

ARTICLES

Redesigning Education Finance: How Student Loans Outgrew the “Debt” Paradigm

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This Article argues that the student loan crisis is due not to the scale of student loan debt, but to the federal education finance system’s failure to utilize its existing mechanisms for progressive, income-based payments and debt cancellation. These mechanisms can make investment in higher education affordable to both individuals and the government, but they have not been fully utilized because of the mismatch between the current system’s economic reality and its legal, financial, and institutional apparatus.

The current economic structure of federal student loans does not resemble a true credit product, but a government grant program coupled with a progressive, income-based tax on recipients. For example, federal direct loans do not require the full repayment of all principal and accrued interest. Instead, borrowers have the contractual right to satisfy their obligations by paying only a percentage of their income for a fixed period of time. Debt forgiveness is contractually baked into the federal student loan product.

The education finance system, however, still relies on a legal, financial, and institutional apparatus based on “debt,” developed under the pre-2010 system, which was based on private loans backed by federal government guarantees, rather than the post-2010 system of direct federal lending with income-driven repayment. The frictions between the legacy legal, financial, and institutional “debt” apparatus and the economic reality of subsidized finance; progressive, income-driven repayment; and debt forgiveness are the source of nearly all of the problems in education finance, including high levels of default, abusive servicing, and even the very idea of a student debt crisis.

It’s time to call federal student loans what they really are—a tuition grant plus an income surtax on students. To this end, this Article proposes a set of targeted reforms: automatic income-based payments using a graduated rate schedule; collection through the tax withholding and return filing; and replacement of interest accrual with an inflation adjustment. Moving toward a grant-and-tax framework would facilitate

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substantial reforms to the financing of higher education and help ensure that instead of being a debt trap, federal financing facilitates affordable higher education.

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INTRODUCTION

We live in an age of student debt. Americans owe over \$1.5 trillion in student loan debt, making it the second largest category of consumer debt behind home mortgages.¹ This debt is held by 45 million people,² roughly fourteen percent of the population,³ with over half of it owed by consumers under age forty.⁴ As a result, carrying student loan debt is increasingly a baseline fact of life for young people and for our economic and financial system more broadly.

For many borrowers, student debt is a source of real pain and distress. Over 9 million borrowers are in default on their loans,⁵ meaning that they have not made regular loan payments for nearly a year.⁶ Borrowers in default can face severe financial consequences, such as capitalized interest that causes loan principal to balloon and loss of eligibility for deferment, consolidation, and most income-driven repayment plans.⁷ Bankruptcy relief is often unavailable for these

1. FED. RESERVE BANK OF N.Y., QUARTERLY REPORT ON HOUSEHOLD DEBT AND CREDIT: 2019: Q3, at 1, 3 (2019), https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/hhdc_2019q3.pdf [<https://perma.cc/8NVK-93ZF>].

2. See FED. RESERVE BANK OF N.Y., 2018 STUDENT LOAN UPDATE (2018), https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/xls/sl_update_2018.xlsx [<https://perma.cc/XZD5-LG34>] (showing that 44.7 million people had outstanding student loans in 2017 Q4).

3. See *id.*; U.S. CENSUS BUREAU, ANNUAL ESTIMATES OF THE RESIDENT POPULATION BY SINGLE YEAR OF AGE AND SEX FOR THE UNITED STATES: APRIL 1, 2010 TO JULY 1, 2019, at 1 (2020), <https://www2.census.gov/programs-surveys/popest/tables/2010-2019/national/asrh/nc-est2019-syasexn.xlsx> [<https://perma.cc/6YCE-EXZM>].

4. See FED. RESERVE BANK OF N.Y., QUARTERLY REPORT ON HOUSEHOLD DEBT AND CREDIT: MAY 2020, at 21 (2020), https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/xls/HHD_C_Report_2020Q1.xlsx [<https://perma.cc/YS7V-A4SL>]. In contrast, the population under forty has less than a quarter of mortgage and credit card debt and only a third of auto loan debt. See *id.* Eighteen to forty-year-olds were thirty-one percent of the total U.S. population in 2019. See U.S. CENSUS BUREAU, *supra* note 3.

5. See OFFICE OF FED. STUDENT AID, U.S. DEP'T OF EDUC., DIRECT LOAN PORTFOLIO BY LOAN STATUS (2020), <https://studentaid.gov/sites/default/files/fsawg/datacenter/library/PortfolioByLoanStatus.xls> [<https://perma.cc/T7UA-7WJF>] (combining the “Cumulative in Default” figures for Direct Loans and FFEL Loans).

6. Default is defined differently for student loans than for other types of debt. For federal student loans, default means either 270 or 330 days of nonpayment depending on the frequency of installments. 34 C.F.R. § 682.200(b) (2018). For private student loans, 120 days of nonpayment is the typical measure of default. See Cheryl Winokur Munk, *What to Know About Missing a Student-Loan Payment*, WALL ST. J. (Oct. 3, 2019, 4:54 PM), <https://www.wsj.com/articles/what-to-know-about-missing-a-student-loan-payment-11570136084>. These are both substantially longer timelines than for mortgages, credit card, or auto loan debt, where thirty days is the standard measure of delinquency, and where regulatory requirements mandate “charge-offs”—meaning that insured depository institutions cannot carry such loans as assets on their regulatory balance sheets—at 90 days delinquent for mortgages, 120 days delinquent for closed-end loans, and 180 days delinquent for open-end loans. See Uniform Retail Credit Classification and Account Management Policy, 65 Fed. Reg. 36,903, 36,904 (June 12, 2000).

7. See 34 C.F.R. § 685.204(a)(3) (2019) (defaulted loans not eligible for deferment); *id.* § 685.209(a)(ii) (defaulted loans not eligible for Pay As You Earn plans); *id.* § 685.209(c)(ii) (defaulted loans not eligible for Revised Pay As You Earn plans); *id.* § 685.210(b)(1) (defaulted borrowers restricted from changing repayment plans); *id.* § 685.219(c)(1)(i) (defaulted loans not eligible for Public Service Loan Forgiveness); *id.* § 685.220 (defaulted loans typically not eligible for consolidation); *id.* § 685.221(a)(2) (defaulted loans not eligible for income-based repayment plans).

borrowers,⁸ and in some states, defaulted borrowers are further punished through suspension of professional licenses.⁹ Some of these borrowers may be permanently financially crippled.

Not as obviously, increased levels of student loan debt are also harmful to consumers who do *not* have 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 the value of many households' main asset—home equity.¹⁰ Moreover, to the extent that student loan debt impairs borrowers' ability to save for retirement, it threatens to impose a greater burden on public resources.¹¹ The reliance on debt to finance tuition also poses a risk to the viability of the higher education sector as a whole. Student loan debt presents a macroeconomic challenge.

As a result, student debt has also become a first-order political issue. As a presidential candidate in 2016, Senator Bernie Sanders made a tuition-free public college proposal a centerpiece of his campaign.¹² Student loan forgiveness proposals as well as tuition-free education proposals further spread throughout the 2020 Democratic presidential primary, and multiple candidates offered plans for free college, debt-free college, student loan cancellation, and more.¹³

These proposals, as well as many academic¹⁴ and journalistic¹⁵ accounts, present the size and scale of student debt as the primary problem. We disagree. The

8. See Jason Iuliano, *An Empirical Assessment of Student Loan Discharges and the Undue Hardship Standard*, 86 AM. BANKR. L.J. 495, 524–25 (2012).

9. See Andrew Wagner, *The Debate Over Suspending Licenses for Student Loan Defaulters*, 26 NAT'L CONF. ST. LEGISLATURES LEGISBRIEF, no. 40, 2018, at 1.

10. See Jesse Bricker, Lisa J. Dettling, Alice Henriques, Joanne W. Hsu, Lindsay Jacobs, Kevin B. Moore, Sarah Pack, John Sabelhaus, Jeffrey Thompson & Richard A. Windle, Bd. of Governors of the Fed. Reserve Sys., *Changes in U.S. Family Finances from 2013 to 2016: Evidence from the Survey of Consumer Finances*, 103 FED. RES. BULL., no. 3, 2017, at 1, 18. 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.*

11. Indeed, student loan debt weighs down the entire economy. Because student loan debt service reduces consumers' current ability to buy other goods and services, it reduces the total level of real consumption in the economy. Certain types of consumption, most notably of housing, have an economic multiplier effect. Every two home purchases generate a new job. *Jobs Impact of an Existing Home Purchase*, NAT'L ASS'N REALTORS, <https://www.nar.realtor/jobs-impact-of-an-existing-home-purchase> [<https://perma.cc/GJ3Y-GQCV>] (last visited Aug. 5, 2020). In contrast, repayment of a student loan to the government has no economic multiplier effect.

12. See Michael Stratford, *How Bernie Sanders Would Cancel All Student Loan Debt*, POLITICO, (June 24, 2019, 4:49 PM), <https://www.politico.com/story/2019/06/24/bernie-sanders-2020-student-loan-debt-forgiveness-plan-1296863> [<https://perma.cc/Z36K-UVHS>].

13. See, e.g., Carmin Chappell, *Here's How the Democratic Presidential Candidates Plan to Address the Student Debt Crisis*, CNBC: MAKE IT (July 30, 2019, 4:46 PM), <https://www.cnbc.com/2019/07/30/democratic-presidential-candidates-plans-for-addressing-student-debt.html> [<https://perma.cc/ZZP6-CZSL>].

14. See, e.g., William S. Howard, *The Student Loan Crisis and the Race to Princeton Law School*, 7 J.L. ECON. & POL'Y 485, 485–87 (2011); Adam Looney & Constantine Yannelis, *A Crisis in Student Loans? How Changes in the Characteristics of Borrowers and in the Institutions They Attended Contributed to Rising Loan Defaults*, 2015 BROOKINGS PAPERS ON ECON. ACTIVITY 1, 1–2; Roger Roots, *The Student Loan Debt Crisis: A Lesson in Unintended Consequences*, 29 SW. U. L. REV. 501, 501–02 (2000); Eryk J. Wachnik, *The Student Debt Crisis: The Impact of the Obama Administration's "Pay as*

student loan system already has in place mechanisms that allow for progressive, income-based payments and debt cancellation that can make the investment in higher education affordable both to individuals and to the government. If the *existing* features of the student loan system were fully implemented and utilized, there would not be a student debt crisis.¹⁶ The problem is that the income-based repayment and debt-cancellation mechanisms are poorly implemented and substantially underutilized.

The underutilization of these mechanisms highlights that the student loan debt crisis is not primarily about the total amount of student loan debt outstanding. Instead, it is about the failure of the education finance system to deliver on the public policy of affordable—not free—education through federal financial support. We argue that this failure is fundamentally due to the mismatch between the legal and institutional apparatus of student loans and the economic reality of education finance.

Education finance transactions are characterized as *loans*, that is, as *debt obligations* that must be repaid. The “loan” characterization and the infrastructure that has emerged around it reflect the origins of the modern education finance system.¹⁷ The system’s development, particularly since the federal government became the primary direct lender in 2010,¹⁸ has completely divorced the financial fundamentals of student loans from those of typical debt arrangements. As a result, the terms of federal education loans are today vastly different than those for any other kind of debt in the marketplace.

For example, there is no underwriting of student loans—borrowers get the same loan terms regardless of risk factors like major and school, an unheard-of situation for most consumer loans. Likewise, the terms of federal student loans are much more borrower-friendly than those of private loans. Interest accrual can be deferred for substantial periods, and interest often does not compound. And critically, borrowers who use one of the Education Department’s income-driven repayment (IDR) plans are not obligated to pay off a fixed amount as with a

you Earn” Plan on Millions of Current and Former Students, 24 LOY. CONSUMER L. REV. 442, 443 (2012).

15. See, e.g., Patrick B. Healey, *We Should All Be Concerned About the Student Debt Crisis*, CNBC (Nov. 4, 2019, 8:00 AM), <https://www.cnbc.com/2019/11/04/we-should-all-be-concerned-about-the-student-debt-crisis.html> [<https://perma.cc/DM92-ZQGR>]; Hillary Hoffer & Allana Akhtar, *11 Mind-Blowing Facts That Show Just How Dire the Student-Loan Crisis in America Is*, BUS. INSIDER (Oct. 11, 2019, 11:17 AM), <https://www.businessinsider.com/student-loan-debt-crisis-college-cost-mind-blowing-facts-2019-7> [<https://perma.cc/2FAT-AQUT>]; John Thune & Mark Warner, *Americans Are Drowning in \$1.5 Trillion of Student Loan Debt. There’s One Easy Way Congress Could Help*, TIME: IDEAS (Aug. 27, 2019, 2:36 PM), <https://time.com/5662626/student-loans-repayment/> [<https://perma.cc/DT6Z-FYEL>].

16. We mean by this that the individual and aggregate levels of borrowing would not be a crisis. There are still many other problems of equity, access, and affordability in higher education, especially in terms of racial disparities.

17. See Jonathan D. Glater, *Student Debt and the Siren Song of Systemic Risk*, 53 HARV. J. ON LEGIS. 99, 103 (2016) (explaining that the Higher Education Act is built on using credit to promote higher education).

18. See SAFRA Act, Pub. L. No. 111-152, §§ 2201–2213, 124 Stat. 1029, 1074–81 (2010) (enacted as part of the Health Care and Education Reconciliation Act of 2010).

typical loan but are instead obligated to pay only a percentage of their income for a fixed number of years.

The terms of federal education loans are so different because the loans do not reflect the commercial considerations that underlie normal debt products. Instead, they reflect the substantial public policy reasons behind federal education finance and public finance in general. They incorporate ideas of progressivity, insurance, and ability to pay that are more akin to taxation. For loans under IDR in particular, the current economic reality of the system would be more accurately described as a combination of transfer payments or *grants* (the funding leg) and *taxes* (the repayment leg): the government makes an up-front grant to pay tuition, and in return the borrower is subject to an income surtax for a fixed number of years. We refer to this economic reality through the shorthand of *grant-and-tax*.

Yet even though the terms of student loans do not look at all like traditional loans, they are still accompanied by a vast legal and institutional infrastructure based on the “loan” characterization. This infrastructure effectively determines the operation of the education finance system. The frictions between the legal and institutional apparatus of “loans” and the economic reality of a progressive grant-and-tax system generate many of the problems in education finance and are the primary source of the student debt crisis itself.

Abandoning the debt paradigm would undo the disconnect between the lack of front-end underwriting on federal student loans and the optional back-end underwriting in the form of IDR plans. Currently, borrowers take on student loan debt without any consideration of their ability to repay.¹⁹ The federal student loan program then offers generous IDR options that account for a borrower’s ability to repay on the back end and provide for substantial debt forgiveness, but this back-end underwriting is not automatic. Instead, it requires borrowers to opt in and annually recertify eligibility for IDR plans.²⁰ The result is that many borrowers are not in IDR plans when they should be, leading to much higher loan payments and default rates than necessary and undermining the federal policy of supporting affordable education finance.

Similarly, the institutional structure of debt—including features like interest, loan servicing, default, and rehabilitation—is poorly designed to manage a program that is fundamentally about progressive and universal financing of higher education. Most, if not all, of the problems borrowers face managing their student loans are a result of these features, rather than of the affordability of the loan payments themselves. If the loan program instead adopted the institutional features of taxation, especially withholding and graduated payments, borrowers’ well-being—and the financial stability of the loan program—would be substantially improved.

19. See Jonathan D. Glater, *Law and the Conundrum of Higher Education Quality*, 51 U.C. DAVIS L. REV. 1211, 1215–16 (2018) (describing disconnect between freely available loans and attempts to police debt levels after the fact).

20. See, e.g., 34 C.F.R. § 685.209(a)(5)(i)(A) (2019).

Additionally, the debt paradigm has encouraged the continued use of private loan servicers under contract with the Department of Education to manage borrowers' accounts. Servicers are borrowers' sole point of contact and their duties include providing borrowers with information about deferment, forbearance, and repayment plan options. Loan servicers are chosen by the Department, not by borrowers, and they operate with little oversight and few incentives to ensure that consumers are able to take advantage of the most favorable features of federal student loans. Instead, servicers are motivated to cut operational costs and lower quality of service, even though it often results in suboptimal servicing. As a result, borrowers often do not obtain the full benefits of student loans or are steered into suboptimal payment plans. Abandoning the debt paradigm for one of grant-and-tax would lead to better alternatives, such as automatic income-based repayment through the tax system.

Likewise, under a grant-and-tax paradigm, the anomalous and notoriously uncharitable treatment of student loans in bankruptcy would cease to be an issue. Moreover, with a grant-and-tax system, there would be no crushing debt burden shaping borrower psychology and credit scores, merely a higher future tax payment for grant recipients with the income to support it.

The insistence on treating education financing as debt rather than as grants and taxes is a legacy of the historical development of education financing from a system of private loans backed by federal loan guarantees and subsidies.²¹ This debt framework has persisted, however, even after the wholesale reform of higher education financing in 2010, when the federal government became the direct lender for almost all student loans and expanded income-based repayment options.²²

The continued use of a debt paradigm is also 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 hardly resemble any sort of arm's-length transaction.²³ This political aversion to taxes and transfers has led to the framing of education financing as a matter of contractual debt arrangements.

Ironically, this very framing created the student debt crisis because of consumers' and voters' different perceptions of debt obligations versus tax obligations and the different legal status of each. 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. Likewise, journalistic reporting on student loan debt—which frames the public policy discourse—focuses on the total stock of indebtedness, some \$1.5 trillion,²⁴ even though a substantial amount of this sum will not actually have to be repaid because of IDR and other forms of debt cancellation.

21. *See infra* Part I.

22. *See* SAFRA Act §§ 2201–2213.

23. A similar tendency can be seen in proposals for postal banking to provide low-cost financial services, including loans, to the poor instead of transfer payments. *See* Postal Banking Act, S. 2755, 115th Cong. § 2(a) (2018).

24. *See* sources cited *supra* note 15.

In contrast, tax obligations are viewed in terms of annual flows, and to the extent there is periodic tax withholding, the consumer's actual flows are never affected. The sum of an individual's 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 is not psychologically weighed down by an insurmountably large obligation, nor does the marketplace treat her as having a balance-sheet liability. Income taxes may be painful, but by definition, they are paid only when there is income sufficient to support payment. 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 education finance were a tax instrument (a flow) rather than a debt obligation (a stock), it would not appear on consumer credit reports as a liability.²⁵ 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.

To be clear, taxation comes with its own institutional, budgetary, and rhetorical baggage. Moreover, student loans retain a few features of traditional debt that differ from taxation, particularly that the total principal obligation is capped at an amount based on the initial sum borrowed. A purely tax-funded program would be more like the Sanders proposal—free college, paid for through actual income taxes. Student debt, even with IDR, is similar to tax-funded free college, but it is not the same.

Therefore, the student loan system is actually a hybrid that falls between pure debt and pure tax. As such, it demands its own legal category and its own set of institutions and practices, taking the most useful and relevant elements from debt law and tax law, while jettisoning the most damaging and counterproductive elements. In particular, student loans should adopt notions from the tax law of automatic enrollment, payroll, and graduated payments among others. The loan system should also reject notions of default, loan serving, and interest accrual and capitalization from debt and commercial law, though it should continue to treat the funds as a credit program of the Department of Education for federal budgetary purposes.

This Article makes several contributions to the scholarly literature. First, we present a concise history of student loans that holds out important lessons about the nature of higher education financing and why the United States chose debt, rather than tax and transfer, as the vehicle of federal funding. We show that the United States' reliance on student loans as a 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 increasingly

25. See Kristin Blagg, Laurie Goodman & Kelia Washington, *All Five Federal Mortgage Programs Should Treat Student Loan Debt the Same Way*, URB. INST.: URB. WIRE (Jan. 15, 2020), <https://www.urban.org/urban-wire/all-five-federal-mortgage-programs-should-treat-student-loan-debt-same-way> [<https://perma.cc/N5FN-LJQC>] (discussing flawed attempts by mortgage programs to account for IDR when underwriting mortgages).

progressive benefits to students. These gradual changes over time ended up fundamentally transforming student loans toward the grant-and-tax model we describe.

