Kreisman of the University of Michigan propose a new system of federal student lending based on an income-

based model of repayment in which payments will automatically rise and fall with a borrower's earnings, just as contributions to Social Security do. Instead of paying off loans during a fixed, ten-year period, payments will continue until the loan (principal plus interest) is paid off, for a maximum of twenty-five years. This approach is likely to be less costly for the federal government than the current student-loan system because it will reduce defaults (and thus the amount of lending that the federal government must write off) and cut the cost of loan servicing, which is currently contracted out.

This is a system of loan repayment designed for the vast majority of former students—the 98 percent who borrow a manageable amount (\$50,000 or less). For the few students who borrow unmanageable amounts, most of whom borrow through the private market, Dynarski and Kreisman propose tighter regulation of private lenders.

## The Challenge

It is more important than ever that student-loan policy be designed to help students and potential students attend and complete college. Over the past thirty years, the United States has fallen from having the second-most college graduates in the world as a share of population to having the fifteenth-most graduates. Not just for society in general, but for individuals, too, the importance of a college degree is growing. Today, a college education is largely a prerequisite for high-earnings occupations that exist in an increasingly competitive global labor market.

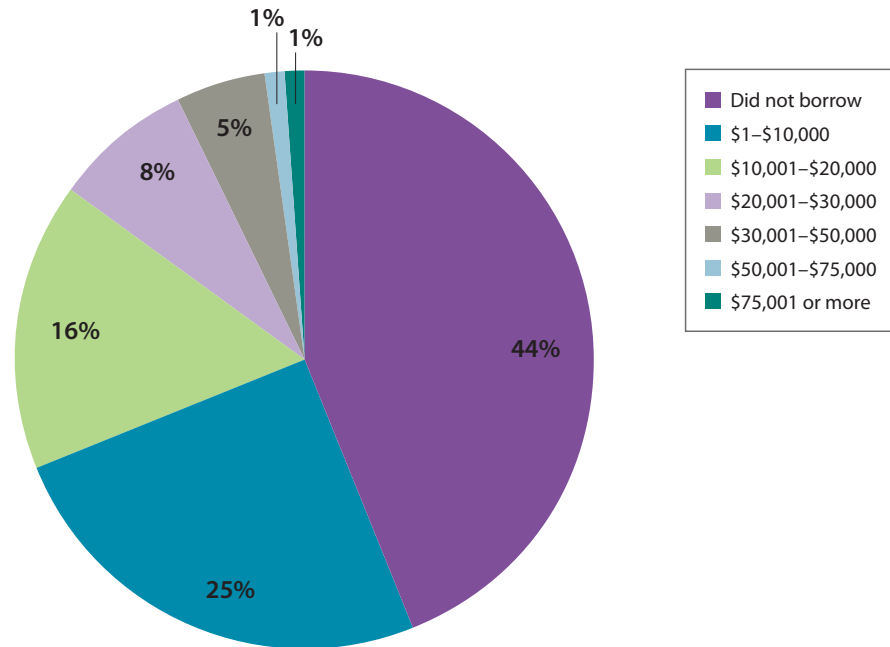
Total annual student borrowing more than doubled between 2001 and 2011, from \$55.7 billion to \$113.4 billion. Part of this increase in borrowing reflects the fact that more students are going to college and, therefore, taking out more loans. But the rise in the college population cannot fully explain the increase in borrowing for college, because per student borrowing also rose 54 percent over the same period. Nor can rising college costs explain this new borrowing trend. While published tuition has been rising sharply for years, net tuition—the average price students actually pay to attend college after taking into account financial aid and scholarships—has been relatively flat, increasing over the past decade by only \$320 at private universities and \$1,160 at public universities.

What *has* changed is that families increasingly use loans to pay for college. In 1990 the average loan per student was about \$2,000, but now it is around \$5,000. Where families once borrowed only 20 percent to finance tuition, they now borrow nearly 50 percent.

Despite these increases in borrowing, the vast majority of students still borrow modest amounts. As figure 1 shows, in 2009, 69 percent of undergraduates borrowed \$10,000 or less, and another 29 percent borrowed between \$10,001 and \$50,000. Even though attention is focused on borrowers with high loan balances, most defaults occur on much smaller loans. In fact, the average loan in default is about \$14,000, while the average loan not in default is \$22,000. Furthermore, the data indicate that many students experience temporary rough patches but do

FIGURE 1.

