How to Alleviate Issues in Student Lending for Graduate Students

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Overview of proposal:

The problems with student loans for graduate students are not inevitable, and the sections that follow recommend a series of reforms that have the potential to significantly alleviate them. The proposed reforms include establishing loan limits by academic field and credential based on the typical earnings of graduates, expanding Pell grant eligibility to graduate students, requiring colleges to cosign the loans of their graduate students, imposing an accountability system based on repayment rates, and dramatically expanding the quantity and quality of information about graduate programs to allow for more informed consumer choice and better targeted accountability systems.

Pillar One: Set Reasonable Loan Limits

When there are no limits on borrowing, borrowers and taxpayers are exposed to unnecessary danger. For borrowers, the lack of limits means it is too easy to overborrow, like the dentist who owed over a million dollars in student loans.[1] For taxpayers, the lack of limits enables colleges to raise prices to harvest student loan funding, a phenomenon referred to as the Bennett Hypothesis.[2] Recent research has shown that "the creation of Grad PLUS led to significantly higher program prices" with net prices increasing "by $0.64 per $1 increase in per-student federal borrowing."[3] In other words, colleges appear to have captured almost two-thirds of the benefits of Grad PLUS lending in the form of higher prices.

Most of these problems for borrowers and taxpayers could be dramatically curtailed by imposing limits on how much can be borrowed. In fact, we already do this for undergraduate and graduate Stafford loans. It is time to set reasonable limits for Grad PLUS loans as well.

When setting limits, we should keep in mind that because earnings potential varies so much by academic field and credential, so too does the amount of debt that can reasonably be repaid. A future medical doctor has a much higher earning potential than a graduate with a master's degree in social work, and therefore can safely take on much more debt. To account for different potential earnings, loan limits should be set by academic field and credential based on the typical earnings of graduates.

When setting limits by academic field and credential, there are a few options. The first relies on a rule of thumb from the personal finance arena which advises that students shouldn't borrow more than their expected starting salary. This would imply that there should be a cumulative debt limit equal to the field's starting salary and an annual limit which divides that by the typical time to degree. Note that this should account for the existing Stafford loan limits ($20,500 per year and $138,500 cumulative, including undergraduate loans). Given the already high Stafford loan limit, Grad PLUS would be restricted to high earning fields like medicine. This also implies that the Stafford loan limits for graduate students should be reduced in many cases.

A second option would be to rely on metrics of affordable debt to identify cutoffs for reasonable debt. For example, the various versions of the gainful employment regulations have established several cutoffs based on annual loan repayments as a percent of earnings. Using the gainful employment formula in reverse would allow us to determine a debt limit based on the earnings of recent graduates. And this could even be done at the individual program level.

Pillar Two: Award Grant Aid to Students and Institutions to Address Equity and Social Good Considerations

Once the first pillar is implemented, there will be some students at some programs at some colleges where borrowers will not be able to borrow as much as recent cohorts. Should additional funds be provided to offset this reduction in available borrowing?

There is little reason to provide additional funding for the affected colleges. The restrictions on lending are designed to prevent unaffordable debt, so rewarding colleges that were previously leaving their students with unaffordable debt would have perverse incentives. Moreover, the most affected sector would be private nonprofit colleges since they currently account for 68% of all Grad PLUS lending (while enrolling only 45% of graduate students).[4] Providing sustained federal funding directly to such colleges would start us down the (undesirable) path towards converting them into public colleges.

What about additional funding for academic fields that are disproportionately affected? Many argue that for some fields, earnings do not adequately account for the social value created by graduates. Since this line of argument basically boils down to the argument that some professions are underpaid, the best solution would be to pay people in that profession more. If that is not feasible, then tax credits (for everyone in the profession, not just current or recent students) would be the next best option. Some have argued for grants for students majoring in certain fields. But such grants would suffer from imprecise targeting and leakage. By only providing grants to students in particular fields, all the alternative routes into that profession would be shunned. At the same time, students in the targeted field that did not graduate or that entered a different profession would siphon funding away from the intended use.

But while compensating colleges and academic fields for a loss of funding should not be supported, there is a reasonable case to be made for additional funding for some affected students. Pell grants are provided to undergraduate students that grew up relatively poor, with a goal of promoting equality of opportunity. While graduate students are not eligible for Pell grants, there is no insurmountable distinction between undergraduate and graduate education to justify the different treatment. The main problem is identifying needy graduate students. Since graduate students are automatically classified as independent, only their own income matters (ignoring their parents' income) for aid eligibility determination, which means that most graduate students would qualify for need based aid, even if they are from well-to-do families. Amending the dependent/independent determinants (e.g., increasing the age cutoff, currently 24, and dropping the automatic treatment of graduate students as independent, etc.) would allow for the existing aid process to distinguish needy from non-needy graduate students, at which point Pell grant eligibility could be extended for those in graduate school.

Pillar Three: Ensure Sufficient Value and Return on Investment for Students and Taxpayers

The best way to ensure that students benefit from a valuable education is to harness their rational self-interest and ensure that they have the necessary information to make informed choices. If the reforms discussed in pillars one and five are implemented, this would go a long way to making sure students are not forced to make choices without adequate information about the costs and benefits. After ensuring that students have enough information to make informed choices, public policy should usually avoid intervening to address seemingly poor returns for students, because the student is best positioned to determine if the education is worth it to them for other reasons. For example, a theology program may not have a good financial return for students, but students may choose it anyway if they prioritize spiritual returns more highly than financial returns. Intervention could be justified if there is evidence that students are consistently making choices that lead to unexpected outcomes.