Second, we show the full extent of the differences between student loans and typical debt. The scholarly literature thus far has yet to fully absorb how substantially the IDR plans alter the very nature of the financing instrument, and journalistic accounts and public discourse are even further behind. This is not a minor point. Student loans are the second largest category of consumer debt²⁶ and the largest category of direct government loans by an order of magnitude.²⁷ That they exist in their own legal and institutional universe is of great importance. Scholarship, policy, and advocacy must better understand the nature of this transformation, and we hope this Article helps that conversation.

Third, the Article presents in particular detail—we believe for the first time in the scholarly literature—the totality of the complex legal and institutional arrangements governing student loans, specifically the loan servicing contracts and the unique (lack of) government oversight. It also shows how these institutional details contribute to problems with student loan debt, often frustrating the policy goals of the education finance system.

Fourth, we present a novel set of policy proposals that begin to carve out the contours of the new debt–tax hybrid space where student debt already de facto resides. Although we would continue to describe student debt as a credit program of the U.S. government, we propose four discrete changes to the education finance system that would better align it with its economic reality and remedy the problems we have identified: we would (1) make IDR the automatic default; (2) move collection from private loan servicers to collection by the Internal Revenue Service (IRS) through the tax system via withholding and tax return filings; (3) cap tax liability at the original grant amount, adjusted for inflation, so there would cease to be either interest accrual or loan forgiveness; and (4) impose a progressive, graduated schedule of marginal repayment rates for the IDR income-based payments, instead of the flat percentage used today. Automatic IDR combined with graduated repayment rates and inflation adjustment in lieu of interest accrual would ensure that education finance obligations are affordable and would virtually eliminate the default problem, and a tax-based collection system operated by the IRS would be fairer to borrowers than one based on private collectors that contract with the Department of Education. We are not alone in

26. See FED. RESERVE BANK OF N.Y., *supra* note 1, at 3.

27. The United States makes around \$112 billion in new student loans each year. The next largest group of direct loans is from the Department of Agriculture, which makes about \$12 billion in loans each year. See OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, FEDERAL CREDIT SUPPLEMENT: FISCAL YEAR 2020: BUDGET OF THE U.S. GOVERNMENT 1–2 (2019), <https://www.govinfo.gov/content/pkg/BUDGET-2020-FCS/pdf/BUDGET-2020-FCS.pdf> [<https://perma.cc/LV9J-4MF2>] (available together with other budgetary materials at <https://www.whitehouse.gov/omb/supplemental-materials> [<https://perma.cc/7DSR-U2UD>]).

making some of these proposals,²⁸ though unlike those before us, we base our proposals not on administrative convenience but on the theoretical relationship between student loans and tax payments that we describe here.

Our proposals are also similar in broad strokes to some ideas for so-called income share agreements (ISAs). These instruments provide students with a grant in exchange for a commitment to pay a percentage of their income above a minimum threshold for a set number of years, rather than a commitment to repay a sum certain, as with a loan.²⁹ (This similarity should not be surprising because income taxation itself is essentially a giant income share agreement, in which taxpayers provide a share of their income to the government in exchange for the benefits government provides.)³⁰ Existing ISA programs are all private, but there are calls for the adoption of public ISA programs.³¹ Like our proposal, public ISAs would jettison elements of debt, like interest, while adopting elements of taxation, like automatic withholding.³² The main difference between our proposals and those for public ISAs is the allocation of “upside” risk, that is, who bears the risk that more than the initial grant will end up being repaid and over how many years. As discussed below, we are wary of the moral hazard and adverse selection problems associated with public ISAs if they are used as an option in addition to student loans, particularly if they have total repayment caps that greatly exceed those of the initial grant.

A final note before proceeding. This Article focuses on how to redesign and reform the current system of higher education finance—a system that relies in large part on student fees facilitated by government credit programs using income-based payments. We therefore do not take a position on alternative proposals to provide free or much more heavily subsidized higher education through increased direct federal funding. Free (or reduced-cost) college that is funded through general tax revenues bears some conceptual similarity to our grant-and-tax framing, which means that the choice between the two is more a question of institutional design than one of public-versus-private funding, but those questions are beyond the scope of this Article.³³

28. See, e.g., SUSAN DYNARSKI & DANIEL KREISMAN, *THE HAMILTON PROJECT, LOANS FOR EDUCATIONAL OPPORTUNITY: MAKING BORROWING WORK FOR TODAY'S STUDENTS* 5–6 (2013), https://www.hamiltonproject.org/assets/legacy/files/downloads_and_links/THP_DynarskiDiscPaper_Final.pdf [<https://perma.cc/XG9N-MR3Q>].

29. In the typical ISA, a party provides up-front capital to pay a student's school expenses and then earns a percentage of the student's income for a term of years. We distinguish public ISAs—where the government provides the funds and earns the income share—from private-sector ISAs, where private investors provide the initial capital and earn the return. Private-sector ISAs have substantially different economics and are beyond the scope of this Article.

30. See John R. Brooks II, *Fiscal Federalism as Risk-Sharing: The Insurance Role of Redistributive Taxation*, 68 *TAX L. REV.* 89, 98 (2014).

31. See, e.g., JASON DELISLE, AM. ENTERPRISE INST., *HOW TO MAKE STUDENT DEBT AFFORDABLE AND EQUITABLE* 5 (2019), <https://media4.manhattan-institute.org/sites/default/files/R-0719-JD2.pdf> [<https://perma.cc/V7XP-F8U6>].

32. See *id.* at 6.

33. For one approach to answering those questions, see John R. Brooks, *Income-Driven Repayment and the Public Financing of Higher Education*, 104 *GEO. L.J.* 229, 263–74 (2016).

The Article proceeds as follows. Part I presents a brief history of student loans that illustrates how education finance has morphed from a program built around federal guarantees of private student loans to one of direct federal lending on income-contingent terms. Part II turns to the unusual nature of student loan debt and how it does not resemble other types of debt obligations in critical ways. Part III addresses the problems that arise from treating education finance as a matter of debt rather than grant-and-tax. Part IV considers a full shift to a taxation framework, where students would face an income surtax to pay for education. We ultimately reject such a shift because the political economy and budgetary implications of a full transition to taxation would be too onerous. Part V presents instead our vision of how education finance could be reframed as a new legal and financial category that is a hybrid of debt and taxation and explains why that would be helpful in ameliorating the adverse consequences of the rising costs of education. It also presents a set of policy proposals that follow from that hybrid treatment.

I. A BRIEF HISTORY OF STUDENT LOANS

Higher education finance is a huge, rich topic with a long history—more than can be covered in this brief overview. Higher education in the United States 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.

The review that follows shows several important points. First, the United States came to rely on student loans for particular political and historical reasons. The United States was willing to make direct grants for education to veterans and, to a lesser extent, for national security purposes. However, the budgetary politics of general education aid was more challenging, forcing Congress to rely on loan guarantees, which did not appear as on-balance-sheet obligations for federal budget purposes, but which were also less generous than direct grants.

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. Congress made other changes to the program 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, the incremental evolution of student loan terms caused student loans to transform over time in an ad hoc way from being primarily private, traditional debt instruments to being essentially a federal transfer program that incorporates notions of progressivity, insurance, and ability to pay, while shedding many of the traditional features of debt. The debt-financing framework remains, however, artificially constraining federal education financing and preventing it from

fulfilling its potential. It is that transformation that necessitates 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 predates the Constitution,³⁴ federal involvement in higher education is typically treated as beginning with the Morrill Land Grant Acts of 1862³⁵ and 1890.³⁶ 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 nine percent of Americans aged eighteen to twenty-four attended college; by 1940, the percentage had barely risen, to thirteen percent.³⁷ In 1940, student tuition and fees constituted about one-third of total revenue for higher education institutions (about fifty percent for private schools and nineteen percent for public).³⁸ In 1947, the President's Commission on Higher Education (the Truman Commission) pinpointed high student fees as one of the primary barriers to higher education and focused much of its attention on ways to bring the fees down—just as we still do today.³⁹

In the pre- and immediate post-World War II years, charitable contributions (especially for private schools) provided some aid to families who could not afford college fees,⁴⁰ 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 have been heavily utilized.⁴¹ The Truman Commission reported that, in 1946–1947, \$23.6 million in loans was available, but only \$3.7 million was actually borrowed because students often found the terms onerous and the loans risky.⁴² Private lenders and philanthropists also tried to get some loan programs off the ground but with limited success.⁴³ Ten years later, on the eve of the passage of the National Defense Education Act of 1958,⁴⁴ roughly 83,000

34. The College of William and Mary, a public institution, was founded by Royal Charter in 1693. 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).

35. Pub. L. No. 37-130, 12 Stat. 503.

36. Pub. L. No. 51-841, 26 Stat. 417.

37. 2 THE PRESIDENT'S COMM'N ON HIGHER EDUC., *HIGHER EDUCATION FOR AMERICAN DEMOCRACY: A REPORT* 4 (1947) [hereinafter TRUMAN COMM'N].

38. 6 *id.* at 45.

39. See 1 *id.* at 28–29.

40. See 6 *id.* at 45.

41. See BETH AKERS & MATTHEW M. CHINGOS, *GAME OF LOANS: THE RHETORIC AND REALITY OF STUDENT DEBT* 45 (2016).

42. 2 TRUMAN COMM'N, *supra* note 37, at 46.

43. See AKERS & CHINGOS, *supra* note 41, at 45–46.

44. Pub. L. No. 85-864, 72 Stat. 1580.

students borrowed a total of only \$13.5 million.⁴⁵ Borrowing remained the exception in higher education financing well into the 1950s.

The lack of privately provided educational financing relative to demand was an indication of the well-known market failure in student lending.⁴⁶ Part of the reason private financing was not readily available for education was that it was typically done through unsecured loans—education borrowers tend to be young and have few pledgable assets.⁴⁷ As a result, only unsecured lending is an option, but unsecured debt is difficult to collect because of state property exemption laws⁴⁸ and limitations on garnishment,⁴⁹ even if a borrower has assets or income. Young borrowers not only often lack assets of value but also have uncertain future income; indeed, for the first few years of the debt, borrowers are proposing being full- or part-time students with little or no income.⁵⁰ Additionally, young borrowers have little if any credit history, so they lack a repayment history that can be used to predict their future propensity to repay.

These factors mean 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. The market relied instead on the limited supply of lenders with philanthropic motives, and these lenders often were not well matched to borrowers.⁵¹ This market failure underlaid, and still underlies, the federal government's intervention into higher education financing.

The experience of the two world wars also underscored to the government the importance of higher education—particularly in languages and applied sciences—to national defense,⁵² a commitment reinforced by the Korean War and the Cold War. In addition, policymakers understood the role of higher education in addressing issues of income, race, and gender inequality⁵³ and the need to plan for the

45. PAMELA EBERT FLATTAU, JEROME BRACKEN, RICHARD VAN ATTA, AYEH BANDEH-AHMADI, RODOLFO DE LA CRUZ & KAY SULLIVAN, INST. FOR DEF. ANALYSIS, *THE NATIONAL DEFENSE EDUCATION ACT OF 1958: SELECTED OUTCOMES*, at II-7 (2006).

46. This market failure has been well understood since at least 1935. See, e.g., J. R. Walsh, *Capital Concept Applied to Man*, 49 Q.J. ECON. 255, 276–77 (1935).

47. See 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, 37 (2011).

48. See generally Richard M. Hynes, Anup Malani & Eric A. Posner, *The Political Economy of Property Exemption Laws*, 47 J.L. & ECON. 19 (2004) (examining the intersection between state and federal exemption laws, which allow people to protect assets when they default on loans).

49. See 15 U.S.C. § 1673 (2018) (establishing federal limitations on wage garnishment); Carolyn Carter, *Wage Garnishments and Bank Account Seizures: Consumer Debt Advice from NCLC*, NAT'L CONSUMER L. CTR. (June 18, 2018), <https://library.nclc.org/wage-garnishments-and-bank-account-seizures-consumer-debt-advice-nclc> [<https://perma.cc/UFK9-Z9DB>] (noting that “[s]tate law may limit garnishment even more or even prohibit wage garnishment” and that “[m]any types of federal and state benefits are completely protected from garnishment”).

50. See Glater, *supra* note 47.

51. See AKERS & CHINGOS, *supra* note 41, at 45–46.

52. See HUGH DAVIS GRAHAM, *THE UNCERTAIN TRIUMPH: FEDERAL EDUCATION POLICY IN THE KENNEDY AND JOHNSON YEARS*, at xviii (1984) (noting “the discovery during the two world wars of widespread illiteracy among the conscripts”).

53. See 2 TRUMAN COMM'N, *supra* note 37, at 3.

explosion of college attendance by the oncoming baby boom generation.⁵⁴ This led to a series of important interventions by the federal government into higher education, each of which had implications for the creation and growth of the student loan program.

The first of these interventions, the Servicemen's Readjustment Act of 1944 (the original GI Bill),⁵⁵ did not have any significant loan provisions. Instead, it provided direct grants for returning servicemembers to cover student tuition and fees (among other benefits).⁵⁶ But the Bill and its justifications provided a template for the expansions to come. One such expansion was the National Defense Education Act of 1958 (NDEA).⁵⁷

These early interventions were rooted in particular constituencies (for example, veterans) or particular policy goals (for example, national defense). In contrast, much of the work in subsequent decades after the NDEA was focused on expanding federal support for higher education to all citizens with the broader and more amorphous goal of general social welfare.⁵⁸ But because this broader goal entailed more money going to groups that were less politically favored than veterans, or for policy reasons that were 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 NDEA. As its title suggests, the Act was justified by a need to invest in higher education—especially science—due to the perceived threat of the Soviet Union, whose 1957 launch of Sputnik, the world's first satellite, had triggered the Space Race.⁵⁹ Unlike those of the GI Bill, however, the NDEA's benefits were available to anyone (including women), not just veterans. The NDEA stated that “no student of ability will be denied an opportunity for higher education because of financial need.”⁶⁰

The NDEA introduced the first substantial federal student loan program, the National Defense Student Loan (NDSL) Program.⁶¹ The bill, as originally proposed in the House, included a direct grant program, perhaps modeled after the

54. See GRAHAM, *supra* note 52, at xviii.

55. Pub. L. No. 78-346, 58 Stat. 284.

56. *Id.* § 400.

57. Pub. L. No. 85-864, 72 Stat. 1580.

58. See Jonathan D. Glater, *Student Debt and Higher Education Risk*, 103 CALIF. L. REV. 1561, 1576 (2015).

59. See National Defense Education Act of 1958 § 101; see also William J. Jordan, *Soviet Fires First Earth Satellite into Space; It Is Circling the Globe at 18,000 M.P.H.; Sphere Tracked in 4 Crossings Over U.S.*, N.Y. TIMES, Oct. 5, 1957, at A1 (announcing the launch of Sputnik I).

60. National Defense Education Act of 1958 § 101.

61. The NDSL Program was renamed the National Direct Student Loan Program in 1972, Pub. L. No. 92-318 § 137, 86 Stat. 235, 272 (1972), and the 1986 HEA reauthorization renamed it the Perkins Loan Program, Higher Education Amendments of 1986, Pub. L. No. 99-498, sec. 405, § 461(a), 100 Stat. 1268, 1439; FLATTAU ET AL., *supra* note 45, at II-4 to -5. The Perkins Loan Program was phased out in 2017. See 20 U.S.C. § 1087aa(b)(1)(B) (2012) (authorizing Perkins Loan expenditures only through September 30, 2017).

GI Bill.⁶² It proposed to give an average grant of \$750 per year (or roughly \$6,700 in 2020) to 23,000 students selected by state scholarship commissions on the basis of “objective criteria,” but it did not require any particular type of student or course of study (though it provided preference to science, math, engineering, and foreign languages).⁶³ At this point, the United States was spending over \$700 million per year on veterans’ education and training through the GI Bill,⁶⁴ but for nonveterans, the proposed \$17.5 million per year was determined to be too generous.⁶⁵ The final version of the bill saw the scholarship provisions eliminated. In their place was an appropriation for a loan program.⁶⁶ The special favor given to veterans was not extended even to needy nonveteran 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 to students.⁶⁷ Formally, the creditors on NDSL loans were the schools, not the federal government.⁶⁸ But the NDEA governed the terms of the institutional loans to students.⁶⁹

The NDEA stated that loans could not exceed \$1,000 per year (about \$9,000 in 2020) and \$5,000 total per student (about \$45,000 in 2020), were to be given to students on the basis of need, and were not to have interest rates exceeding three percent per year.⁷⁰ The federal money was divvied out by state and then by institution, with no institution receiving more than \$250,000 each fiscal year.⁷¹ Schools were also supposed to provide ten percent of the loan funds themselves,

62. See H.R. REP. NO. 85-2157, at 6 (1958). The grants would have been for a base amount of \$500 plus an additional amount up to \$500 based on need. *Id.* That structure is similar to the GI Bill education grants. See Servicemen’s Readjustment Act of 1944, Pub. L. No. 78-346, § 400(b), 58 Stat. 284, 289.

63. See National Defense Education Act of 1958 § 204(4) (“[S]pecial consideration shall be given to (A) students with a superior academic background who express a desire to teach in elementary or secondary schools, and (B) students whose academic background indicates a superior capacity or preparation in science, mathematics, engineering, or a modern foreign language.”); H.R. REP. NO. 85-2157, at 6 (explaining that, even if chosen under the above criteria, “[s]tudents will be completely free to select their own course of study”).

64. THE BUDGET OF THE UNITED STATES GOVERNMENT FOR THE FISCAL YEAR ENDING JUNE 30, 1958, at 102 (1957), https://fraser.stlouisfed.org/files/docs/publications/usbudget/bus_1958.pdf [<https://perma.cc/P9A9-YVEH>].

65. See, e.g., H.R. REP. NO. 85-2688, at 5, 29–30 (1958) (Conf. Rep.); 104 CONG. REC. 19,612 (1958) (statement of Rep. Judd).

66. See National Defense Education Act of 1958 § 201.

67. *Id.* §§ 201, 203, 207; see also *id.* § 206 (on repayment). As a formal matter, much of the federal money to schools was structured as a “capital contribution” to a student loan fund, which would then make “capital distribution[s]” back to the government of its proportionate share of the principal and interest repaid. *Id.* §§ 203, 206. Typical direct loans to institutions were also available. *Id.* § 207.

68. See *id.* § 205(b)–(c).

69. See *id.* § 205(b).

70. *Id.* § 205(a), (b)(1), (b)(4). The law also provided that interest would not accrue before repayment began. See *id.* § 205(b)(4).