## The Real Numbers Behind Student Borrowing



Source: College Board. 2012. *Trends in Student Aid 2012*.

Note: Data come from the 2009 Beginning Postsecondary Students Longitudinal Study for students first enrolling in fall 2003.

not default: the delinquency rate (being behind on payments for 60 to 120 days) is much higher than the default rate. Most of these delinquent borrowers eventually manage to repay, but end up with damaged credit histories.

Under the current system, the primary reason that so many borrowers are having difficulty paying back their student loans is that the standard repayment period is restricted to the first ten years of borrowers' careers when their incomes are far more likely to be low and volatile. A college education, however, is an investment that pays off over many decades. The typical college graduate earns several hundred thousand dollars more than a high school graduate, but those earnings manifest over many years or even over a lifetime. For most types of borrowing, the life of a loan matches the life of the collateral, but the relatively short repayment period of a student loan does not match the lifetime of increased earnings. The mismatch between the timing of the costs and benefits of education is especially salient among young borrowers, who are most likely to default. Of borrowers under twenty-one, for example, 28 percent default on their loan.

The current system of borrowing and repaying student loans was devised at a time when students did not borrow to pay for as much of their college costs as they do now. Dynarski and Kreisman argue that the federal student lending system is outdated, and that it was not designed for the debt load and earnings profiles of today's borrowers.

## A New Approach

Dynarski and Kreisman propose replacing the current array of federal student-loan repayment options with a single, simple,

income-based repayment system called Loans for Educational Opportunity (LEO). Payments will be spread out beyond the typically low-earning early years so that young workers are not hit with large payments when they are least prepared to handle them. To address the small percentage of students with high levels of debt, Dynarski and Kreisman propose reforms to the private-loan market.

## Income-Based Repayment with Loans for Educational Opportunity

The key principles of this proposal are that the repayment of loans will be automatic and simple, and that repayments will increase (and decline) with earnings. Just as Social Security allows workers to transfer funds from their productive working years to their older, retired selves, LEO will allow workers to transfer funds from their productive working years to their younger, student selves. Employers will deduct contributions in the same way that they deduct payroll taxes. The W-4 will be modified to include a checkbox that asks whether a worker has a LEO. Borrowers can also indicate a higher repayment amount than the one that would otherwise be automatically deducted by filing a W-4 that specifies additional withholding. Self-employment and multiple jobs will be handled in the same way as they are for Social Security and income taxes, with quarterly payments and an annual reconciliation in April to correct any over- or underpayment. Contributions will stop when the loan is repaid or after twenty-five years.

The authors point to the Social Security Administration (SSA) as a good model for how LEO should be administered, since SSA serves a similar function in collecting and tabulating Social



Security contributions. SSA manages the Social Security system at very low cost, tracks contributions made through the payroll system, receives payments from employers, shares data with the IRS to monitor compliance, and provides timely and helpful communication with workers and beneficiaries. Since LEO would replace the current federal student-loan program, the U.S. Department of Education could instead have responsibility for the administration of LEO. Policymakers would decide which agency is best suited to handle this new student-loan program.

### ***Contribution rates will rise with earnings.***

The authors propose a progressive system of loan payments that rise with earnings. Specifically, they show that setting rates at 3 percent of earnings up to \$10,000, 7 percent between \$10,001 and \$25,000, and 10 percent above \$25,001 would result in the typical loan being paid off in ten to fifteen years, with some loans paid much more quickly. A flat contribution rate of 6 to 9 percent of earnings would achieve similar results.

Policymakers can adjust the specific parameters of this system to achieve alternative goals. Indeed, there are many contribution schedules that will work, with the choices affecting the length of payment, the level of payments, and the share of loans forgiven. A lower contribution rate leads to a lower monthly payment; a longer payment horizon, more interest paid by the borrower and more loans forgiven after twenty-five years. Higher contribution rates have the opposite effects.