But a heavy hand is warranted to ensure that taxpayers get sufficient value from the college education they finance. The main problem occurs when colleges benefit from providing an education that leaves students and taxpayers worse off. For example, a student could enroll in a college using student loans, but then fail to pay back those loans. This would impose a significant loss on taxpayers and the student in the form of lowered credit scores and garnished wages. But the college still benefits, because it gets to keep all the tuition money that was paid using the loans. This misalignment of incentives means that colleges can profit from offering an "education" that fleeces taxpayers and students.

There are two solutions to this problem.

First, ensure the colleges' incentives align with the taxpayers' by making sure that colleges only benefit from providing a taxpayer financed education if taxpayers do too. The best way of accomplishing this realignment would be to have colleges cosign loans. As a cosigner, colleges would be on the hook for any payments that a student failed to make. Many of the objections to this policy at the undergraduate level are not as relevant at the graduate level. For example, while a community college may lack the resources to take on their students' loans while maintaining their open-access mission, most graduate education is concentrated at private nonprofit or top tier public colleges that screen applicants and have significant financial resources, including large endowments.

A second potential solution would be to implement an accountability system. Since the main losses to taxpayers from graduate students arises from unpaid student loans, the most sensible solution would be to establish repayment rate cutoffs where college programs would lose access to the student loan programs if their students' repayment rates fall below these cutoffs.

Pillar Four: Enhance the Regulatory Structure and Consumer Protections for Private Lending

Private lending has a number of advantages over government-as-lender, including 1) less malinvestment (the government has continued to make unprofitable investments year after year whereas private lenders would not), 2) greater accountability for colleges (private lenders will cut off financing for poorly performing colleges), 3) better incentives for students (hard working and high achieving students will be rewarded with better loan terms), 4) better incentives for colleges (colleges that improve in quality will see better loan terms for their students), and 5) more informed decision-making (differential pricing by college and program conveys useful information about the riskiness of choices).

There are also strong reasons to prefer income contingent repayment systems over the more traditional fixed payment method (e.g., payments of 10% of income rather than $300 a month). For example, income contingent repayment systems allow for flexible repayment (which helps avoid defaults due to liquidity rather than solvency issues) and facilitates consumption smoothing.

Thus, private, income-contingent lending would be an excellent loan system. Unfortunately, legal and regulatory hurdles are hobbling the field. Two changes are needed. First, private income-contingent loans need firmer legal foundations to be enforceable. Analysts note that "there is doubt about whether [income contingent contracts] would be enforceable in twelve states … or about whether they would be enforceable if the student declared herself bankrupt."[5] And regulators have been harassing income share agreement providers, which use a similar repayment structure.[6] Establishing firmer legal foundations for income contingent lending (and income share agreements too for that matter) would allow private income contingent lending to expand.

The second necessary change is to streamline the legal process in the event of nonpayment. Currently, a lender would first need to sue the student in court, and only after winning a costly legal battle could the lender begin garnishing wages. Creating a streamlined process would expand the number of borrowers and lenders that could mutually benefit from lending.

Pillar Five: Improve Data Disclosure and Transparency

Improved data disclosure and transparency will achieve two important goals: providing consumer information and enabling accountability systems.

To improve consumer information, the Department of Education's College Navigator and College Scorecard should be expanded to provide more accurate information to students and parents to help them make more informed decisions. The key pieces of information that should be added include program level data on:

- **Admissions:** How many students applied, how many were accepted, and the distribution of test scores of admitted students (for required tests).
- **Completion:** The percent of students who start the program that complete it broken down by entering qualifications (e.g., any required tests, undergraduate selectivity, etc.).
- **Cost:** Cost of attendance, room and board, tuition, and the net version of each.
- **Aid:** Grant and loan sources and amounts (aggregate total, per recipients, and per student).
- **Employment:** Unemployment rate and the most common jobs for recent graduates.
- **Earnings:** Expand the reporting on earnings of recent graduates. Include return on investment figures where possible.

Accountability systems can make use of much of the information provided for consumers but would benefit from additional information as well. For example, the repayment rate accountability system suggested in pillar three could use the Department of Education's National Student Loan Data System (NSLDS), which contains all the information needed to calculate these repayment rates. Utilizing the NSLDS to determine program level borrowing (aggregate and average amounts) and repayment metrics would enable the Department to determine which programs are consistently costing the taxpayer money in the form of unrepaid loans.

Notes

[1] Josh Mitchell, "Mike Meru Has $1 Million in Student Loans. How Did That Happen?," Wall Street Journal, May 25, 2018, https://www.wsj.com/articles/mike-meru-has-1-million-in-student-loans-how-did-that-happen-1527252975.

[2] Andrew Gillen, "Introducing Bennett Hypothesis 2.0", Center for College Affordability and Productivity, February 2012, https://files.eric.ed.gov/fulltext/ED536151.pdf

[3] Sandra E. Black, Lesley J. Turner, and Jeffrey T. Denning, "PLUS or Minus? The Effect of Graduate School Loans on Access, Attainment, and Prices," NBER Working Paper No. 31291, May 2023, https://www.nber.org/papers/w31291.

[4] Jennifer Ma, Matea Pender, and Meghan Oster, "Trends in College Pricing and Student Aid 2024", College Board, 2024, https://research.collegeboard.org/media/pdf/Trends-in-College-Pricing-and-Student-Aid-2024-ADA.pdf.

[5] Miguel Palacios, "Financing human capital through income-contingent agreements."

[6] Alexis Gravely, "Federal Agency Acts Against Income-Share Agreement Lender," Inside Higher Ed, September 7, 2021, https://www.insidehighered.com/quicktakes/2021/09/08/federal-agency-acts-against-income-share-agreement-lender.