71. *Id.* §§ 202(a), 203(b). This cap was later increased to \$800,000 in 1963, see Act of Dec. 18, 1963, Pub. L. No. 88-210, sec. 22(c), § 203(b), 77 Stat. 403, 416, and then eliminated in 1964, see National Defense Education Act Amendments, 1964, Pub. L. No. 88-665, sec. 203, § 203, 78 Stat. 1100, 1101.

with the hope that the schools would thereby build capacity for more direct support of students.⁷²

Setting the stage for later developments, the NDEA also provided for a loan forgiveness plan for teachers, cancelling ten percent of the loan balance for each year of service, up to a maximum of fifty percent.⁷³ Some states had already instituted similar plans, especially for medical students that agreed to practice in underserved (typically rural) areas.⁷⁴

Although needy students relied heavily on the loans, there is some evidence that the loans were still not enough to substantially reduce financial barriers to higher education. In 1963–1964, right before the passage of the Higher Education Act, average tuition, fees, room, and board at all four-year institutions was \$1,286 (\$10,700 in 2020), and at public four-year institutions it was \$929 (\$7,700 in 2020).⁷⁵ The maximum \$1,000 loan would therefore have been just barely sufficient, but because the total and per-school appropriations were capped, the funds ended up being spread more widely, with loans averaging between \$400 and \$500 per student.⁷⁶ By 1964, Congress and the former Department of Housing, Education, and Welfare found that NDSL was falling short of meeting student need.⁷⁷

Moreover, many students simply did not qualify for NDSL, either because of higher family income, grades below the required minimums, or studies outside of the favored fields.⁷⁸ Some of these students and their families turned to loans

72. See National Defense Education Act of 1958 § 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”); *id.* § 204(2)(B) (requiring institutions to contribute one-ninth the amount of federal funds); FLATTAU ET AL., *supra* note 45, at II-3. Half of the institutions participating in NDSL in 1962 had never offered long-term loans prior to NDEA. *Id.* at II-7.

73. National Defense Education Act of 1958 § 205(b)(3).

74. See, e.g., I.R.S. Priv. Ltr. Rul. 5604265200A (Apr. 26, 1956) (describing a typical state program). Loan forgiveness raises tax issues, because cancellation of debt typically creates taxable income for the debtor. I.R.C. § 61(a)(11) (2018). As we will see, the tax question is particularly acute for the modern IDR plans. See *infra* Section II.F. At the time, the issue was resolved by treating the forgiven loans as “scholarships,” which were excluded from gross income under § 117 of the Internal Revenue Code, but the IRS would reverse this position in 1973. See, e.g., Rev. Rul. 73-256, 1973-1 C.B. 56 (declaring that medical loan forgiveness *is* taxable); I.R.S. Priv. Ltr. Rul. 6004275330A (Apr. 27, 1960) (declaring that teachers’ student loan forgiveness *is not* taxable); I.R.S. Priv. Ltr. Rul. 5807039700A (July 3, 1958) (declaring that state medical loan forgiveness *is not* taxable); see also Richard C.E. Beck, *Loan Repayment Assistance Programs for Public-Interest Loans: Why Does Everyone Think They Are Taxable?*, 40 N.Y.L. SCH. L. REV. 251, 261-63 (1996) (discussing the IRS’ policy change); John R. Brooks, *Treasury Should Exclude Income from Discharge of Student Loans*, 152 TAX NOTES 751, 754 (2016) (providing a general history on the issue).

75. NAT’L CTR. FOR EDUC. STATISTICS, U.S. DEP’T OF EDUC., DIGEST OF EDUCATION STATISTICS tbl.330.10 (2017), https://nces.ed.gov/programs/digest/d17/tables/dt17_330.10.asp [<https://perma.cc/7BKF-S79N>] (cataloging 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).

76. See U.S. DEP’T OF HEALTH, EDUC., & WELFARE, 1964 ANNUAL REPORT 237 (1964) (reporting that the average loan in 1964 was \$484).

77. See FLATTAU ET AL., *supra* note 45, at II-6; Glater, *supra* note 47, at 36.

78. See SUZANNE METTLER, DEGREES OF INEQUALITY: HOW THE POLITICS OF HIGHER EDUCATION SABOTAGED THE AMERICAN DREAM 61 (2014).

from banks and other private lenders, the terms of which varied greatly depending on perceptions of risk.⁷⁹ By 1964, at a time when the risk-free rate was 3.5%,⁸⁰ 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 collateral.⁸¹ By 1962, even libertarian economist Milton Friedman was pointing out the market failure around private student lending and the need for more government intervention.⁸²

C. GUARANTEED LOANS: THE HIGHER EDUCATION ACT OF 1965

By the Kennedy and Johnson Administrations, the focus and goals of national higher education policy had shifted somewhat. The Cold War remained a concern, but there was also a renewed focus on domestic issues, particularly social welfare and economic concerns as embodied in the Great Society programs.⁸³ Moreover, the baby boom generation was entering college, driving growth in demand for higher education, which strained the NDSL Program's ability to meet the country's education financing needs. Just like today, college costs were rising rapidly, and many families who did not qualify for NDSL could not afford to pay more out of pocket.

Congress's response to these problems was the Higher Education Act of 1965 (HEA).⁸⁴ The HEA included many provisions that expanded the federal role in higher education, including the creation of the Guaranteed Student Loan (GSL) Program, the predecessor of the current federal student loan program.⁸⁵ The GSL Program was modeled off of more limited state "loan insurance" programs⁸⁶ and, unlike the NDSL Program, was designed to stimulate lending by private lenders rather than by educational institutions.⁸⁷ Also unlike the NDSL Program, the GSL Program did not require the federal government to put up any capital because the government would be only guaranteeing private loans, rather than

79. See Glater, *supra* note 47, at 36.

80. *Yields on Short-Term United States Securities, Three-Six Month Treasury Notes and Certificates, Three Month Treasury Bills for United States*, FED. RES. BANK ST. LOUIS: THE RES. DIVISION, <https://fred.stlouisfed.org/series/M1329BUSM193NNBR> [<https://perma.cc/TR8T-XXBK>] (last updated Aug. 20, 2012) (analyzing data provided by the National Bureau of Economic Research).

81. *President's Consumer Panel Studies High Interest Rates on Student Loans*, WASH. POST, Feb. 29, 1964, at A3.

82. MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 104 (40th anniversary ed. 2002) ("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.").

83. See Glater, *supra* note 47, at 35.

84. Pub. L. No. 89-329, 79 Stat. 1219.

85. See *id.* § 421(a)(1)(B). The GSL Program was renamed the Stafford Loan Program in 1987. AKERS & CHINGOS, *supra* note 41, at 47; see SUZANNE METTLER, *THE SUBMERGED STATE: HOW INVISIBLE GOVERNMENT POLICIES UNDERMINE AMERICAN DEMOCRACY* 10 (2011) (detailing the GSL Program).

86. See Glater, *supra* note 47, at 37–38.

87. See *id.* at 37.

making loans itself.⁸⁸ However, the government also subsidized interest on the loans by paying the interest during the years the borrower was still enrolled in college, plus a share of the interest for those with family incomes below \$15,000 (or roughly \$125,000 in 2020).⁸⁹

The GSL Program greatly increased the amount of higher education financing available, authorizing as much as \$700 million in its first year and \$1.4 billion by 1968 (contrasted with \$17.5 million in the first year of the NDSL).⁹⁰ There was technically no income cap under the GSL Program to determine eligibility for the loans, but because subsidized interest was available only to families with income under \$15,000, lenders would usually lend only to families below that income threshold.⁹¹ The HEA also included a direct grant to the neediest students, but the funds involved were a fraction of the amount devoted to loans.⁹²

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 budgetary effects than a fundamental belief in the policy instrument itself, for three reasons. First, the precedent of the NDSL Program (and the state insurance schemes) created a model to follow.⁹³ This was a new era in federal financing for higher education, and the NDEA had been essentially the first federal intervention in *general* aid to higher education since the Morrill Land Grant Acts (because the GI Bill was limited to veterans). Given this background, policymakers may have understandably wanted to step carefully and incrementally, relying on existing models instead of something big and new.

Likewise, earlier federal forays into consumer financial markets had relied on the provision of indirect support through loan guarantees and secondary market activities. In housing finance markets, the federal government guaranteed or insured mortgage loans through the Department of Veterans Affairs, and the Federal Housing Administration provided a secondary market in mortgages through the Federal National Mortgage Association (Fannie Mae), then a wholly-owned government corporation.⁹⁴ Indirect support of debt markets was already well established as the federal government's *modus operandi*.⁹⁵

Second, a loan guarantee appears to have a lighter fiscal footprint than a direct loan. With a loan guarantee, the government does not put up the initial capital and is only secondarily and contingently liable should the original lender go unpaid. The use of a guarantee, rather than a direct loan, however, is but a budgetary fiction. In either arrangement, most or all of the credit risk is on the federal

88. See Higher Education Act of 1965 § 421.

89. *Id.* § 428(a).

90. *Id.* § 424(a); *supra* notes 63–66 and accompanying text (discussing the NDSL loans).

91. See H.R. REP. NO. 95-951, at 11 (1978), as reprinted in 1978 U.S.C.A.N. 5314, 5324.

92. See Higher Education Act of 1965 § 401(b) (authorizing \$70 million in grants).

93. See Glater, *supra* note 47.

94. See Adam J. Levitin & Susan M. Wachter, *The Public Option in Housing Finance*, 46 U.C. DAVIS L. REV. 1111, 1130 (2013).

95. See Adam J. Levitin, *Public-Private Risk Sharing in Financial Regulation* 3 (Feb. 8, 2019) (unpublished manuscript) (on file with author).

government. The only difference is the source of the original capital. But because the government does not need to make an initial outlay, a guarantee program requires a smaller budget appropriation than a direct lending program. Additionally, most of the appropriations for a guarantee program would be deferred because funds would be outlaid only when the guarantees were triggered in the future. Thus, a guarantee program is preferable from a budgetary standpoint, but because the federal government has essentially unfettered access to cheap capital, requiring the capital to come initially from private lenders had little effect on total liquidity and only added to the cost of funds for the program as well as an additional layer of administrative expense. 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, off-budget structure.⁹⁶

Third, and also pointing to budgetary concerns, there was a push during the HEA debates by some Republicans to offer benefits in the form of tax credits instead of loans or loan guarantees.⁹⁷ President Johnson and the Democratic leadership refused, however, in part because of the effects that credits would have had on tax revenue.⁹⁸ Loan guarantees provided an alternative way to get substantial amounts of money in the hands of students without substantially affecting the national budget, which Johnson was trying to free up to fund the Vietnam War and the Great Society programs.

The GSL Program was thus a product of compromise and the politics of the HEA in particular 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 reasons⁹⁹—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 purposes.¹⁰⁰ And in the background were the beginnings of the conservative antitax response to the Great Society. As with much of the growth of the American welfare state, the

96. Prior to the Federal Credit Reform Act of 1990 (FCRA), the national budget included direct loans as an outlay—thus increasing total government spending as much as direct grants—but loan *guarantees* only had a budgetary cost to the extent of any subsidies and guarantees actually paid out. See Thomas H. Stanton, *Loans and Loan Guarantees*, in *THE TOOLS OF GOVERNMENT: A GUIDE TO THE NEW GOVERNANCE* 381, 383–84 (Lester M. Salamon ed., 2002). This made loan guarantees much more budgetarily attractive than direct loans. After the FCRA, the only on-budget cost for both direct loans and loan guarantees is the net subsidy cost, which is the expected difference between outlays and receipts, including interest, discounted to present value. See Federal Credit Reform Act of 1990, 2 U.S.C. §§ 661a(5), 661c (2018).

97. See METTLER, *supra* note 78.

98. *Id.*

99. See 1 TRUMAN COMM'N, *supra* note 37, at 29.

100. See Jonathan D. Glater, *Debt, Merit, and Equity in Higher Education Access*, 79 *LAW & CONTEMP. PROBS.* 89, 91–95 (2016).

GSL Program relied on a relatively opaque, quasi-public arrangement to partially mask the extent of government involvement.¹⁰¹

D. SOLIDIFYING THE FEDERAL ROLE: 1970s–1980s

Student loans became an element of higher education finance for particular historically contingent reasons, but once created, they became an important vehicle for delivery of additional support and benefits. Although other funding programs—most notably the Pell Grant¹⁰²—were created and expanded along the way, policymakers also continued to tinker with the student loan program as the primary way to deliver benefits. Over the next few decades, the student loan program changed in several important ways, which we summarize here.

The 1972 Amendments to the HEA created not only the aforementioned Pell Grants but also the Student Loan Marketing Association.¹⁰³ This government-owned corporation, better known under the portmanteau “Sallie Mae,” purchased student loans that it financed with the sale of bonds.¹⁰⁴ Sallie Mae’s bonds were backed by the full faith and credit of the United States.¹⁰⁵ Sallie Mae guaranteed timely payment of principal and interest on the bonds, meaning that investors assumed the interest rate risk (including prepayment risk) on the underlying loans, while the federal government bore the credit risk. Issuance of the bonds through Sallie Mae, rather than as general Treasury bonds, enabled investors to invest solely in the interest rate risk of student loans. 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.¹⁰⁶

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.¹⁰⁷ It also increased the income threshold for subsidized loans from \$15,000 to \$25,000 (which, because of inflation, was a reset to the same real income level it had been in 1965).¹⁰⁸

These 1972 and 1976 changes show 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 that market failure and ensure financing to meet student needs.

101. On hidden welfare state spending, see, for example, JACOB S. HACKER, *THE DIVIDED WELFARE STATE: THE BATTLE OVER PUBLIC AND PRIVATE SOCIAL BENEFITS IN THE UNITED STATES* (2002) and John R. Brooks, *Quasi-Public Spending*, 104 *GEO. L.J.* 1057 (2016).

102. See Education Amendments of 1972, Pub. L. No. 92-318, secs. 131, 401, 411, 413A–D, § 401, 86 Stat. 235, 247–55.

103. See *id.* sec. 133(a), § 439 (adding a new section to the HEA).

104. *Id.*

105. See *id.* sec. 133(a), § 439(h).

106. See S. REP. NO. 92-346, at 46–47 (1971).

107. See Education Amendments of 1976, Pub. L. No. 94-482, sec. 127(a), § 428A, 90 Stat. 2081, 2120–23 (adding a new section to the HEA); H.R. REP. NO. 94-1701, at 185 (1976) (Conf. Rep.), as reprinted in 1976 U.S.C.C.A.N. 4877, 4886.

108. See Education Amendments of 1976 sec. 127(a), § 428(a)(2)(B)(i); H.R. REP. NO. 94-1701, at 187, as reprinted in 1976 U.S.C.C.A.N. 4877, 4888.

A bigger change in federal support for education financing came in 1978, as 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 unwilling 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.¹⁰⁹ As a result, many students found themselves shut out of the GSL Program,¹¹⁰ 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.¹¹¹ The change greatly expanded the pool of students that could rely on guaranteed loans, and guaranteed student loan volume about doubled as a result.¹¹²

The no-cap era was brief, however. In 1981, under the Reagan Administration, Congress reintroduced a family-income cap of \$30,000 (about \$89,000 in 2020) to be eligible for subsidized guaranteed loans.¹¹³ Although loan volume dipped a bit as a result, it maintained its higher post-1978 levels until the more dramatic changes to the student loan program in 1992.¹¹⁴

This period also saw developments in the tax treatment of forgiven debt. In 1973, the IRS 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 element more akin to employment.¹¹⁵ As a result, the debt cancellation could lead to a tax bill. This was contrary to earlier rulings that had held the opposite.¹¹⁶ Congress responded with some temporary exclusions before finally adding § 108(f) to the Internal Revenue Code in 1984, 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.¹¹⁷

Finally, in 1980, Congress added the Parent Loan for Undergraduate Student (PLUS) Loan, a federal loan to parents of students, rather than to students themselves.¹¹⁸ This expanded the amount of funds available to pay for college, but the

109. H.R. REP. NO. 95-951, at 11 (1978), as reprinted in 1978 U.S.C.C.A.N. 5314, 5324.

110. *Id.*

111. See Pub. L. No. 95-566, sec. 5(b)(1)(A), § 428(a)(2), 92 Stat. 2402, 2403 (removing Higher Education Act Section 428(a)(2)(A)–(B)).

112. See AKERS & CHINGOS, *supra* note 41, at 43 fig.3.2; ZUMETA ET AL., *supra* note 34, at 79 fig.4.3.

113. See Postsecondary Student Assistance Amendments of 1981, Pub. L. No. 97-35, sec. 532(a), § 428(a)(2), 95 Stat. 357, 451 (enacted as part of the Omnibus Budget Reconciliation Act of 1981).

114. See AKERS & CHINGOS, *supra* note 41, at 43 fig.3.2.

115. See Rev. Rul. 73-256, 1973-1 C.B. 56.

116. See, e.g., I.R.S. Priv. Ltr. Rul. 6004275330A (Apr. 27, 1960) (declaring that teachers’ student loan forgiveness is not taxable); I.R.S. Priv. Ltr. Rul. 5807039700A (July 3, 1958) (declaring that state medical loan forgiveness is not taxable); see also *supra* note 74 (detailing change in the IRS’s position).

117. Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 1076(a), § 108, 98 Stat. 494, 1053–54 (codified as amended at I.R.C. § 108(f)(1) (2018)).

118. Education Amendments of 1980, Pub. L. No. 96-374, sec. 419, § 428B(a), 94 Stat. 1367, 1424–25.

actual debtor (the parent) had more regular income and assets than a student and therefore was a more attractive borrower. Although not a huge change at the time, PLUS Loans would later become a meaningful tool for significantly expanding student loans to graduate students.¹¹⁹

E. WATERSHED CHANGES: 1992 AND 1993

The student loan program faced probably its biggest change since the establishment of the GSL Program in the 1992 reauthorization of the HEA and the following year's Student Loan Reform Act. These bills made four important changes. First, the 1992 bill created a new category of unsubsidized Stafford Loans (which the GSL Program had been renamed to in 1987).¹²⁰ Subsidized Stafford Loans retained income eligibility requirements, but the new unsubsidized Stafford Loans had no income limits.¹²¹

Second, the 1992 Amendments removed the borrowing cap on PLUS Loans.¹²² Prior to 1992, parents could borrow up to only \$4,000 per year, but after 1992, parents could borrow up to the full "cost of attendance" of a college or university.¹²³ The cost of attendance is determined by each school and is defined to include living expenses, tuition, fees, room, and board.¹²⁴ Although the measure is not perfect,¹²⁵ this change meant that, for the first time, a student could be assured of having sufficient funds to cover nearly all of the costs of education. The bill also increased the loan limits on Stafford Loans.¹²⁶

Third, the 1992 Amendments created a pilot Direct Loan Program (while also consolidating the Stafford and PLUS Loans under the renamed Federal Family Education Loan (FFEL) Program),¹²⁷ and the 1993 bill greatly expanded Direct Loans.¹²⁸ In contrast to FFEL Loans, Direct Loans were made directly by the federal government and held on its balance sheet.¹²⁹ The federal government, rather than a private lender, was the creditor on these loans.

119. See *infra* notes 149–55 and accompanying text.

120. See Higher Education Amendments of 1992, Pub. L. No. 102-325, sec. 422, § 428H, 106 Stat. 448, 535.

121. *Id.* (expanding loans to those who did not qualify for subsidies under Higher Education Act Section 428).

122. See *id.* sec. 418(b)(2), § 428B (eliminating prior Higher Education Act Section 428B(b)(1)–(2)).

123. *Id.* sec. 422, § 428H(c) (setting cost of attendance as maximum loan amount).

124. 20 U.S.C. § 1087ll (2018).

125. 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 the cost of attendance are often undervalued).

126. See Higher Education Amendments of 1992 sec. 413, § 425. Limits were also raised in 1986. Higher Education Amendments of 1986, Pub. L. No. 99-498, sec. 402(a), § 425, 100 Stat. 1268, 1353, 1359–60.

127. See Higher Education Amendments of 1992 sec. 411(a)(1), § 421(c) (renaming the programs); *id.* sec. 451, § 451 (creating the "Federal Direct Loan Demonstration Program").

128. See Student Loan Reform Act of 1993, Pub. L. No. 103-66, sec. 4021, § 451, 107 Stat. 312, 341 (enacted as part of the Omnibus Budget Reconciliation Act of 1993) (authorizing the Direct Student Loan Program).