### ***Interest rates should hold the taxpayers harmless.***

Dynarski and Kreisman argue that the federal government should seek neither to make nor to lose money from student loans. They assert that student loans correct a capital market failure: the private sector will not provide loans that are secured only by a borrower's future earnings. Therefore, student loans solve a liquidity problem, not a pricing problem.

Under the proposed income-based repayment system, interest rates would be set so as to hold taxpayers harmless for the costs of making student loans. These costs consist of the cost of borrowing, credit risk from unpaid loans, and administrative overhead. To keep loan rates closely tied to borrowing costs (which vary over the business cycle), the authors propose an interest rate that adjusts annually over the life of the loan and is not nominally capped. Specifically, they propose using a loan rate pegged to Treasury rates, plus a fixed markup to compensate for credit risk and the costs of administration.

### ***Eliminate in-school interest subsidies.***

The subsidized Stafford loan, which is limited to students with sufficient financial need, does not begin to charge interest until the students are out of school. This is expensive for the government and has little bearing on either college attendance or persistence because it does not put any money into the hands of students. Instead, these interest subsidies reduce monthly payments after borrowers enter the workforce.

Dynarski and Kreisman propose eliminating subsidized Stafford loans and other specialized loan programs, which

## Roadmap

- The current, complicated federal loan system will be replaced by an income-based repayment schedule called Loans for Educational Opportunity (LEO).
- A board analogous to the Social Security Advisory Board will be created to administer LEO. This board will call on outside academic expertise to undertake the analyses and projections needed to keep the program running efficiently. This board could be housed within the U.S. Department of Education, or elsewhere at policymakers' discretion.
- The Department of Education will purchase federal loans now held by private loan companies to allow existing borrowers to shift to the new system.
- Student loan rates will be pegged to a variable interest rate that adjusts during the life of the loan.
- The federal government will increase regulation of private loans by taking the following steps to protect borrowers:
  - Repealing protections for private lenders that allow private student loans to survive bankruptcy.
  - Forbidding any loans that require a credit check or cosigner to be labeled as student loans.
  - Requiring that financial aid offices certify a student's need before she can take out a private loan. This step would prevent students from taking out a private loan when federal loans are still available to her.
- To offset the costs associated with the proposal, the federal government can take the following steps:
  - Stop paying loan servicers to collect loans, thereby reducing government expenditures by about \$360 million per year.
  - Eliminate the federal deduction for student loan interest, which will save another \$1 billion annually.
  - Eliminate the in-school interest subsidy. The billions used on this subsidy will instead be used as grant aid.

together make up over one-third of all student loans. Under LEO there would be no relationship between the interest charged and the payments students make when they enter the labor market. Deferring interest accrual while students attend school would serve only to shorten the repayment period for those who receive it—from, for example, fifteen years to twelve years. This early cessation of payments would equally benefit borrowers with very high incomes and those with typical incomes. In-school interest subsidies would not benefit those with the lowest incomes, since their balances would be forgiven after twenty-five years.

### ***Allow existing borrowers to join the new system.***

Certain borrowers under the old federal loan system will have the opportunity to convert their loans to the new system. Only

## Learn More about This Proposal

This policy brief is based on The Hamilton Project discussion paper, “Loans for Educational Opportunity: Making Borrowing Work for Today’s Students,” which was authored by:

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federal, undergraduate loans can be repaid in this way; loans made to parents of students will not be eligible. This includes Federal Family Education Loans, which are private, and loans from the Department of Education’s Direct Loan Program, which are public. Existing borrowers can be brought into the new system by having the Department of Education purchase existing loans from the private loan companies. There is a precedent for this: during the credit crunch, the Department of Education was authorized to buy loans from private servicers in order to free up capital so that more student loans could be made.

### Reforming the Private Sector’s Role in Student Loans

Despite the fact that the vast majority of students borrow little or moderate amounts, a small percentage take on very high levels of student debt. Some of these students repay without incident, but others struggle with these large debt burdens. The system currently has protections in place for private lenders but not for students—who may be young, first-time borrowers—or their families, many of whom lack financial sophistication. To protect students and their families from taking on too much debt, and to ensure that individuals are properly informed of their options in repaying their loans, the authors propose three specific reforms to private student lending.