129. See *id.* sec. 4021, § 452.

As noted above, from a financial standpoint it is immaterial whether the government is making the loan or merely subsidizing and guaranteeing it.¹³⁰ In both cases the economic risk of the loan rests with the federal government. But Direct Loans were considerably cheaper because the federal government would not need to subsidize banks' high rates.¹³¹ The 1993 bill aimed to have sixty percent of all lending come from Direct Loans within the next five years.¹³²

Fourth, the 1993 bill created the Income-Contingent Repayment (ICR) plan, 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.¹³³ As it was designed, ICR had little uptake, but it played an important role in terms of both policy design and regulatory process for the post-2010 changes discussed below.¹³⁴

In sum, the 1992 and 1993 legislation were important steps forward for the government's direct role in higher education finance and a large shift in the loan terms themselves. Through a combination of student and parent borrowing, federal loans could now fully finance higher education for any student, regardless of income. The loans themselves were increasingly made directly by the federal government, rather than by private lenders with federal loan guarantees and subsidies. And, with ICR, the stage was set for the massive shift in repayment terms that would follow the 2010s-era changes. Not surprisingly, loan volume exploded after 1993, nearly doubling over the following few years and beginning the steep upward climb that we still see today.¹³⁵

F. THE OLD SYSTEM BREAKS DOWN: 1990s AND 2000s

Recall where federal student loans began in the 1950s: with the National Defense Student Loan Program providing funds for colleges themselves to make relatively small, low-interest loans.¹³⁶ By the late 1990s, however, student loans had become big business for private lenders, with government-guaranteed profits and, as Suzanne Mettler has documented, powerful lobbying activities.¹³⁷ Banks and other private lenders also started aggressively marketing directly to colleges.¹³⁸

130. See *supra* note 96 and accompanying text.

131. The Direct Loans were also cheaper because, following the FCRA in 1990, direct government loans had the same minimal budget footprint as loan guarantees. See *supra* note 96.

132. Student Loan Reform Act of 1993 sec. 4021, § 453(a)(2)(D) (stating the goal of sixty percent by 1998).

133. See *id.* sec. 4021, § 455(d)(1)(D), (e).

134. Though the ICR plan was the first significant income-contingent loan repayment plan, there had been other proposals and pilot programs as far back as 1962. See Robert Shireman, *Learn Now, Pay Later: A History of Income-Contingent Student Loans in the United States*, 671 ANNALS AM. ACAD. POL. & SOC. SCI. 184, 188 (2017).

135. See AKERS & CHINGOS, *supra* note 41, at 47–49; ZUMETA ET AL., *supra* note 34, at 79 fig.4.3.

136. See *supra* Section I.B.

137. See METTLER, *supra* note 85, at 34–35, 71–79.

138. See, e.g., Jonathan D. Glater, *Offering Perks, Lenders Court Colleges' Favor*, N.Y. TIMES (Oct. 24, 2006), <https://www.nytimes.com/2006/10/24/education/24loans.html?smid=pl-share>.

Moreover, as tuition and student living expenses continued to rise, private lenders began offering nonfederal, truly private loans—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). Nonfederal loans went from being almost zero percent of loan volume in 1994¹³⁹ to twenty-five percent by 2007–2008.¹⁴⁰ 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.¹⁴¹

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; it was no different than any other type of unsecured debt. In 1976, however, Congress amended the HEA to prohibit a discharge during the first five years after repayment was first due, unless the loan imposed an “undue hardship” on the borrower.¹⁴² Subsequent amendments to the law excluded forbearance and deferment periods from the five-year nondischargeability period;¹⁴³ expanded the limitation on discharge to all loans from nonprofit institutions;¹⁴⁴ extended the five-year nondischargeability period to seven years;¹⁴⁵ and extended the discharge restriction to cover educational benefits, scholarships, and stipends.¹⁴⁶ In 1998, Congress restricted discharge on public and nonprofit student loans, educational benefits, scholarships, and stipends to cases of undue hardship, no matter how much time had elapsed.¹⁴⁷ Finally, in 2005, Congress extended the discharge restriction to all student loans, including non-FFEL loans.¹⁴⁸

In some ways, the substantial restriction on discharge of student loan debt in bankruptcy created the demand for IDR plans. For most debts, bankruptcy functions as a backstop social insurance program to address severe financial distress.

139. See AKERS & CHINGOS, *supra* note 41, at 43 fig.3.2.

140. See COLL. BD., TRENDS IN STUDENT AID 2018, at 15 fig.6 (2018), <https://research.collegeboard.org/pdf/trends-student-aid-2018-full-report.pdf> [<https://perma.cc/PLL4-TMJE>]; see also AKERS & CHINGOS, *supra* note 41, at 43 fig.3.2 (charting the increase in dollars disbursed by type of loan).

141. See, e.g., Jonathan D. Glater, *U.S. Is Lax on Loans, Cuomo Says*, N.Y. TIMES (Apr. 26, 2007), <https://www.nytimes.com/2007/04/26/us/26loans.html?smid=pl-share>; Doug Lederman, *Taming the Student Loan ‘Wild West,’* INSIDE HIGHER ED (June 7, 2007), <https://www.insidehighered.com/news/2007/06/07/taming-student-loan-wild-west> [<https://perma.cc/2XXS-WKYU>].

142. See Education Amendments of 1976, Pub. L. No. 94-482, sec. 127(a), § 439A, 90 Stat. 2081, 2141 (codified as amended at 11 U.S.C. § 523(a)(8) (2018)).

143. See Act of Aug. 14, 1979, Pub. L. No. 96-56, sec. 1, § 17(a), 93 Stat. 387, 387 (excluding forbearance and deferment periods from the five-year nondischargeability period).

144. See Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 454(a)(1)(A)(2), 98 Stat. 333, 376.

145. See Crime Control Act of 1990, Pub. L. No. 101-647, § 3621(2), 104 Stat. 4789, 4965.

146. See *id.* § 3621(1).

147. See Higher Education Amendments of 1998, Pub. L. No. 105-244, § 971, 112 Stat. 1581, 1837.

148. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 220, 119 Stat. 23, 59.

But with that safety valve essentially gone after 1998, the need for another form of insurance for student loans became more pressing.

Another important development in this period was the extension of PLUS Loans to graduate students in 2005 (thus splitting Parent PLUS Loans, taken out by a student's parents, and Grad PLUS Loans, taken out by the graduate or professional student).¹⁴⁹ Because PLUS Loans had essentially no borrowing cap after 1992,¹⁵⁰ a graduate student could, after the 2005 changes, directly borrow up to the full cost of attendance for expensive graduate programs, including law and medical school. As we will see in the next Section, Grad PLUS Loans also have important implications for the later IDR plans, and thus the overall progression of student loans toward becoming essentially a progressive government transfer program.

In 2007, Congress created Public Service Loan Forgiveness (PSLF)¹⁵¹ and the first iteration of Income-Based Repayment (Old IBR),¹⁵² both important steps in the move toward more redistribution and insurance through the federal government. The PSLF plan provided that borrowers working in public service jobs could have the balance of their loan forgiven after ten years of regular payments.¹⁵³ Old IBR—which was available to everyone, not just those working in public service—allowed borrowers to cap their monthly payments at fifteen percent of discretionary income, with loan forgiveness after twenty-five years of regular payments.¹⁵⁴ Importantly, the still relatively new Grad PLUS Loans were made eligible for Old IBR, but the original Parent PLUS Loans were not.¹⁵⁵

Finally, 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 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 financial asset classes).¹⁵⁶

149. See Higher Education Reconciliation Act of 2005, Pub. L. No. 109-171, sec. 8005(c), § 425(a)(1)(A), 120 Stat. 4, 158–59 (2006) (enacted as part of the Deficit Reduction Act of 2005).

150. See Higher Education Amendments of 1992, Pub. L. No. 102-325, sec. 418(b)(2), § 428B(b), 106 Stat. 448, 531.

151. See College Cost Reduction and Access Act, Pub. L. No. 110-84, sec. 401, § 455, 121 Stat. 784, 800 (2007).

152. See *id.* sec. 203, § 493C(b).

153. College Cost Reduction and Access Act sec. 401, § 455(m)(1) (codified as amended at 20 U.S.C. § 1087e(m)(1) (2018)).

154. See College Cost Reduction and Access Act sec. 203, § 493C (codified as amended at 20 U.S.C. § 1098e(e) (2018)).

155. See 34 C.F.R. § 685.221(a)(2) (2019) (excepting Direct PLUS Loans made to parent borrowers, but not to student borrowers). Similar provisions apply for the other IDR plans. See, e.g., *id.* § 685.209(a)(1)(ii) (similar scheme for Pay As You Earn plan); *id.* § 685.209(c)(1)(ii) (similar scheme for Revised Pay As You Earn plan).

156. Pub. L. No. 110-227, sec. 7, § 459A, 122 Stat. 740, 746–47.

G. A NEW ERA: 2009 TO PRESENT

When President Obama and a Democratic Congress entered office in 2009, the stage was set for some big changes. The FFEL system of subsidizing private lenders had proven to be expensive and a source of corruption. The credit crisis had proven that ultimately the federal government was bearing the credit risk on FFEL Loans anyway. And the Direct Loan Program that started in 1992–1993 had proven itself to be an effective alternative. Moreover, after a slow start with ICR in the 1990s, the more generous Old IBR and PSLF plans provided a platform for further reforms to make student loans a vehicle for more generous and progressive support for students.

The SAFRA Act eliminated the FFEL Program, ending subsidized government guarantees of private student loans.¹⁵⁷ Going forward, the Direct Loan Program would be the only source of federal student loans. 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.¹⁵⁸ Student loans immediately became the biggest direct government loan program, dwarfing the next largest category, direct loans from the Department of Agriculture, by a factor of more than ten.¹⁵⁹

The SAFRA Act also made IBR more generous (New IBR) by allowing those who would be “new borrowers” after July 1, 2014, to pay ten percent of their discretionary incomes (rather than fifteen percent under Old IBR) and receive forgiveness after twenty years (rather than twenty-five years under Old IBR).¹⁶⁰ Both IBR plans 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 have little relief for interest accrual. If borrowers do not make payments sufficient to cover any interest currently due, the interest that accrues will be capitalized, meaning it will be added to the principal balance of the loan.¹⁶¹ That means that interest will compound on that larger principal (“negative amortization”), in contrast to the usual noncompounding interest on fully amortizing

157. Technically the “SAFRA Act” is the name for Title II, Subtitle A, of the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 2001, 124 Stat. 1029, 1071, more famous as the final piece of legislation that completed the enactment of Obamacare. The FFEL Program was terminated by Section 2205 of that Act. *Id.* sec. 2205, § 428(B)(a)(1).

158. See METTLER, *supra* note 85, at 85.

159. Compare OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, FEDERAL CREDIT SUPPLEMENT: BUDGET OF THE U.S. GOVERNMENT: FISCAL YEAR 2010, at 2 tbl.1 (2009), <https://www.govinfo.gov/content/pkg/BUDGET-2010-FCS/pdf/BUDGET-2010-FCS.pdf> [<https://perma.cc/5F4T-5BMR>] (showing total student Direct Loan obligations of \$41.2 billion for Fiscal Year 2009), with OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, FEDERAL CREDIT SUPPLEMENT: BUDGET OF THE U.S. GOVERNMENT: FISCAL YEAR 2012, at 2 tbl.1 (2011), <https://www.govinfo.gov/content/pkg/BUDGET-2012-FCS/pdf/BUDGET-2012-FCS.pdf> [<https://perma.cc/5LNP-8D7D>] (showing projected Direct Loan obligations of \$162.3 billion for Fiscal Year 2012), and *id.* at 1–2 tbl.1 (showing projected Direct Loan obligations of \$10.9 billion for the Department of Agriculture in Fiscal Year 2012).

160. SAFRA Act sec. 2213, § 493C (codified at 26 U.S.C. 1098e(e) (2018)).

161. See 34 C.F.R. § 685.221(b)(4) (2019) (“Except as provided in paragraph (b)(3) of this section [regarding subsidized loans], accrued interest is capitalized at the time a borrower chooses to leave the income-based repayment plan or no longer has a partial financial hardship.”).

FFEL and Direct Loans. Capitalization also means the accrued interest will be fully payable whenever a borrower's income becomes high enough that IBR is no longer necessary.¹⁶²

The Obama Administration quickly turned to regulation to fix these problems and, in 2012, created the Pay As You Earn (PAYE) plan. The PAYE plan took the New IBR payment terms—ten percent of discretionary income and forgiveness after twenty years—and extended them earlier, to loans taken out after October 1, 2011.¹⁶³ 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 when in negative amortization.¹⁶⁴

Both of these regulatory moves were not authorized by the IBR statute, which would not take effect until 2014, so the Administration relied on the Income-Contingent Repayment portions of the HEA, which gave more leeway to the Department of Education to set the repayment terms.¹⁶⁵ So, although ICR itself was never heavily used by borrowers, it became the basis for much of the growth in income-contingent loans after 2012.

Finally, in 2015, the Obama Administration created yet another repayment plan, Revised Pay As You Earn (REPAYE), which added some important new terms.¹⁶⁶ The REPAYE plan was open to all borrowers, not just post-2011 borrowers.¹⁶⁷ The REPAYE plan also had even more generous (though complicated) rules on interest accrual and capitalization, but it had somewhat less generous terms for graduate borrowers.¹⁶⁸ Most significantly for our story of the progress of student loans, REPAYE removed the monthly cap on the income-contingent payments.¹⁶⁹ In all the other plans—ICR, IBR, and PAYE—a borrower reverts to paying a flat, standard payment once the borrower's income is high enough. For

162. *See id.*

163. *See* 34 C.F.R. § 685.209(a)(1)(iii)(B) (2019) (time period for applicable loans); *id.* § 685.209(a)(2)(i) (repayment terms).

164. *See id.* § 685.209(a)(2)(iv)(B) (limiting capitalized accrued interest to ten percent of original loan principal balance at the time the borrower entered repayment). For more on interest accrual and capitalization, see *infra* Section II.D.

165. *See* Federal Perkins Loan Program, Federal Family Education Loan Program, and William D. Ford Federal Direct Loan Program, 77 Fed. Reg. 66,088, 66,088 (Nov. 1, 2012) (describing PAYE as a “new ICR plan”).

166. *See* Student Assistance General Provisions, Federal Family Education Loan Program, and William D. Ford Federal Direct Loan Program, 80 Fed. Reg. 67,204 (Oct. 30, 2015) [hereinafter Final REPAYE Rules].

167. *See* 34 C.F.R. § 685.209(c)(1)(ii) (2019). In the REPAYE regulation, the term “[e]ligible loan” was defined broadly, without any limitation to “[e]ligible new borrower[s],” as seen in the PAYE regulations. *See id.* § 685.209(a)(1)(ii)–(iii).

168. On interest accrual and capitalization, see *id.* § 685.209(c)(2)(iii) and *infra* Section II.D. Graduate borrowers have a repayment period of twenty-five years—instead of twenty—that includes any outstanding undergraduate debt. 34 C.F.R. § 685.209(c)(5)(ii)(B).

169. REPAYE does not include a provision similar to 34 C.F.R. § 685.209(a)(4)(i), which recalculates the loan payment under PAYE when a borrower no longer has a partial financial hardship. *See* Final REPAYE Rules, 80 Fed. Reg. at 67,213.

REPAYE, however, borrowers continue to pay ten percent of their discretionary incomes no matter how high their incomes are.¹⁷⁰

The unlimited-ten-percent provision was intended to make the plan less generous to borrowers who eventually have high incomes.¹⁷¹ In financial terms, however, it actually has the opposite effect. Instead of making a high-income borrower pay *more*, it actually makes the borrower pay *faster* and therefore pay *less*. The loan principal is the same irrespective of the payment plan. Therefore, if a payment of ten percent of the borrower's income is greater than the standard payment, the borrower will pay down the principal faster with REPAYE than with the standard payment, and a faster repayment means less interest will accrue on the loan, thus saving the borrower money over the full loan term.¹⁷²

II. STUDENT LOAN DEBT IS NOT LIKE OTHER DEBT

In the previous Part, we laid out how the government's involvement in higher education finance over the last seven decades was an evolving response to a market failure—the private market provides inadequate funding for student borrowers because of lenders' difficulty 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 policy instrument of loans, rather than tax-funded grants or institutional support, to finance higher education, even as the program shifted from federal guarantees of private student loans to direct federal lending. Finally, we showed how student loans evolved over time, from being financial instruments with fairly standard terms to having a variety of features including income-contingent payments, interest relief, and potential loan cancellation that materially affect the total amount that the borrower must repay to satisfy the loan obligation.

In this Part, we break down why this current structure of student loans is so unlike other forms of debt. Other forms of debt sometimes have one or more of these features; what makes student debt different is the totality of these features—student loans go well beyond even most forms of contingent debt. The aggregation of what we term “nondebt features” requires us to look beyond the form of an instrument and consider better ways to describe its substance.

The standard debt paradigm is a loan made at arm's length by a private lender to a private borrower. The loan will be underwritten—that is, priced—based in part on the borrower's risk profile; riskier borrowers receive less favorable terms, and at a certain point, will not be able to obtain a loan at all. Under the standard

170. See Final REPAYE Rules, 80 Fed. Reg. at 67,213.

171. See *id.* (stating that the provision was “directed towards ensuring that borrowers pay equitably”).

172. See *id.* at 67,214 (responding to a comment submitted by one of us (Brooks)). To be clear, if ten percent of the borrower's income is greater than the standard loan payment, then the borrower would be paying essentially the standard payment of principal and full interest, plus an additional paydown of principal. That means less (high-rate) interest accruing on that principal going forward, and thus a lower total cost over the life of the loan.

debt paradigm, the loan will be for a fixed sum, payable according to an agreed-upon schedule. The loan may or may not be amortized; it may allow for prepayment or have late payment penalties; and interest may or may not compound, but the loan nevertheless contemplates a particular payment schedule as a baseline. This payment schedule makes it possible for the borrower to determine the cost of the loan and to therefore compare the loan with other products. Under the standard debt paradigm, the repayment schedule contemplates repayment in full of the principal. If prepayment is allowed, it will reduce interest payments, but it will not result in principal forgiveness.

Under the standard debt paradigm, the loan will also come with a contractual asterisk regarding repayment. Although future-Justice Oliver Wendell Holmes Jr. famously described a contract at common law as the obligation to perform as agreed or to pay damages (which in the case of a loan would be the same as performance),¹⁷³ under contemporary American law, a loan agreement is an agreement for the borrower to pay as agreed or pay damages, *subject to the possibility of restructuring or discharging the debt in bankruptcy*. The bankruptcy asterisk represents an important safety valve against overleverage. Finally, under the standard debt paradigm, the lender will always be subject to regulatory oversight of some sort, although the details might vary by lender, borrower, and product.

When viewed against this yardstick, student loan debt looks very different. 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 different goals, incentives, and economics than a private lender. Whereas a private, for-profit 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.¹⁷⁴ 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.

The federal government's lack of profit motive, its goal to have more college graduates, and 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, a lack of compounding interest, a lack of interest accrual in some circumstances, favorable tax treatment, and other pro-debtor features. However, they also

173. O. W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (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's famous dictum is limited to common law, but it was also made at a time when there was no bankruptcy law in force in the United States.

174. See, e.g., H.R. REP. NO. 95-951, at 1 (1978) (stating the purpose of the Middle Income Student Assistance Act was "to provide needed financial assistance to students from hard-pressed working class and middle-income families"); H.R. REP. NO. 85-2157, at 1 (1958) (stating the purpose of the NDEA was "to assist in the improvement and strengthening of our educational system at all levels and to encourage able students to continue their education beyond high school").

include sharp limitations on bankruptcy discharge. The federal government's role as a direct lender also affects regulatory oversight of the loans because the Department of Education is not subject to regulation by the Consumer Financial Protection Bureau (CFPB), the Federal Trade Commission (FTC), or state regulatory authorities.¹⁷⁵ Although we would describe many federal direct loan programs other than student lending as fairly typical debt contracts—government lending alone is hardly dispositive here—this totality of differences leads us to conclude that student loans are, in substance, a unique financial and legal category.

A. LACK OF UNDERWRITING

Perhaps the most remarkable and nondebt-like feature of federal student loans is that they are not underwritten in any way. Most lending is underwritten (priced) to reflect the borrower's risk over a risk-free rate. This underwriting looks to various measures of the consumer's credit quality and the consumer's capacity to repay from income and assets. Riskier borrowers pay more or receive less credit, and when borrowers become too risky, they do not receive credit on any terms.

Federal loans to students have no underwriting. Instead, federal student loans are one-size-fits-all products in terms of loan eligibility, rates, and maximum loan size.¹⁷⁶ It does not matter if a borrower is an engineering major at MIT or a poetry major at Upper Vermont State Community College. The loan terms for both borrowers will be the same despite vastly different career, and hence repayment, prospects.

The lack of underwriting reflects, in part, the difficulty in underwriting borrowers with little or no credit history and no or part-time employment. It also reflects a reasonable political reluctance to price based on the borrower's school and course of study because of concerns about steering students into particular schools or programs of study. Additionally, pricing based on school or course of study could raise discriminatory lending issues. Would rates be higher for students at historically Black colleges and universities? Would there be different rates for students majoring in women's studies than for computer science majors?

The lack of underwriting has cross-cutting effects on borrowers. It increases the pool of borrowers who can get loans, which is helpful for those borrowers who would otherwise not be able to finance higher education. Lack of underwriting also means there is a cross-subsidization from borrowers who have lower risk profiles to those with higher risk profiles because all borrowers pay the same price.¹⁷⁷ Directly, this is good for some borrowers and bad for others, but indirectly its net impact is harder to discern because the cross-subsidy likely has

175. Significantly, however, private loan servicers working for the Department of Education may be subject to regulation by the CFPB, FTC, and state authorities.

176. See Glater, *supra* note 19.

177. On cross-subsidization, see generally John Brooks, Brian Galle & Brendan Maher, *Cross-Subsidies: Government's Hidden Pocketbook*, 106 GEO. L.J. 1229 (2018) (describing cross-subsidies and arguing that they are efficient in certain circumstances). Regarding cross-subsidization in student loans, see Brooks, *supra* note 33, at 269–71 and Brooks et al., *supra*, at 1260–61.

systemic benefits that accrue to all borrowers, such as helping create economies of scale in higher education and increasing the diversity of student bodies and the overall educational level of Americans.

The lack of underwriting does have one clearly negative effect on borrowers, however. The absence of risk-based pricing means that borrowers do not receive market feedback about the riskiness of their borrowing. If a potential borrower is able to obtain credit only at a high price, that is a signal to the borrower that the creditor specifically and the market generally have doubts about the borrower's likelihood of successful repayment. This, combined with the difficulty of predicting effective interest rates, makes it near impossible for student borrowers to know if their borrowing is within their ability to repay.¹⁷⁸

Notably, the lack of front-end underwriting is mitigated by the availability of back-end “underwriting” in the form of IDR options, as discussed below.¹⁷⁹ Although affordability is not considered on the front end, it is essentially built into federal student loan products through repayment options that limit the obligations based on a rough measure of affordability, namely a percentage of the borrower's adjusted gross income. Additionally, deferment and forbearance options help ensure affordability of monthly payments at times when the borrower is unlikely to have significant income.

B. INCOME-CONTINGENT PAYMENTS

A borrower in one of the IDR plans (ICR, Old IBR, New IBR, PAYE, REPAYE) is not required to pay a fixed monthly amount based on their principal and interest rate but instead is to make payments that are a function of their income. This is especially true for REPAYE, where a borrower pays ten percent of their discretionary income no matter what their income is.¹⁸⁰ (In the other IDR plans, a borrower may revert to paying the standard loan amount when their income is high enough.)¹⁸¹ 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.¹⁸²

Income-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. Only student loans have a standing option of income-contingent repayment.

178. See, e.g., Michael Simkovic, *Risk-Based Student Loans*, 70 WASH. & LEE L. REV. 527, 530 (2013) (arguing that the “price signal” of risk-based pricing “would likely improve students’ ability to make informed decisions about the course of study that would best balance their innate abilities and individual preferences with postgraduate economic opportunities”).

179. See *infra* Section II.B.

180. See *supra* notes 166–72 and accompanying text.

181. See *supra* note 169.

182. See *infra* Section II.D.

To illustrate the unusualness, consider that 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 consumer credit regulation. Loan payments as variable as student loan obligations and based directly on revenue or profit of the borrower, with no relation to the stated interest rate or some other rate index, carry a serious risk of being legally recharacterized as equity instead of debt for tax, bankruptcy, or consumer credit purposes.¹⁸³ Of course, the concerns of tax law—protecting the tax base against excessive earnings stripping through interest deductions—and the concerns of bankruptcy law—determining the priority of claims or interests in the debtor—are not the same concerns as consumer credit law—ensuring smooth functioning of debt markets by protecting borrower rights. But in the case of federal loans to fund higher education, it is not clear whether *any* of these concerns are present.

C. FORGIVENESS OF UNPAID BALANCES

All borrowers in IDR are entitled to forgiveness of any unpaid balances—principal and interest—after being in a repayment plan for some set amount of time (ten, twenty, or twenty-five years, depending on the plan).¹⁸⁴ The forgiveness is contractual, not discretionary, and is based only on objective factors, such as the borrower’s income and length of time in repayment. If the terms of the loan require payment only for a fixed number of years, with no discretion for the lender on whether payments must continue after that, it is debatable whether the end of the loan after that period is truly “forgiveness.” Instead, the contract itself is more aptly described as giving the borrower a right to satisfy the debt by paying *X* percent of income for *Y* years. This is vastly different than a standard debt contract, which requires repayment in full of all loan principal and accrued interest.

Student loan forgiveness can also occur outside the IDR 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.”¹⁸⁵ Although these rules were written to apply to private lenders under the Guaranteed Student Loan Program, they also apply to Direct Loans,¹⁸⁶ meaning 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. Whereas some commercial law and bankruptcy remedies provide for

183. See, e.g., William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 431–47 (1971).

184. See *supra* Section I.G.

185. 34 C.F.R. § 685.222(a)(5)(i) (2019); see *id.* § 685.212(a) (borrower’s death); *id.* § 685.213(a) (borrower’s disability); *id.* § 685.214(a) (closed school); *id.* § 685.215(a) (false certification of eligibility).

186. See 20 U.S.C. § 1087e(a)(1) (2018) (stating that, unless otherwise specified, Direct Loans are to be treated the same as guaranteed loans).

cancellation or subordination of a debt in the case of lender malfeasance,¹⁸⁷ student loan forgiveness for federal Direct Loans applies where the lender (the U.S. government) has done nothing wrong, and at most perhaps a *school*, a third party that is neither the borrower nor the lender under the current program, has behaved badly.¹⁸⁸ 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, so it is almost impossible for borrowers to understand *ex ante* how much interest they will actually pay or what their effective interest rates will be. Federal student loans are not subject to the Truth in Lending Act disclosure regime,¹⁸⁹ 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 IDR plans. It is not an exaggeration to say that a student borrower cannot know *ex ante* how much the borrowing will ultimately cost.

To illustrate how complex the interest accrual rules are, we briefly summarize the interest terms of the various IDR plans. Together they show that the amount of interest that will actually be charged on a loan is indeterminate *ex ante*—it will depend on factors that neither the borrower nor the government can know at the time the loan is made. Moreover, the complexity of the terms makes it difficult to guess with much precision.

It is necessary as an initial matter to define a few terms. Interest *accrues* monthly based on the unpaid principal balance and stated interest rate. Sometimes this accrued interest is paid by the borrower in the current monthly period, sometimes it is paid by the government (and thus not charged to the borrower), and sometimes it is simply unpaid. In some cases, 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 IDR or not, there is a distinction between unsubsidized and subsidized loans.¹⁹⁰ Subsidized loans are available for families and students below a specified income threshold. With subsidized loans, the government pays the accrued interest while the student is enrolled in higher

187. *See, e.g.*, 11 U.S.C. § 510(c) (2018) (providing for equitable subordination in bankruptcy); CONN. GEN. STAT. § 37-8 (2020) (principal and interest payments on usurious loan unenforceable); N.Y. GEN. OBLIG. LAW § 5-511 (McKinney 2020) (principal and interest payments on usurious loan unenforceable); *Pepper v. Litton*, 308 U.S. 295, 305–06 (1939) (recognizing availability of equitable disallowance in bankruptcy (citing *Lesser v. Gray*, 236 U.S. 70, 74 (1915))).

188. *See, e.g.*, 34 C.F.R. §§ 685.215(a), 685.222(d) (2019).

189. 15 U.S.C. § 1603(7) (2018).

190. *See supra* Section I.E.

education and for a six-month period after leaving school (and also during any period of deferment).¹⁹¹

For unsubsidized loans, however, all interest accrues and is owed by the borrower, unless an IDR provision provides otherwise.¹⁹² As noted in Section I.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 to a private lender.¹⁹³ 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 otherwise merely be “paying” itself. Essentially, the government just forgives some of the interest that would otherwise be charged to the borrower.

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,¹⁹⁴ or is forgiving part of the debt to itself.¹⁹⁵ This issue does not appear to have ever been raised, and there is no authority on point. That this has never been broached suggests 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 using one of the IDR plans, the interest-accrual rules differ starkly based on the particular plan. To review, there are four types of IDR plans: Income-Contingent Repayment (ICR), Income-Based Repayment (Old and New IBR), Pay As You Earn (PAYE), and Revised Pay As You Earn (REPAYE).¹⁹⁶ We briefly explain these varied interest rules in order to illustrate the complexity for borrowers.

1. Income-Contingent Repayment

For a borrower in ICR (other than PAYE and REPAYE), unpaid accrued interest is capitalized into the loan for an amount up to ten percent of the original loan balance.¹⁹⁷ Unpaid, accrued interest beyond that is still owed but does not grow and compound over time—it is essentially an additional, interest-free loan. Because the debt is long-term (ICR forgiveness is at twenty-five 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

191. See 34 C.F.R. § 685.207(b)(3) (2019).

192. *Id.* § 685.207(c)(3).

193. See Higher Education Act of 1965, Pub. L. No. 89-329, § 428(a), 79 Stat. 1219, 1240–41; *supra* text accompanying note 89.

194. See, e.g., *Old Colony Tr. Co. v. Comm’r*, 279 U.S. 716, 729 (1929) (“The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed.”).

195. See I.R.C. § 61(a)(11) (2018) (stating that gross income includes “[i]ncome from discharge of indebtedness”).

196. See *supra* Section I.G.

197. 34 C.F.R. § 685.209(b)(3)(iv) (2019).

Treasury rate (roughly three percent at the time of this writing¹⁹⁸), a debt of \$100 in Year 1 that charges no interest would have a present value of about \$48 in Year 25—that is, noncapitalization is equivalent to cancellation of \$52 of debt in present value.¹⁹⁹ 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).²⁰⁰

2. Income-Based Repayment

If the payment of a borrower in IBR (Old or New) is not sufficient to cover the interest otherwise due, the government will cover the unpaid interest during the first three years of repayment (for both subsidized and unsubsidized Direct Loans).²⁰¹ After that, however, any unpaid interest accrues and is fully capitalized into the loan if the borrower's income becomes high enough that the borrower no longer needs income-based payments, or if the borrower simply leaves the plan.²⁰² Contrast that with ICR, which does not reduce the interest payments for any period but caps the amount of unpaid interest that can be capitalized.

3. Pay As You Earn

The PAYE plan combines the terms of ICR and IBR. The government will cover unpaid interest during the first three years of repayment²⁰³ and will also cap the capitalization of any interest after that at ten percent of the original loan.²⁰⁴ As with ICR, uncapitalized interest still accrues but does not bear an interest charge of its own.²⁰⁵

4. Revised Pay As You Earn

The REPAYE plan provides yet another treatment of interest. Under this plan, the government will pay all the interest in the first three years only for subsidized loans.²⁰⁶ For unsubsidized loans, the government covers only half of the interest (the rest is either paid or accrued and unpaid).²⁰⁷ However, after the first three years, the government will continue to cover half of the unpaid interest for all loans, subsidized and unsubsidized.²⁰⁸ Moreover, none of the leftover unpaid

198. See *Daily Treasury Long Term Rate Data*, U.S. DEP'T TREASURY: RESOURCE CTR., <https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=longtermrate> [<https://perma.cc/BHB3-T85M>] (last visited Sept. 10, 2020).

199. That is, \$48 in Year 1, invested at a three-percent return, would generate \$100 in Year 25.

200. Interest on Grad PLUS Loans issued for 2018–19 is 7.6%. Annual Notice of Interest Rates for Fixed-Rate Federal Student Loans Made Under the William D. Ford Federal Direct Loan Program, 83 Fed. Reg. 53,864, 53,865 (Oct. 25, 2018).

201. 34 C.F.R. § 685.221(b)(3) (2019).

202. *Id.* § 685.221(b)(4).

203. *Id.* § 685.209(a)(2)(iii).

204. *Id.* § 685.209(a)(2)(iv)(B)(1).

205. *Id.* § 685.209(a)(2)(iv)(B)(2).

206. *Id.* § 685.209(c)(2)(iii)(A).

207. *Id.* § 685.209(c)(2)(iii)(B).

208. *Id.* § 685.209(c)(2)(iii)(A)–(B).

accrued interest is capitalized into the loan principal unless the borrower leaves REPAYE (which is not required, even for a person with high income).²⁰⁹

* * *

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 the repayment plan he or she will ultimately use. The borrower may select a repayment plan years after the actual loan. As a result, the borrower cannot know how interest accrual will work and thus cannot know the total cost of borrowing. The amount of interest a borrower will actually pay, or even have forgiven in a formal sense, is a complex function of 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.²¹⁰

E. LACK OF PENALTY FOR LATE PAYMENTS

Late fees are a standard feature of most consumer loans. Nearly all mortgages, auto loans, and credit card loans have late fees. The form of the note for federal student loans authorizes late fees,²¹¹ but the Department of Education does not levy late fees and forbids its loan servicers from charging them.²¹² Thus, if a consumer is delinquent, interest will continue to accrue, but there is no special penalty for late payment.

F. 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 received the money to pay off the debt.²¹³ Relieving someone of that debt burden increases the person's net wealth just as much as receiving cash. Therefore, this gain in wealth is treated as income by the tax system 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 plan and the reasons for forgiveness. That varied treatment is also in flux, subject to *ad hoc* rulings by the Treasury and IRS. The tax code has long provided that debt forgiven under PSLF (or its predecessors) is excluded from gross income for tax

209. *See id.* § 685.209(c)(2)(iv).

210. *See, e.g.*, 15 U.S.C. § 1637(a) (2018) (mandating certain disclosures for open-end consumer credit plans).

211. *See* OFFICE OF FED. STUDENT AID, U.S. DEP'T OF EDUC., OMB No. 1845-0007, MASTER PROMISSORY NOTE 5 (2019), <https://studentloans.gov/myDirectLoan/subUnsubHTMLPreview.action> [<https://perma.cc/WS5P-NZEF>] (authorizing a six-percent late fee).

212. CFPB, SUPERVISORY HIGHLIGHTS: ISSUE 9, FALL 2015, at 24 (2015), https://files.consumerfinance.gov/f/201510_cfpb_supervisory-highlights.pdf [<https://perma.cc/DXC6-665E>].

213. *See* I.R.C. § 61(a)(11) (2018).

purposes.²¹⁴ The 2017 tax reform bill added an additional exclusion for debt forgiven due to death and disability (at least through 2025).²¹⁵ Moreover, the HEA states that debt forgiven because of school closure is excluded from gross income for tax purposes.²¹⁶

The tax treatment of student debt discharged for 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 borrower defense to repayment, and the Treasury's position seems to be that the forgiven debt *does* create taxable income in those situations.²¹⁷

Yet on at least two occasions, the IRS has ruled that debt forgiven under the borrower-defense 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 borrower-defense (for students who had graduated or were no longer enrolled) theories.²¹⁸ Only the closed-school discharge has a statutory exclusion from taxation, but the IRS announced that it would not assert that gross income had been created for any borrower.²¹⁹ The IRS reasoned that many borrowers with borrower-defense discharge were either victims of fraudulent misrepresentation or insolvent, both of which can lead to an income exclusion under the tax code.²²⁰ But because it would be too difficult to determine which borrowers actually qualified for these exclusions, the IRS simply applied those theories to everyone.²²¹

In 2017, the IRS extended that same ruling to former students of American Career Institutes, whose debt had been discharged in similar circumstances.²²² These two examples might be enough to assume a pattern and a precedent, but the tax impact of these discharges still relies on the IRS issuing a formal ruling in future cases, and it is not clear whether future discharges under borrower defense would receive similar tax treatment.

In any case, neither of these rulings apply to IDR discharges. Currently, the Treasury's position is that those discharges will be taxable because no clear

214. *See id.* § 108(f)(1).

215. Pub. L. No. 115-97, sec. 11,031, § 108(f), 131 Stat. 2054, 2081 (codified at I.R.C. § 108(f)(5)(A)(iii) (2018)).

216. *See* 20 U.S.C. § 1087ee(a)(5) (PSLF loans); *id.* § 1087(c)(4) (incorporating § 1087ee(a)(5) for FFEL loans); *id.* § 1087e(a)(1) (incorporating FFEL terms for Direct Loans). 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. *See* Brooks, *supra* note 74, at 752.

217. *See* Letter from Eric Solomon, Assistant Sec'y for Tax Policy, Dep't of Treasury, to Hon. Sander Levin, U.S. House of Representatives 4 (Sept. 19, 2008) (on file with author).

218. *Fact Sheet: Protecting Students from Abusive Career Colleges*, U.S. DEP'T EDUC. (June 8, 2015), <http://www.ed.gov/news/press-releases/fact-sheet-protecting-students-abusive-career-colleges> [<https://perma.cc/QD8L-GBTY>].

219. *See* Rev. Proc. 15-57, 2015-51 I.R.B. 863.

220. *See id.*

221. *See id.*

222. *See* Rev. Proc. 17-24, 2017-7 I.R.B. 916.

statutory exclusion applies.²²³ 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.²²⁴ Recall that § 108(f) of the Internal Revenue Code, which formally excludes debt discharge for PSLF, was added because of an adverse IRS ruling for an early PSLF-like plan.²²⁵ In that 1973 ruling, the IRS reversed its earlier position and ruled that debt forgiveness under that plan did *not* qualify as an excluded “scholarship” under Section 117 because there was a quid pro quo—a benefit could not be a “scholarship” if it was essentially pay for services.²²⁶ Congress then enacted Section 108(f) to plug that hole and continue the exclusion.²²⁷ But for IDR, as opposed to PSLF, there is no quid pro quo in the first place—the borrower is not required to work in a particular field or geographic region, or to do anything else. Thus, the scholarship exclusion should continue to apply in principle.

At any rate, the takeaway is that there is inconsistent and fluctuating tax treatment of the forgiven debt and a lack of clarity as to 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.

G. NONDISCHARGEABILITY IN BANKRUPTCY

There are sharp limitations on the dischargeability of student loan debt in bankruptcy. Conventional wisdom is that student loan debt is usually nondischargeable in bankruptcy.²²⁸ Recent scholarship has shown that the restriction is not as absolute in practice,²²⁹ 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 seeking to address their debt burdens through bankruptcy.²³⁰

In a sense, nondischargeability makes student loan debt *more* like traditional debt in that it tightens the obligation to repay. But dischargeability is a feature of most debt, including consumer debt.²³¹ Typically debt is not an absolute obligation to pay but an obligation to pay *or file for bankruptcy*. Moreover, the IDR plans function more like a sliding-scale discharge, without the borrower having

223. See Letter from Eric Solomon, *supra* note 217.

224. See Brooks, *supra* note 74.

225. See *supra* notes 115–17 and accompanying text.

226. See Rev. Rul. 73-256, 1973-1 C.B. 56.

227. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 1076(a), § 108, 98 Stat. 494, 1053–54 (codified as amended at I.R.C. § 108(f)(1) (2018)); JOINT COMM. ON TAXATION, JCS-41-84, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 1199–1201 (1984).