First, private loans should not survive bankruptcy. This unprecedented level of protection to private lenders, which was established only in 2005, should be repealed. The protection from bankruptcy gives lenders incentives to make loans even to students who are unlikely to be able to handle the payments, since the lender knows the borrower cannot ever escape the debt.

Second, private lenders should not be allowed to use the label “student loan” for a loan that requires a cosigner or credit history. True student loans are secured only by the future earnings stream of the student. The lender’s willingness to make such a loan is limited by the potential earnings of the student borrower. If a parent or other relative wants to help a student attend a college by borrowing against her own credit, she is free to do so. But the borrower—and the student—should recognize this loan for what it is: a consumer loan. Removing the student

loan label ensures that borrowers cannot confuse them with federal student loans and signals to students that they should borrow with caution.

Third, students must exhaust federal lending options before taking out private loans. For example, there is evidence that students take out private loans without exhausting their Stafford loan options, which reflects a lack of information on the part of the borrowers, because Stafford loans are less costly than private loans. Simply requiring that colleges certify a student’s need before she can take out a private loan is a good step, but may be insufficient to rein in borrowing at for-profit colleges, where the share of students taking out private loans is three times as high as among students at nonprofit colleges.

### Budgetary Impacts of this Proposal

This proposal can be implemented without adding to the federal deficit; in fact, it will likely save money for the federal government. The only major costs that the government would bear are those associated with administering repayment of the loans, which is currently handled by the private sector. These costs, however, can be more than offset by three provisions of this proposal. First, the federal deduction of loan interest would be eliminated for federal borrowers paying through the new system (which, in time, should be all student borrowers), saving \$1 billion in tax expenditures. Second, the proposal eliminates the contracts with private loan servicers, which currently cost about \$360 million annually. Finally, as discussed above, the proposal eliminates the in-school subsidy, which will reduce by billions the cost of the federal loan program.

## Conclusion

Contrary to the popular narrative, evidence suggests that we are faced not with a student debt crisis, but rather with a repayment crisis. By compressing repayment into early careers, when earnings are lowest and most variable, the current system can turn reasonable levels of debt into payment burdens that are difficult to manage.

Dynarski and Kreisman propose a new approach to federal student lending, replacing the current loan system with an income-based repayment system in which payments automatically rise and fall with a borrower’s earnings and are automatically deducted from paychecks, just like Social Security contributions. This proposal is based on the premise that student-loan policy should be designed for the 98 percent of students who borrow a manageable amount. Dynarski and Kreisman also propose better consumer protection in the private loan market, where most individuals with very high and unmanageable levels of debt borrow.

Student loans need to work for today’s borrowers both when they are in school and after they enter the labor market. This proposal allows borrowers the time and flexibility they need to repay their loans without jeopardizing their financial stability, credit, or job opportunities. At the same time, it protects taxpayers from having to bear additional costs for the needless defaults and subsidized interest rates, both features of a program in need of reform.

# Questions and Concerns

## 1. What about graduate students?

This proposal is limited to undergraduate loans because there is less of a repayment problem among graduate students. Even though graduate students' loan balances are much higher, their default rate is only 3 percent, much lower than the 21 percent among undergraduates.

This proposal will help those with graduate loans by making the payment of their undergraduate loans more manageable. Down the road, federal graduate loans could be integrated into this proposal, but further analysis would be necessary to estimate the appropriate contribution rates for graduate student-loan repayment.

## 2. Have similar proposals been tried elsewhere?

Yes. There are income-contingent loan programs in many countries, including Australia, Chile, New Zealand, Thailand, and the United Kingdom, with generally favorable results. In the United Kingdom, for instance, borrowers contribute 9 percent of any income that exceeds £21,000 (roughly \$34,000); any remaining student-loan balance is forgiven after thirty years. These countries can be useful models as policymakers explore switching to an income-based repayment schedule. The State of Oregon is currently considering adopting a similar repayment schedule called a graduate tax. With a graduate tax, the student's obligation is not denominated in dollars but rather as a percentage of income and number of years. In such a scheme, students with high earnings pay back much more than they borrow.

## 3. What about PLUS Loans?

PLUS loans—loans to the parents of college students—currently constitute about 10 percent of student loan volume. These loans are extended based on the creditworthiness of the parent, not on the potential benefit of college to the student. Loans taken out by parents will not be paid through the payroll system. The system we propose is a means for young people to access their future earnings.