228. See, e.g., Kat Tretina, *Is It Worth Using Bankruptcy to Free Yourself from Student Loans?*, CREDIT KARMA (Aug. 7, 2019), <https://www.creditkarma.com/advice/i/student-loans-in-bankruptcy> (citing an education finance expert as stating: “Getting your loans discharged in bankruptcy is theoretically possible, but it’s not your ordinary bankruptcy proceeding, and it’s incredibly difficult”).

229. See Iuliano, *supra* note 8, at 501.

230. See *id.* at 499 (“99.9 percent of bankrupt student loan debtors do not even try to discharge their student loans.”).

231. See 11 U.S.C. § 523 (2018) (excepting limited, enumerated types of debt from discharge).

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 in their own category.

H. FEWER CONSUMER PROTECTIONS

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, for example, does not apply to federal student loans, even though it covers private student loans.²³² Likewise, federal student loans are exempt from state-law disclosure regimes.²³³ This has four important implications.

First, it means that federal student loan borrowers do not receive equivalent disclosures about the terms of their loans compared to other types of credit, including other types of credit that they might use as substitutes for financing their educations—private student loans and credit cards. A lack of adequate and comparable information impedes borrowers' abilities to make informed consumption decisions, such as whether to borrow and how much from which sources.

The Truth in Lending Act has an *ex ante* disclosure regime, designed to promote an “informed use of credit.”²³⁴ This 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.”²³⁵

The HEA has its own disclosure requirements, but it does not require pre-borrowing disclosures of credit costs or use the standardized “finance charge” and “annual percentage rate” for disclosures.²³⁶ Instead, disclosures must merely disclose the “actual interest rate,” an undefined term.²³⁷ 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 by manipulating the presentation of the interest rate.²³⁸ 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.²³⁹

232. 15 U.S.C. § 1603(7) (2018).

233. 20 U.S.C. § 1098g (2018).

234. 15 U.S.C. § 1601(a) (2018).

235. *Id.* § 1637(a).

236. See 34 C.F.R. § 682.205(a)(1)–(2) (2019). The Department of Education regulations are for FFEL loans, but pursuant to 20 U.S.C. § 1087e(a)(1) (2018), the regulations governing FFEL loans apply to Direct Loans unless otherwise specified.

237. 34 C.F.R. § 682.205(a)(2)(iv) (2019).

238. See Anne Fleming, *The Long History of “Truth in Lending,”* 30 J. POL'Y HIST. 236, 237, 247 (2018).

239. See 20 U.S.C. § 1083(b) (2018); 34 C.F.R. § 682.205(a)(1) (2019).

Second, failure to comply with HEA loan disclosure requirements does not create civil liability for the Department of Education²⁴⁰ or relieve the borrower of the obligation to repay the loan.²⁴¹ In contrast, failure to provide Truth in Lending Act disclosures for typical debt results in the lender's civil liability, including statutory damages of two times the finance charge and attorney's fees.²⁴²

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 requires lenders to undertake a good-faith investigation into disputed charges while the consumer withholds payment, without triggering collection activity or negative credit reporting.²⁴³ Given the high costs of litigation relative to consumer debt amounts, this is an important consumer protection that encourages consensual resolution of disputes. Borrowers under federal student loans do not have this protection because the Truth in Lending Act does not apply to them, even though it does apply to private student loans.²⁴⁴

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.²⁴⁵ The HEA, in contrast, specifically authorizes the Department of Education to engage in "administrative offset," that is, garnishment from government payments, such as tax refunds or other government transfers.²⁴⁶

I. MINIMAL REGULATORY OVERSIGHT

Unlike all other types of consumer credit, federal student loans are exempt from independent regulatory oversight. Other types of consumer loans are subject to oversight and regulation variously by the CFPB and the FTC, as well as state regulatory authorities.²⁴⁷ Although these regulators may maintain authority over the servicing of student loans by private servicers,²⁴⁸ they have no authority to police the terms of the loans or the application of Department of Education

240. 20 U.S.C. § 1083(f)(2)(B) (2018).

241. *Id.* § 1083(f)(2)(A).

242. 15 U.S.C. § 1640(a) (2018).

243. *Id.* § 1666(a).

244. *See id.* § 1603(7).

245. *Id.* § 1640(h).

246. *See* 34 C.F.R. § 682.410(b)(5)(iii) (2019); *infra* Section II.J.

247. *See, e.g.*, 15 U.S.C. § 45(a)(2) (2018) (empowering the FTC to prohibit unfair and deceptive acts and practices in commerce, excluding depositories and credit unions); Adam J. Levitin, *The Consumer Financial Protection Bureau: An Introduction*, 32 REV. BANKING & FIN. L. 321, 322 (2012–2013).

248. *See* Complaint for Permanent Injunction & Other Relief ¶ 16, CFPB v. Navient Corp., No. 3:17-cv-101, 2017 WL 3380530 (M.D. Pa. Aug. 4, 2017) (bringing enforcement action against student loan servicer). The Department of Education asserts that the HEA preempts state regulation of federal student loan servicers. Federal Preemption and State Regulation of the Department of Education's Federal Student Loan Programs and Federal Student Loan Servicers, 83 Fed. Reg. 10,619, 10,619 (Mar. 12, 2018). This argument was rejected by the Seventh Circuit. *See* Nelson v. Great Lakes Educ. Loan Servs., Inc., 928 F.3d 639, 642 (7th Cir. 2019).

discharge decisions.²⁴⁹ In particular, federal student loans are not subject to prohibitions on unfair, deceptive, or abusive acts and practices.²⁵⁰ Thus, what consumer protection exists for federal student loans is undertaken primarily by the Department of Education, meaning that the lender is policing itself.

Although the Department of Education is the first line of supervision of federal student loan servicers, that supervision is not undertaken by a dedicated consumer protection unit in the Department of Education—there is none—but by employees from three offices within Federal Student Aid (the unit of the Department of Education responsible for student loans), namely Business Operations, Program Compliance, and Finance.²⁵¹ These offices are tasked with ensuring that the servicers are complying with the terms of their contracts and general federal student loan servicing requirements.²⁵² They have no authority to ensure that servicers comply with broader standards prohibiting unfairness, deception, or abuse, much less to discipline servicers based on these broad standards.

Even within the scope of its authority, the Department of Education has done little to ensure servicer compliance with contract and regulatory requirements. A Department of Education Inspector General report found that Federal Student Aid “had not established policies and procedures that provided reasonable assurance that the risk of servicer noncompliance with requirements for servicing federally held student loans was mitigated.”²⁵³ The report further found that: “[Federal Student Aid] management rarely used available contract accountability provisions to hold servicers accountable for instances of noncompliance.”²⁵⁴ Thus, the Inspector General found that “[Federal Student Aid] also rarely penalized servicers for recurring noncompliance. In the 5 years that ended September 2017, FSA had required only three servicers to return about \$181,000 to FSA for four instances of failure to service loans in compliance with Federal loan servicing requirements.”²⁵⁵ The Department of Education’s weak oversight of servicers means that servicers have little incentive to take care to comply with federal loan servicing requirements.²⁵⁶

249. There is no express exception to CFPB or FTC authority for federal student loans. For the CFPB, the Department of Education does not seem to fall under the definition of “person” and thus under the definition of “covered person,” which is its jurisdictional trigger, unless it falls within the catchall of “other entity,” which seems unlikely. *See* 12 U.S.C. § 5481(6), (19) (2018). Similarly, the FTC’s authority to prohibit unfair and deceptive acts and practices extends to “persons,” a term that is not defined in the Federal Trade Commission Act of 1914 or its amendments. *See* 15 U.S.C. §§ 44, 45(a) (2018). It is unclear if the term could extend to the federal government.

250. *See supra* note 249.

251. *See* OFFICE OF INSPECTOR GEN., U.S. DEP’T OF EDUC., ED-OIG/A05Q0008, FEDERAL STUDENT AID: ADDITIONAL ACTIONS NEEDED TO MITIGATE THE RISK OF SERVICER NONCOMPLIANCE WITH REQUIREMENTS FOR SERVICING FEDERALLY HELD STUDENT LOANS 7 (2019).

252. *Id.* at 30.

253. *Id.* at 2.

254. *Id.*

255. *Id.* at 4.

256. *Id.*

What all of this means is that the due process and borrower protections that Congress thinks should exist in the context of private loans do 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.²⁵⁷ Student loans are again in their own category: one without the legal protections and oversight that apply to other categories.

J. EXTREME CONSEQUENCES OF DEFAULT

The consequences of defaulting on a student loan are substantially worse than defaulting on other forms of consumer debt. A default on regular consumer debt can result in dunning by debt collectors or a judgment followed by either garnishment or execution on and the foreclosure sale of a debtor's nonexempt property. Critically, a creditor on a standard loan can reach only the debtor's future income or nonexempt property,²⁵⁸ but federal benefit payments are ordinarily exempt from garnishment.²⁵⁹

In contrast, the federal government, as creditor, has collection capabilities that exceed those of private lenders. The federal government is allowed to engage in "administrative offset" of past-due student loan debt payments against future federal benefit payments and tax refunds.²⁶⁰ Private creditors are also able to engage in setoff, say against a deposit account balance, but a consumer can readily avoid setoff simply by limiting its dealings with a creditor. A consumer cannot avoid being a federal benefit recipient so easily.

Moreover, under some state laws, a default on student loan debt can mean frozen college credentials (for example, transcripts being withheld)²⁶¹ or even suspension of state occupational licenses.²⁶² These modern-day forms of debtors' prison are unique among consumer debts.²⁶³

257. See, e.g., I.R.C. §§ 6320, 6330 (2018) (due process in tax collection); *Mathews v. Eldridge*, 424 U.S. 319, 332–33 (1976) (due process in Social Security administrative proceedings).

258. Property exemptions vary significantly among the states, as do wage garnishment restrictions above the federal floor. See *Hynes et al.*, *supra* note 48, at 25–28 (explaining variation in state property exemption laws); see also 15 U.S.C. § 1673 (2018) (establishing federal limitations on wage garnishment).

259. See, e.g., 42 U.S.C. § 407(a) (2018) (prohibiting garnishment of Social Security benefits); 31 C.F.R. § 212.6 (2019) (exempting federal benefit payments from garnishment while in a deposit account). Exceptions exist for federal- and state-tax delinquencies and domestic support obligation debts. See 15 U.S.C. § 1673(b)(1)(A) (2018) (support orders); *id.* § 1673(b)(1)(C) (federal- and state-tax delinquencies).

260. See 34 C.F.R. §§ 30.20–31, 682.410(b)(5)(iii) (2019).

261. See KASEY KLEPFER, CHRIS FERNANDEZ, CARLA FLETCHER & JEFF WEBSTER, TG RESEARCH & ANALYTICAL SERVS., INFORMED OR OVERWHELMED?: A LEGISLATIVE HISTORY OF STUDENT LOAN COUNSELING WITH A LITERATURE REVIEW ON THE EFFICACY OF LOAN COUNSELING 4 (2015), <https://files.eric.ed.gov/fulltext/ED579985.pdf> [<https://perma.cc/N59V-B7MR>].

262. See *id.*; *Wagner*, *supra* note 9, at 1.

263. They are also self-defeating because depriving a borrower of an occupational license makes it less likely that the borrower will be able to repay. More mundanely, debt concerns may drive some students to avoid fields that require graduate degrees or professional licensing or credentialing, or to live at home and attend lower ranked schools.

III. STUDENT LOAN PROBLEMS STEMMING FROM THE DEBT PARADIGM

The primary claim of this Article is that most, if not all, of the problems with student loan debt in general and IDR debt in particular are due to the incompatibility between the legal and institutional apparatus of debt and the economic reality of student loans as they exist today. Student loans operate like traditional debt when they should not and not like traditional debt when they should.

The debt-based attributes of federal student loans are carryovers from the legacy structure of education financing. When education financing was done through private loans backed by federal loan guarantees, the transaction was more clearly one of debt. From this debt framework, a number of features followed.

For example, interest subsidization, the tax treatment of forgiven debt, and private loan servicing all make sense in the context of a loan guarantee program. Interest subsidization was necessary because private lenders required a regular revenue stream on the loans while the student was still enrolled; the uncertainty of length of enrollment would otherwise make it difficult to price loans. Interest subsidization ensured this needed revenue stream.

Likewise, the original tax treatment of student loan debt forgiveness lined up more closely with the treatment for other debt. And private loan servicing was the only option for collections on private loans.

These concepts and features, among others, have carried over to the Direct Loan era, but they make little sense today, particularly because they have been tweaked and adjusted as the government's direct role in lending has increased. As discussed in Part II, the federal government does not require a regular revenue stream on the loans; it can provide grants or loan forgiveness for a variety of reasons, and it has collection options besides private loan servicers—the legacy features are increasingly inapposite to the needs of today's loan program and the powers of the government. For the reasons that we lay out below, the direct federal role in student loans requires a fundamental rethinking of the underlying structure of the education financing program.

A. UNNECESSARILY HIGH LEVEL OF LOAN DEFAULTS

Over 9 million student borrowers are currently in default,²⁶⁴ which is typically triggered after 270 days of nonpayment.²⁶⁵ This translates into a default rate of nearly thirteen percent,²⁶⁶ a materially higher default rate than for any other type

264. See OFFICE OF FED. STUDENT AID, *supra* note 5.

265. See 34 C.F.R. § 682.200(b) (2019).

266. See OFFICE OF FED. STUDENT AID, *supra* note 5. By dollar amount, 12.7% of debt is in default, but it represents 18.4% of borrowers because small loans are more likely to be in default. See *id.* A different default number that is watched more closely, because it is tied to school eligibility for Title IV funding, is the “three-year cohort default rate,” defined as the percentage of borrowers (not debt) who enter default within the first three years after they enter repayment. See 34 C.F.R. § 668.202 (2019) (method of calculating cohort default rates); *id.* § 668.206 (school eligibility for Title IV funding). For Fiscal Year 2016 (the most recent data), the national cohort default rate is 10.1%, a drop compared to prior years. See *Official Cohort Default Rates for Schools*, U.S. DEP’T EDUC.: OFF. OF FED. STUDENT

of consumer debt, even with a more generous measure of default for student loans.²⁶⁷

Although one would expect high default rates for loans that are not underwritten in any manner, the availability of IDR operates as a mitigant, a sort of back-end, ex post underwriting that keys payment obligations to income. If IDR were working properly, there ought to be close to zero defaults because repayments are based on income at a level that should ensure affordability.

The continuing high level of defaults underscores several problems: (1) enrollment in IDR is voluntary and complicated, rather than automatic; (2) the federal student loan servicing model creates bad incentives (discussed below) that reduce the use of IDR; (3) eligibility for IDR is restricted to borrowers with at most two periods of default,²⁶⁸ and (4) the concept of default itself is a legacy tool mismatched to the current policy issues.

In a world where the federal government is the creditor and loan payments are directly related to borrowers' adjusted gross incomes, there is no reason for any of the above problems to exist. Automatic IDR with paycheck withholding (as for income taxes) would virtually eliminate default.²⁶⁹ The general purpose of the default tool in lending—a set of legal and economic consequences that follow from loan nonpayment—is to ensure timely payment and trigger additional collection tools when payment is not timely. But this series of sticks—including self-defeating ineligibility for IDR—is a mismatched and overly punitive set of tools when the government has the simpler and more effective tool of the tax system at its disposal. Moreover, by inserting the administrative burden of borrower opt-in to IDR through a disincentivized private loan servicer (as discussed in the next Section), the government is guaranteeing some degree of failure, unnecessarily driving some borrowers into default. The debt-based enforcement tool of default is unnecessary, ineffective, and overly punitive.²⁷⁰

AID, <https://www2.ed.gov/offices/OSFAP/defaultmanagement/cdr.html> [<https://perma.cc/DC9E-VYCL>] (last updated Feb. 18, 2020).

267. In the first quarter of 2020, the credit card delinquency rate was 2.73%. *See Delinquency Rate on Credit Card Loans, All Commercial Banks*, FED. RES. BANK ST. LOUIS, <https://fred.stlouisfed.org/series/DRCCCLACBS> [<https://perma.cc/GMW7-ZZ3Z>] (last updated Feb. 18, 2020) (analyzing data provided by the Board of Governors of the Federal Reserve System). In the first quarter of 2020, the home mortgage delinquency rate was 2.33%. *See Delinquency Rate on Single-Family Residential Mortgages, Booked in Domestic Offices, All Commercial Banks*, FED. RES. BANK ST. LOUIS, <https://fred.stlouisfed.org/series/DRSFRMACBS> [<https://perma.cc/83CQ-FYHT>] (last updated Feb. 18, 2020) (analyzing data provided by the Board of Governors of the Federal Reserve System).

268. *See, e.g.*, 34 C.F.R. § 685.209(a)(1)(ii) (2019) (defaulted loans not eligible for PAYE); *id.* § 685.209(c)(1)(ii) (defaulted loans not eligible for REPAYE); *id.* § 685.210(b)(1) (defaulted borrowers restricted from changing repayment plans); *id.* § 685.219(c)(1)(i) (defaulted loans not eligible for PSLF); *id.* § 685.221(a)(2) (defaulted loans not eligible for IBR plans). A borrower can receive a second chance by consolidating, but if the consolidated loan enters default, then it becomes a defaulted loan as well. *See id.* § 685.220(d)(1)(i)(A) (defaulted loans are eligible for consolidation under certain circumstances).

269. We address the primary criticism of automatic withholding *infra* Section III.E.

270. Under current higher education law, default rates also provide information about school quality. For example, a school with greater than a forty-percent cohort default rate can lose access to Title IV funding. *See* 34 C.F.R. § 668.206(a) (2019). Automatic IDR with paycheck withholding would

B. ABUSIVE LOAN SERVICING

1. Student Loan Servicing

Loans require administration. This includes the sending of invoices, the collection and processing of payments, the maintenance of account balances, management of repayment plans, and resolution of defaults. In many types of lending, the administration of the loan is not done by the creditor on the loan but by a party called a servicing agent or servicer that is hired by the creditor;²⁷¹ borrowers have no choice regarding who services their loans.²⁷²

Federal student loans utilize private servicers contracted by the Department of Education. Direct Loan servicers send out billing invoices; maintain account balances; provide borrowers with information regarding forbearance, deferment, and repayment plans; and process borrower elections of those options.²⁷³ Notably, however, Direct Loan servicers do not process payments.²⁷⁴ Payments are made by borrowers directly to a Department of Education lockbox account.²⁷⁵ Moreover, Direct Loan servicers do not undertake collection suits.²⁷⁶ Once a loan runs 360-days delinquent, it is reassigned from the servicer to a private collection agency.²⁷⁷

Federal student loans have, unfortunately, been marked with a range of serious loan servicing problems that have compromised some of the benefits of the program and resulted in borrowers paying billions in unnecessary interest by virtue of being in suboptimal repayment plans.²⁷⁸ Of all the problems with the current loan programing, servicing may be the single biggest.

Because servicers are the point of communication and contact for borrowers, they are the node through which borrowers' rights regarding forbearance,

potentially eliminate that signal of school quality, but others could be created, such as per-school loan subsidy rates or a broader application of the Gainful Employment (GE) regulations. *See generally* 34 C.F.R. §§ 668.401–415 (2019) (GE regulations). As of this writing, the Trump Administration is seeking to rescind the GE regulations. *See* Program Integrity: Gainful Employment, 84 Fed. Reg. 31,392, 31,392 (July 1, 2019).

271. ADAM J. LEVITIN, *BUSINESS BANKRUPTCY: FINANCIAL RESTRUCTURING AND MODERN COMMERCIAL MARKETS* 124 (2d ed. 2019).

272. ADAM J. LEVITIN, *CONSUMER FINANCE: MARKETS AND REGULATION* 29 (2018).

273. *See, e.g.*, OFFICE OF FED. STUDENT AID, U.S. DEP'T OF EDUC., ED-FSA-09-D-0012, Attachment A-1 to SOLICITATION/CONTRACT/ORDER FOR COMMERCIAL ITEMS 6, 9 (2009), <https://www2.ed.gov/policy/gen/leg/foia/contract/greatlakes-061709.pdf> [<https://perma.cc/85QF-ZXP2>] (original Title IV Additional Servicers base contract with Great Lakes Educational Loan Services).

274. *See, e.g., id.* at 5.

275. *See, e.g., id.*

276. *See* Memorandum from Patrick J. Howard, Assistant Inspector Gen. for Audit, U.S. Dep't of Educ., to James W. Runcie, Chief Operating Officer, Office of Fed. Student Aid, U.S. Dep't of Educ. 3 (Dec. 13, 2012).

277. *See, e.g., id.* Since servicers can continue to earn servicing fees on a delinquent account, some servicers could even intentionally delay assignment to a collection agency in order to continue earning servicing fees. *See id.* at 1, 3 (stating that servicers continue to receive fees on loans that fail to be transferred, but suggesting the transfers are the result of failed technology, not intentional delay).

278. *See, e.g.*, Stacy Cowley, *28,000 Public Servants Sought Student Loan Forgiveness*. *96 Got It.*, N.Y. TIMES (Sept. 27, 2018), <https://www.nytimes.com/2018/09/27/business/student-loan-forgiveness.html>.

deferment, repayment plans, and loan forgiveness are effectuated (or not). This makes servicing of utmost importance in the operation of the Direct Loan system. Direct Loan servicing, however, is rife with problems because of the design of the system, which is in large measure a carryover from the debt paradigm of the FFEL Program of federal guarantees of private loans.

Direct loans are serviced by a combination of private for-profit and not-for-profit (NFP) servicers. In 2009, just before the transition to full direct lending, the Department of Education entered into five-year servicing contracts with four for-profit firms, called Title IV Additional Servicers (TIVAS).²⁷⁹ In 2010, Congress provided that the Department of Education would keep using private loan servicers even after it became the direct lender but required the Department to use NFP servicers in addition to the TIVAS.²⁸⁰ A number of NFP entities had serviced loans under the FFEL Program, and they successfully lobbied to receive a guaranteed initial allocation of 100,000 loan accounts each, subject to performance-based adjustments.²⁸¹ Until 2014, the NFP servicers were compensated at a premium over TIVAS for the same Direct Loan servicing, resulting in some NFP servicers outsourcing their accounts to TIVAS and keeping the spread in compensation.²⁸²

The continued use of private servicers under the Direct Loan Program was in part a way to appease the old FFEL lenders who lost out with the move to direct lending and in part a move to avoid the need to design an alternative servicing system. But it was also based on the continuation of the debt paradigm, which requires loan servicing.

The Department of Education renewed the TIVAS' contracts in 2014 for another five years.²⁸³ Today the Department of Education works with both the three TIVAS (two TIVAS merged in 2018)²⁸⁴ and eleven NFP servicers, one of which handles all PSLF and Teacher Education Assistance for College and Higher Education Grant Program (TEACH) servicing.²⁸⁵ The for-profit TIVAS

279. NAT'L CONSUMER LAW CTR. & STUDENT LOAN BORROWER ASSISTANCE, MAKING STUDENT LOAN SERVICING WORK FOR BORROWERS 1 (2014), <https://www.studentloanborrowerassistance.org/wp-content/uploads/2013/05/issue-brief-servicing-fed-loans.pdf> [<https://perma.cc/4GXY-BVBB>].

280. See SAFRA Act, Pub. L. No. 111-152, sec. 2212(a), § 456, 124 Stat. 1029, 1078–80 (2010) (enacted as part of the Health Care and Education Reconciliation Act of 2010).

281. See *id.* (allocating the servicing rights for loan accounts of 100,000 borrowers to eligible NFPs, defined as “not-for-profit holder[s] under section 435(p) [of the HEA]”).

282. See ERIC M. FINK & ROLAND ZULLO, FEDERAL STUDENT LOAN SERVICING: CONTRACT PROBLEMS AND PUBLIC SOLUTIONS 5 (2014), https://www.elon.edu/docs/e-web/law/faculty/Fink_Zullo_Federal_Student_Loan_Servicing_report_06_25_2014.pdf [<https://perma.cc/VM7J-YGFZ>].

283. See NAT'L CONSUMER LAW CTR. & STUDENT LOAN BORROWER ASSISTANCE, *supra* note 279 (“The Department has said that it intends to ‘exercise the option’ and extend the contracts with all of the TIVAS.”).

284. Matt Carter, ‘Big Four’ Student Loan Servicers Now ‘Big Three,’ CREDIBLE (Feb. 8, 2018), <https://www.credible.com/news/student-loans/big-four-student-loan-servicers-now-three/> [<https://perma.cc/N8DZ-UBL8>].

285. See Bob Fernandez & Erin Arvedlund, *Is FedLoan, America’s Giant Student Loan Servicer, Running Out of Money?*, PHILA. INQUIRER (Feb. 24, 2019), <https://www.inquirer.com/business/fedloan-student-loans-lending-pheaa-pennsylvania-higher-education-assistance-agency-james-steeley-20190224.html> (identifying the Pennsylvania Higher Education Assistance Agency as the exclusive servicer for TEACH and PSLF); *Loan Servicing Contracts*, OFF. FED. STUDENT AID,

have the lion's share of the servicing market, managing eighty-eight percent of all loan amounts outstanding and seventy-nine percent of all borrowers.²⁸⁶

This use of private servicers for student loans is problematic because it shifts all the important interactions with borrowers to private parties that have perverse incentives and minimal oversight. We expand on the reasons for this by examining the arrangements in detail.

2. Misaligned Servicer Compensation

Student loan servicers are compensated differently from mortgage servicers, which form a better-studied loan servicing industry. Mortgage servicers are compensated with a flat percentage fee based on the outstanding principal balance of serviced loans, plus investment (“float”) income on funds collected from mortgage borrowers before the funds are turned over to investors.²⁸⁷ They are also allowed to keep any ancillary fees collected, but they bear the costs of “advancing” delinquent payments to the creditor and trying to recoup them from subsequent recoveries.²⁸⁸ In contrast, Direct Loan servicers are compensated with a monthly per-borrower (not per-loan) fee that varies depending on whether the loan is in repayment, deferment, forbearance, or various stages of delinquency or default.²⁸⁹ The servicing fee does not depend on the number of loans that the borrower has being serviced by the servicer because borrowers are counted as unique borrowers by Social Security number.²⁹⁰

Under the 2014-contract renewals for the TIVAS, the monthly fee starts at \$2.85 per borrower who is in repayment and then declines in various stages of deferment, forbearance, or delinquency until it is a mere \$0.45 per borrower with any loan that is over 270-days delinquent.²⁹¹ An additional incentive of up to

center/business-info/contracts/loan-servicing [https://perma.cc/C3SM-S74Z] (last visited Aug. 12, 2020) (offering data on eleven NFP servicing contracts).

286. See OFFICE OF FED. STUDENT AID, U.S. DEP'T OF EDUC., SERVICER PORTFOLIO BY LOAN STATUS (2020), <https://studentaid.gov/sites/default/files/fsawg/datacenter/library/servicer-portfolio-by-loan-status033120.xls> [https://perma.cc/CMC9-KVXU].

287. See Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 70–71 (2011).

288. See *id.*

289. See, e.g., OFFICE OF FED. STUDENT AID, U.S. DEP'T OF EDUC., ED-FSA-09-D-0012/0080, AMENDMENT OF SOLICITATION/MODIFICATION OF CONTRACT 12–13 (2014) [hereinafter OFFICE OF FED. STUDENT AID, GREAT LAKES CONTRACT], https://studentaid.gov/sites/default/files/ED-FSA-09-D-0012_MOD_0080_GreatLakes.pdf [https://perma.cc/6CEH-QYJR] (contract with Great Lakes Educational Loan Services); OFFICE OF FED. STUDENT AID, U.S. DEP'T OF EDUC., ED-FSA-09-D-0015/0085, AMENDMENT OF SOLICITATION/MODIFICATION OF CONTRACT 12–13 (2014) [hereinafter OFFICE OF FED. STUDENT AID, NAVIENT CONTRACT], https://studentaid.gov/sites/default/files/ED-FSA-09-D-0015_MOD_0085_Navient.pdf [https://perma.cc/CA4C-BVRN] (contract with Navient).

290. See, e.g., OFFICE OF FED. STUDENT AID, GREAT LAKES CONTRACT, *supra* note 289; OFFICE OF FED. STUDENT AID, NAVIENT CONTRACT, *supra* note 289.

291. See, e.g., OFFICE OF FED. STUDENT AID, GREAT LAKES CONTRACT, *supra* note 289, at 4; OFFICE OF FED. STUDENT AID, NAVIENT CONTRACT, *supra* note 289, at 4.

\$2 million annually is available if the TIVAS servicer succeeds in reducing delinquency rates beyond a certain level.²⁹²

Because Direct Loan servicers do not process payments, they do not enjoy any float income from investment of funds between when they are collected from the borrower and paid to the creditor. Nor can Direct Loan servicers collect any ancillary fee income; there are no “junk fees” for various unrequested services allowed on Direct Loans, unlike on mortgages. The Department of Education’s Master Promissory Note permits a six-percent late fee,²⁹³ but the Department of Education has instructed servicers not to levy the fee,²⁹⁴ and in any event, the servicers have no contractual right to retain that fee, unlike most mortgage servicing contracts.²⁹⁵ At the same time, because Direct Loan servicers are not involved in the handling of payments, they are not responsible for advancing delinquent payments to the creditor and trying to recoup the advances from subsequent recoveries.

The flat per-borrower fees for federal student loan servicing are designed to encourage servicer operational efficiency; the more efficient a servicer is, the greater its profit with fixed-rate compensation. The flat fees, however, have a gradation depending on repayment status.²⁹⁶ In theory, the lower compensation for delinquent borrowers is designed to incentivize servicers to keep borrowers current on repayment and to assist delinquent borrowers with returning their accounts to repayment status. Moreover, as discussed below, allocations of future business flows to servicers also depend in part on relative delinquency rates among servicers, which is meant to further incentivize servicers to take steps to reduce delinquency rates.²⁹⁷

Unfortunately, there is a tension between encouraging servicers to keep down operational expenses through flat per-borrower fees and encouraging servicers to take action to keep loans performing through greater compensation for performing loans. Servicers can increase their profitability by either reducing expenses or maximizing revenues. Keeping loans performing will maximize servicer revenue but doing so will also increase servicer expenses because interventions with borrowers to either prevent or cure delinquency are costly. The servicer has to spend time working with the individual borrower—collecting and analyzing borrower data and then processing paperwork. If the gain in revenue is insufficient to offset the additional expenses, then a profit-maximizing servicer will rationally decline to undertake the interventions necessary to help borrowers remain current on

292. See, e.g., OFFICE OF FED. STUDENT AID, GREAT LAKES CONTRACT, *supra* note 289, at 3; OFFICE OF FED. STUDENT AID, NAVIENT CONTRACT, *supra* note 289, at 3.

293. OFFICE OF FED. STUDENT AID, *supra* note 211; see also 34 C.F.R. § 685.202(d)(1) (2019) (authorizing the Secretary to charge a late fee of up to six percent).

294. CFPB, *supra* note 212.

295. See Levitin & Twomey, *supra* note 287, at 41.

296. See, e.g., OFFICE OF FED. STUDENT AID, GREAT LAKES CONTRACT, *supra* note 289, at 4; OFFICE OF FED. STUDENT AID, NAVIENT CONTRACT, *supra* note 289, at 4.

297. See *infra* Section III.B.3.

payments and will instead simply focus on cutting costs, even if that means providing lower quality service to borrowers.

In particular, a servicer that is focused on cost cutting will likely concentrate on increasing the automation of its operations in order to take advantage of economies of scale. This works well when dealing with routine procedures such as sending out billing statements or annual certification requirements, but it is a poor fit when dealing with distressed borrowers. Distressed borrowers often have idiosyncratic problems, and successfully dealing with them requires substantial time from skilled—and relatively expensive—personnel who are able to assist the borrowers in determining the appropriate repayment options and collecting and processing the paperwork necessary to implement these options.

The Department of Education's servicing contracts do not require servicers to maintain a certain level of staffing in terms of number or skill of personnel or even that their personnel be native English speakers or based in the United States.²⁹⁸ Thus, there is no check on servicers pursuing a strategy of maximizing profits by minimizing service quality.

The graduated compensation that favors performing loans is meant to encourage servicers to take steps to minimize default rates, but it falls short for two reasons. First, servicers have no stake in the ultimate performance of the loans because their compensation is unconnected with recoveries or even with loan balances. Second, the differences in the graduated, per-borrower fee levels are so small that it makes little sense for a servicer to spend any time engaging with any borrower. A borrower that is in repayment generates all of \$2.85 in monthly servicing income, whereas a borrower that is between thirty-one- and ninety-days delinquent generates revenue of \$1.46 monthly.²⁹⁹ The delinquency thus results in a decline of \$1.39 in monthly income for the servicer. Suppose that intervening to cure the delinquency requires an hour of time from an employee whose compensation (including benefits) is \$30 per hour. Ignoring the time value of money, it will take the servicer over twenty-one months of continuing loan performance to recoup its expenses.

Now consider that some delinquent loans will self-cure without servicer intervention, some cannot be cured despite intervention, and some that are cured with servicer intervention will redefault. If a loan would self-cure, then any effort the servicer spends on curing the loan is a superfluous waste. If a loan cannot be cured, then any effort the servicer spends on intervention is also a waste. And if a loan is cured but redefaults, the servicer's increased compensation will be curtailed, perhaps before the cost of intervention has been recouped. A servicer cannot, however, identify *ex ante* whether a loan will self-cure, cannot be cured, or will redefault after cure.

298. See, e.g., OFFICE OF FED. STUDENT AID, GREAT LAKES CONTRACT, *supra* note 289, at 1–21 (containing none of these requirements); OFFICE OF FED. STUDENT AID, NAVIENT CONTRACT, *supra* note 289, at 1–21 (same).

299. See, e.g., OFFICE OF FED. STUDENT AID, GREAT LAKES CONTRACT, *supra* note 289, at 4; OFFICE OF FED. STUDENT AID, NAVIENT CONTRACT, *supra* note 289, at 4.

The difficulty in sorting between good and bad candidates for intervention means that the servicer will be more reluctant to expend the effort on intervention for any delinquent borrowers. To illustrate, suppose that it costs a servicer \$30 per intervention with a thirty-one-day delinquent borrower, irrespective of the outcome. Let's also suppose a servicer has 100 borrowers that are thirty-one-days delinquent. The servicer anticipates that twenty percent of the delinquencies will self-cure, thirty percent cannot be cured, and that ten percent (separate from self-cures) will redefault after a cure after one year.

With these assumptions, if the servicer intervened in all 100 cases, the cost to the servicer would be \$3,000 relative to doing nothing (and not even employing staff to intervene). But the increase in revenue attributable to the intervention would be only \$69.50 per month for one year and then \$55.60 thereafter. On these numbers, it would take over four years to recoup the costs of the interventions, even disregarding the time value of money. Once the cost of funds is considered, recoupment would take even longer.

These illustrative figures demonstrate the larger point that if servicers cannot sort between good and bad candidates for intervention, they will be less likely to expend the funds and the effort to intervene with any delinquent borrowers. The surer and easier way for a servicer to increase profitability is to spend as little as possible on interventions with defaulted borrowers and to cut operational costs to the bone, no matter the effect on quality of performance.

Thus, consumer advocates cite the problem that servicers often place distressed borrowers into forbearance, a process that requires relatively little time for the servicer, rather than undertake the more involved and time-consuming process of explaining the availability of IDR plans to borrowers and then assisting them in compiling the paperwork necessary to qualify for such a plan.³⁰⁰ An IDR plan is usually better for the consumer both because it is a long-term, rather than a stop-gap (annual), solution and because interest accrues and is capitalized during forbearance periods, even as principal is not paid down.³⁰¹ Though the servicer is compensated less per month for a loan in forbearance than one performing in IDR,³⁰² the reduced revenue from forbearance does not outweigh the added expense for the servicer from helping the consumer get into an IDR plan. Servicers are incentivized to keep down their costs rather than provide optimal results for borrowers.

3. Misdesigned Allocation of Servicing Rights

Borrowers, unfortunately, have no way of avoiding low-quality servicing because they cannot choose their servicer (with the limited exception of when

300. See, e.g., *Strengthening the Federal Student Loan Program for Borrowers: Hearing Before the S. Comm. on Health, Educ., Labor, & Pensions*, 113th Cong. 7 (2014) (statement of Deanne Loonin, Attorney, Nat'l Consumer Law Ctr.).

301. See 34 C.F.R. § 685.205(a) (2019).

302. See, e.g., OFFICE OF FED. STUDENT AID, GREAT LAKES CONTRACT, *supra* note 289, at 4 (paying the servicer \$1.05 monthly for each borrower in forbearance and \$2.85 monthly for each borrower in repayment); OFFICE OF FED. STUDENT AID, NAVIENT CONTRACT, *supra* note 289, at 4 (same).

they are consolidating loans). The servicing of loans is determined by the Department of Education through a complex and dysfunctional allocation system that discourages servicers from spending on achieving high-performance servicing by limiting their rewards for success.

Allocation of servicing of new loans is done twice a year based on the Department of Education's application of five weighted servicer-performance metrics: the percentage of borrowers currently or less than 90-days delinquent (30% weight), the percentage of borrowers 91- to 270-days delinquent (15% weight), the percentage of borrowers 271- to 360-days delinquent (15% weight), borrower-satisfaction survey results (35% weight), and a Federal Student Aid employee-satisfaction survey (5% weight).³⁰³ Servicers are then ranked in each category, with the highest score being the total number of servicers and the lowest score being one.³⁰⁴ The scores are then adjusted by the category weight, such that if there are nine servicers, then the servicer with the highest borrower-satisfaction survey results would receive a score of 3.15 (9 multiplied by 0.35) for that category.³⁰⁵ A servicer's total score divided by the combined score of all the servicers is used to determine the percentage of new business allocation in the next half of the year.³⁰⁶

The consideration of delinquency rates in this system is intended to encourage servicers to invest in default servicing capacity in order to receive greater future business flows, but a servicer might still reasonably conclude that the surest way to maximize profits is to cut costs. A servicer with higher profits per loan might still be more profitable with a smaller market share than one with lower margins and a larger market share.

The allocation system limits the consequences for pursuing a low-cost servicing model because it puts a floor and a ceiling on servicer market shares. With nine servicers, if a servicer were consistently the lowest ranked, it would still receive two percent of the new business, whereas the highest ranked servicer would still not be able to receive more than twenty percent of new business, no matter how much better the highest ranked servicer was than the lowest ranked servicer.³⁰⁷ There is limited incentive for a servicer to attempt to improve its performance because upside is capped at a gain of approximately eighteen percent of market share of new loan flows in that year. (The Department of Education retains discretion to give a servicer no new business.)³⁰⁸

303. OFFICE OF FED. STUDENT AID, U.S. DEP'T OF EDUC., EXPLANATION OF ALLOCATION AND PERFORMANCE MEASURE METHODOLOGY 3 (2019), <https://studentaid.gov/sites/default/files/Explanation-2019.pdf> [<https://perma.cc/FBF6-V9PM>].