Labeling loans to parents as student loans (and setting high borrowing limits) signals to students and parents that taking out large loans for college is a reasonable investment. The authors suggest that the federal government get out of the business of making loans to parents. Comparable products exist in the private sector. Labeling them as federal aid is not warranted and may in fact make it easier for families to borrow more than they can afford.

## 4. What about nonworkers?

The proposed withholding system collects loan payments from borrowers with earnings. Some will not work for pay after college, including those who step out of the labor force to raise children. Lacking earnings, these borrowers fall outside the traditional withholding system.

The authors propose a number of solutions. For borrowers with a nonworking spouse who also borrowed for college, the W-4 form will allow for withholding for both the worker and the spouse. This allows couples to have their payments withheld automatically, without additional paperwork. The same percentage of earnings will be withheld as would be for a single borrower, but payments will continue until both loans are repaid.

In the case of borrowers with no labor earnings and no working spouse and therefore no W-4 form or withholding, the administrator will send bills based on the current, standard, ten-year payment. Borrowers can either pay the bill or file for deferment (reduction in payments) by demonstrating financial distress. When requesting deferment, the borrower would authorize the administrator to verify income periodically with data retrieved from the IRS. Any underpayments will be reconciled via annual income tax returns.

## 5. Don't we already have income-based repayment plans?

Yes, but they're broken. In order to be eligible for one of these plans, borrowers must prove financial hardship by filing complicated and tedious forms every year they want to enter this phase of repayment. Moreover, these payments are then capped at what borrowers would pay under a ten-year mortgage-type plan, meaning that while these options help those with very low earnings, they do nothing to help middle earners move payments to their more-productive years, and do not require the highest earners to pay more when they can.

## Highlights

In a new Hamilton Project discussion paper, Susan Dynarski and Daniel Kreisman of the University of Michigan propose the creation of a new, income-based system of student-loan repayment to replace current federal loan programs. In this increasingly competitive global labor market, it is more important than ever that student-loan policy be designed to help make a college education accessible to all students.

## The Proposal

**Replace the current student-loan system with an income-based repayment system.** A single, simple, income-based repayment system, Loans for Educational Opportunity (LEO), will replace the current complicated federal loan system. Employers will withhold a fixed percentage from individuals' paychecks, and payments will be spread out beyond the low-earning early years so that young workers are not hit with large payments when they can least handle them. Instead of paying off loans during a fixed, ten-year period, borrowers will have up to twenty-five years to repay, although most borrowers will repay in about ten years, as is the case now.

Following the model of Social Security, the proposal creates a board that calls on outside academic expertise to undertake the analyses and projections necessary to administer LEO. Additionally, the U.S. Department of Education will purchase federal loans now held by private loan companies to allow existing borrowers to shift to the new system, and student-loan rates will be pegged to a variable interest rate that adjusts during the life of the loan.

**Eliminate private servicing of loans and regulate private loans more tightly.** Currently there are protections in the student-loan system for lenders, but not enough protections for borrowers. To protect students and their families from taking on too much debt and to ensure that individuals are properly informed of their options in repaying their loans, the authors propose a number of changes to how private lenders operate: private student loans should not survive bankruptcy, loans that need a credit check will not be marketed as student loans, and individuals must exhaust all federal student loans before being allowed to take out any private loans.

## Benefits

By compressing repayment during the first ten years of borrowers' careers, when earnings are lowest and most variable, the current system turns reasonable levels of debt into payment burdens that are difficult to manage. This proposal will make it easier for borrowers to pay back their student loans by linking workers' repayments to their earnings, thereby lengthening the repayment period for individuals with lower incomes who would otherwise struggle to make their payments. The proposal also suggests ways to improve consumer protection for the relatively few individuals who take out large, private student loans. This proposal will likely save taxpayers' money because it will reduce defaults and cut the cost of loan servicing, which is currently contracted out to private loan companies. Further savings will come from eliminating the student-loan interest deduction and the in-school interest subsidy. Finally, this proposal allows borrowers the time and flexibility they need to repay their loans without jeopardizing their financial stability, credit, or job opportunities.



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