304. *Id.* at 2.

305. *Id.* at 3.

306. *Id.* at 4.

307. With nine servicers, ranked in reverse numeric order, the sum of the possible rankings is 45 ($\sum_{i=1}^9 i$). The lowest ranked servicer has a ranking of 1, which divided by 45 is 2.22%. The highest ranked servicer has a ranking of 9, which divided by 45 is 20%.

308. See, e.g., OFFICE OF FED. STUDENT AID, GREAT LAKES CONTRACT, *supra* note 289, at 8; OFFICE OF FED. STUDENT AID, NAVIENT CONTRACT, *supra* note 289, at 8.

If all servicers opt to pursue a cost cutting model, rather than a high-performance model, the Department of Education's allocation system will do nothing to correct it. The effect of the Department of Education's servicing rights allocation system is to herd servicers into mediocrity by limiting the upside for excellence. Benchmarking is a poor method of quality assurance when all parties have an incentive to perform poorly. Indeed, as the Department of Education's Inspector General noted, the methodology for assigning loans to servicers does not account for "servicers' compliance with Federal loan servicing requirements. Therefore, servicers with more frequent instances of noncompliance experienced no reduction in the amount of new loans that FSA assigned to them."³⁰⁹ Because borrowers cannot choose their servicer and the Department of Education does not penalize poor servicers by depriving them of business, there is no market discipline protecting borrowers against poor loan servicing.

4. Lack of Oversight of Servicers

Because consumers cannot choose their servicer, they lack the important market protection of ability to exit. And because of the perverse allocation system used by the Department of Education, there is no meaningful market check on servicer behavior. This makes oversight of servicers all the more critical, but that oversight is sorely lacking.

Because of the debt framework for student loans, the Department of Education views itself as a lender and therefore 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. It also leads the Department of Education to disclaim its role as a regulator of loan servicers, which it treats much more like contracted vendors.

The Department of Education does not regulate servicers for consumer protection purposes. Instead, to the extent that servicers are regulated at all by the Department, it is for contract compliance, which requires relatively little for servicers.³¹⁰ The Department does not conduct examinations of servicers for consumer protection compliance. The Department has never applied penalties to a servicer or disqualified a servicer, even though other federal agencies have brought actions against servicers for substantial legal violations.³¹¹ The

309. OFFICE OF INSPECTOR GEN., *supra* note 251, at 4.

310. *See* FINK & ZULLO, *supra* note 282.

311. The Federal Deposit Insurance Corporation (FDIC) and the U.S. Department of Justice settled with Sallie Mae in 2014 for violations of the Servicemembers Civil Relief Act. *See* Press Release, Dep't of Justice, Justice Department Reaches \$60 Million Settlement with Sallie Mae to Resolve Allegations of Charging Military Servicemembers Excessive Rates on Student Loans (May 13, 2014), <http://www.justice.gov/opa/pr/2014/May/14-ag-502.html> [<https://perma.cc/RS4M-PADK>]; Press Release, Fed. Deposit Ins. Corp., FDIC Announces Settlement with Sallie Mae for Unfair and Deceptive Practices and Violations of the Servicemembers Civil Relief Act (May 13, 2014), <http://www.fdic.gov/news/news/press/2014/pr14033.html> [<https://perma.cc/SSS7-5DA5>]; *see also* Complaint for Permanent Injunction & Other Relief, *supra* note 248, ¶ 1 (action against servicer for violations of the Consumer Financial Protection Act of 2010, the Fair Credit Reporting Act, and Fair Debt Collection Practices Act); Complaint, Commonwealth v. Pa. Higher Educ. Assistance Agency, No. 1784-cv-02682 (Mass. Super.

Department of Education has some authority to manage servicer problems, including changing servicer compensation and excluding problematic servicers from eligibility for future business, but it has little political incentive to do so.³¹²

Not surprisingly, the servicers appear to prefer this minimal federal oversight to any supervision under state-consumer debt law and often argue that state law is preempted by federal law—either the HEA or the Department of Education’s contracting requirements (which, as noted, are not a substitute for true oversight).³¹³ Should these theories prevail, student loan servicers would have nearly free rein.³¹⁴ The only check on them is the CFPB, which supervises “larger participants” in the student loan servicing market, including all TIVAS and the largest NFPs,³¹⁵ but since December 2017, student loan servicers have refused to cooperate with CFPB examinations based on guidance issued by the Department of Education.³¹⁶

The poor design and lack of oversight of the student loan servicing system have resulted in billions of dollars of unnecessary charges for borrowers. For example, borrowers need to know a precise projected loan balance in order to pay off a loan; if so much as one cent remains unpaid, the loan will keep accruing interest, and the servicer will keep receiving its servicing fee on the loan.³¹⁷ Not surprisingly, servicers have often failed to inform borrowers about failed payoff attempts.³¹⁸

Ct. Aug. 23, 2017) (action against servicer for violations of the Massachusetts Consumer Protection Act and the Consumer Financial Protection Act).

312. See OFFICE OF INSPECTOR GEN., *supra* note 251, at 2 (“[The Office of Federal Student Aid] management rarely used available contract accountability provisions to hold servicers accountable for instances of noncompliance.”).

313. See *Nelson v. Great Lakes Educ. Loan Servs., Inc.*, 928 F.3d 639, 642 (7th Cir. 2019) (holding that the HEA *does not* preempt state regulations of student loan servicers).

314. See generally David S. Rubenstein, *Supremacy, Inc.*, 67 UCLA L. REV. (forthcoming 2020) (manuscript at 34–43) (discussing cases of state law preemption by federal contracts).

315. Defining Larger Participants of the Student Loan Servicing Market, 78 Fed. Reg. 73,383, 73,384 (Dec. 6, 2013) (to be codified at 12 C.F.R. pt. 1090) (defining the loan servicing market to encompass both federal and private student loans and “larger participants” as those with loan servicing-account volumes exceeding 1 million). This category includes all of the TIVAS plus the largest NFPs. *Id.* at 73,396.

316. Chris Arnold, *CFPB Chief Says Education Department Is Blocking Student Loan Oversight*, NPR (May 16, 2019, 5:00 AM), <https://www.npr.org/2019/05/16/723568597/cfpb-chief-says-education-department-is-blocking-student-loan-oversight> [<https://perma.cc/AF8H-YDEK>]. It is unclear whether this situation has changed as a result of a new Memorandum of Understanding between the Department of Education and CFPB signed in January 2020. See Memorandum of Understanding Concerning Coordination in Resolving Borrower Complaints, Bureau of Consumer Fin. Prot.–U.S. Dep’t of Educ., Jan. 31, 2020, at 1, https://files.consumerfinance.gov/f/documents/cfpb_ed-memorandum-of-understanding_student-loan-borrowers_2020-02.pdf [<https://perma.cc/9VCT-KGZ3>].

317. See CFPB, *supra* note 212, at 24–25.

318. *Id.* (“Many student loan servicers do not inform borrowers that the payoff attempt failed and cease communicating regularly with the borrower for a significant period of time because the borrower has paid enough to cover subsequent months and does not have a monthly payment due, even though a small balance remains on the loan or account. When this type of situation occurs, borrowers may be left unaware that a balance remains, resulting in months or years of interest accrual, tradelines remaining open in borrowers’ credit reports, and potential delinquency or default when monthly payments are again due months or years later.”).

Servicers are also disincentivized to facilitate prepayments. When a loan is paid off, the servicer's revenue stream disappears. Borrowers who prepay tend to be lower credit risks, and they are most likely to be in repayment status, which makes their loans the most lucrative for servicers.³¹⁹ Therefore, when given a prepayment, servicers may encourage borrowers to take a "payment holiday" that undoes the benefit of prepayment or to extend the loan term to lower monthly payments in order to reduce future prepayments.³²⁰

Likewise, servicers are disincentivized to make borrowers aware of the PSLF option because when a borrower joins PSLF, the loan is usually transferred to a different servicer, depriving the original servicer of its revenue on the loan.³²¹ There is some evidence that servicers have also avoided giving disabled borrowers information about how to have their loans cancelled under disability discharge.³²²

The CFPB has accused Navient, one of the TIVAS, of having steered borrowers into forbearance rather than into IDR because this was the more cost-effective measure for Navient, even though the servicing fees on loans in IDR are higher than those in forbearance.³²³ Placing IDR-eligible borrowers into forbearance meant that interest accrued to borrowers' accounts when some or all interest would have been waived under various IDR plans.³²⁴ The CFPB also alleged that borrowers incurred some \$4 billion in extra charges because Navient capitalized the interest due to multiple, consecutive forbearances.³²⁵ Likewise, the CFPB alleged that Navient failed to adequately notify borrowers of the need to recertify their income and family size to retain eligibility for IDR.³²⁶ As a result, borrowers lost eligibility for IDR and saw their payments go up.

* * *

We discuss the issues around servicing contracts in detail because, like the rules on interest accrual and capitalization, the arrangements are central to the experience and treatment of the borrower but are highly complex and opaque and have not been expounded upon elsewhere. Dysfunctional loan servicing is the

319. See, e.g., OFFICE OF FED. STUDENT AID, GREAT LAKES CONTRACT, *supra* note 289, at 4; OFFICE OF FED. STUDENT AID, NAVIENT CONTRACT, *supra* note 289, at 4.

320. See Seth Frotman, *You Have the Right to Pay Off Your Student Loan as Fast as You Can, Without a Penalty*, CONSUMER FIN. PROTECTION BUREAU (Sept. 26, 2016), <http://www.consumerfinance.gov/about-us/blog/you-have-right-pay-your-student-loan-fast-you-can-without-penalty> [<https://perma.cc/X2G4-3QWW>].

321. See Stacy Cowley, *New York Sues Student Loan Servicer for 'Abusive' Acts*, N.Y. TIMES (Oct. 3, 2019), <https://www.nytimes.com/2019/10/03/business/student-loans-forgiveness-phaea.html> ("The servicer, the Pennsylvania Higher Education Assistance Agency, . . . is the sole servicer for the federal government's [PSLF] Program.").

322. See Clare Lombardo & Cory Turner, *Student Loan Borrowers with Disabilities Aren't Getting Help They Were Promised*, NPR (Dec. 4, 2019, 5:00 AM), <https://www.npr.org/2019/12/04/776058798/why-student-loan-borrowers-with-disabilities-arent-getting-the-help-they-deserve> [<https://perma.cc/QU6T-F7ZS>].

323. Complaint for Permanent Injunction & Other Relief, *supra* note 248, ¶¶ 26–54.

324. *Id.* ¶¶ 35–36.

325. *Id.* ¶ 54.

326. *Id.* ¶¶ 155–59.

primary reason that the loan program continues to have 9.5 million borrowers in default,³²⁷ despite the wide availability of IDR. That the loan program even uses private loan servicing at all is an artifact of the now-defunct FFEL Program of guaranteed loans from private lenders, and the poor design of the servicing contracts is strong evidence that private servicing is a bad fit with Congress's intent to have the student loan program serve borrowers and try to improve their lives. Student borrowers are not counterparties to be "serviced"; they are recipients of public aid and investment.

C. OUTDATED REHABILITATION APPROACH

Prior to IDR, the main way to help defaulted borrowers—those whose loans were 270-days delinquent but had not yet been assigned to debt-collection agencies for collection—was through loan rehabilitation. Under the FFEL Program, rehabilitation allowed defaulted borrowers to move back into good standing by making nine payments over ten months of a reduced amount, presumptively fifteen percent of discretionary income.³²⁸ In the meantime, however, interest would accrue, and the servicer could charge fees of up to sixteen percent of the unpaid principal balance and accrued interest.³²⁹ Then the borrower would go back to the already-unaffordable full payments but with an even higher principal amount, thereby extending the loan's maturity. Even for Direct Loans, the rehabilitation structure was preserved, with around twenty percent of the rehabilitation payments going to collection agency fees, rather than to principal and interest.³³⁰ Not surprisingly, because loan rehabilitation does not address the prospective payment burden on borrowers, about one-third of those who go through rehabilitation end up redefaulting within twenty-four months.³³¹

A much better option for a distressed borrower would be to consolidate the borrower's old loans into one new loan, and then to put that new loan in IDR so that payments would be permanently keyed to the borrower's income level. Servicers, however, are incentivized to prefer rehabilitation rather than consolidation and

327. See OFFICE OF FED. STUDENT AID, *supra* note 5.

328. 34 C.F.R. § 682.405(a)(2), (b)(1)(iii) (2019).

329. See *id.* § 682.405(b)(1)(vi)(B) (guarantor servicing fees under FFEL Program).

330. See *id.* § 685.211(f)(1) (rehabilitation program for Direct Loans); *Loan Servicing and Collection - Frequently Asked Questions*, U.S. DEP'T EDUC.: OFF. OF FED. STUDENT AID, <https://ifap.ed.gov/loan-servicing-and-collection-frequently-asked-questions#CF-Q2> [<https://perma.cc/N7YR-NR46>] (last visited Aug. 14, 2020) (collection fees for FFEL and Direct Loans held by the Department of Education). Individual private collection agency contracts with the Department of Education indicate a lower fee for rehabilitations. See, e.g., OFFICE OF FED. STUDENT AID, U.S. DEP'T OF EDUC., SOLICITATION/CONTRACT/ORDER FOR COMMERCIAL ITEMS, ED-FSA-09-O-0014, at 6 (2009), <https://studentaid.gov/sites/default/files/NCOFinancialBaseContract.pdf> [<https://perma.cc/66T6-QVAA>] (awarding to the collection agency a 13.5% commission on the final payoff amount); OFFICE OF FED. STUDENT AID, U.S. DEP'T OF EDUC., SOLICITATION/CONTRACT/ORDER FOR COMMERCIAL ITEMS, ED-FSA-09-O-0020, at 6 (2009), <https://studentaid.gov/sites/default/files/EnterpriseRecoverySystems.pdf> [<https://perma.cc/RRC9-NLS2>] (same).

331. CFPB, UPDATE FROM THE CFPB STUDENT LOAN OMBUDSMAN: TRANSITIONING FROM DEFAULT TO AN INCOME-DRIVEN REPAYMENT PLAN (2017), https://files.consumerfinance.gov/f/documents/201705_cfpb_Update-from-Student-Loan-Ombudsman-on-Redefaults.pdf [<https://perma.cc/EMW5-TFUG>].

IDR because, when a loan is consolidated, it is awarded as part of a new-loan allocation. In other words, the servicer will incur costs to do the loan consolidation, for which it will receive a one-time payment of \$27.35,³³² roughly compensating the servicer for the cost of the consolidation, but the servicer will not necessarily get any future revenue stream from servicing the loan. In contrast, rehabilitation allows the servicer to levy fees and retain a future revenue stream.

The very concept of rehabilitation is one that follows from a debt-based education financing framework. It is premised on forbearing on the loan if the borrower makes a showing of good faith through consecutive on-time payments of a percentage of income. A grant-and-tax framework would have IDR as a built-in structure, in that taxation would be keyed to the borrower's income, such that there would never be any need for rehabilitation. If a borrower's income were to decline, so too would the borrower's payment obligation. Special rehabilitation procedures that might be suboptimal for borrowers would not be necessary in a grant-and-tax framework.

D. PUNITIVE TAX TREATMENT

As noted in Section II.F, the Treasury Department currently takes the position that loan forgiveness through the IDR plans (other than PSLF) would create taxable income for the borrower, although there is some legal uncertainty around the issue.³³³ 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 affirmative exclusion in the tax law, and there is no such affirmative 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%, depending on the applicable tax rate.

Gregory 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.³³⁴ The potential impact has also been a subject of media reports and may cause stress among borrowers who feel that they were baited and switched.³³⁵

332. See, e.g., OFFICE OF FED. STUDENT AID, GREAT LAKES CONTRACT, *supra* note 289, at 4; OFFICE OF FED. STUDENT AID, NAVIENT CONTRACT, *supra* note 289, at 4.

333. See *supra* Section II.F.

334. Gregory Crespi, *Should We Defuse the “Tax Bomb” Facing Lawyers Who Are Enrolled in Income-Based Student Loan Repayment Plans?* 2 (S. Methodist Univ. Dedman Sch. of Law Legal Studies, Research Paper No. 225, 2016), <https://ssrn.com/abstract=2615561> [<https://perma.cc/XRH6-LR5T>].

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 make only income-based payments for twenty to twenty-five years. It is not so much forgiveness as an option for the borrower. 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 afford only to make income-based payments for twenty to twenty-five years should be relieved of the remaining debt. To then tax that relief undermines the goal of forgiveness and makes the lack of underwriting of student loans based on the borrower’s ability to pay much more problematic. In similar government transfer contexts, a general welfare exception applies to exclude the transfer from the transferee’s income.³³⁶

It is not clear that any policymaker affirmatively wanted IDR forgiveness to be taxed, and some immediately began trying to correct the issue after the IBR option was passed in 2008.³³⁷ But this problematic tax treatment automatically follows from labeling the program “debt” because the tax treatment is one of the legal consequences of “debt.” As noted above, the problem could be solved simply by labeling the forgiveness (or, indeed, all of the loan) instead as a “scholarship,” which is excluded from gross income for tax purposes.³³⁸ Even further, if the transfer of funds were not labeled debt at all, then the question of tax consequences would be entirely moot.

E. OVERWEIGHTING THE IMPORTANCE OF PAYMENT HIERARCHY

Many of the problems with default and IDR complexity could be alleviated if (1) IDR were the default repayment plan and (2) payments were collected through wage withholding with tax return reconciliation. (This is how Australia and the United Kingdom do it, for example.)³³⁹ Because the IDR payments are

335. See, e.g., Ryan Lane, *Student Loan Forgiveness Is Nice, Until You Get Hit by This Tax Bomb*, MARKETWATCH (Jan. 29, 2020, 5:01 AM), <https://www.marketwatch.com/story/student-loan-forgiveness-is-nice-until-you-get-hit-by-this-tax-bomb-2020-01-29?siteid=rss&rss=1> [<https://perma.cc/MU9U-VC3J>]; Noam Scheiber, *An Expensive Law Degree, and No Place to Use It*, N.Y. TIMES (June 17, 2016), <https://www.nytimes.com/2016/06/19/business/dealbook/an-expensive-law-degree-and-no-place-to-use-it.html> (framing student debt problems in terms of the tax bill, not the nominal amount of debt).

336. See, e.g., Rev. Proc. 14-35, 2014-26 I.R.B. 1110 (describing general welfare exclusion); Rev. Rul. 75-271, 1975-2 C.B. 23 (excluding “[m]ortgage assistance payments” from income); Rev. Rul. 74-205, 1974-1 C.B. 20 (excluding “[r]eplacement housing payments” from income); Rev. Rul. 57-102, 1957-1 C.B. 26 (excluding payments to the blind from income).

337. See, e.g., H.R. 2492, 111th Cong. § 1 (2009).

338. See I.R.C. § 117 (2018); *supra* notes 224–27 and accompanying text.

339. Since 1989, the Australian Government has offered student loans through its Higher Education Loan Program. Students can borrow up to AUS106,319 in 2020, and loans are repaid through the tax system as a percentage of income, between one and ten percent depending on income level. The loans are not charged interest but are indexed to inflation. See AUSTRALIAN GOV’T, COMMONWEALTH SUPPORTED PLACES AND HECS-HELP INFORMATION 14, 20–22 (2020), <https://www.studyassist.gov.au/>

based on adjusted gross income, collection through wage withholding would be relatively trivial. However, many student debt advocates (and likely other financial institutions would) resist this because mandatory collection would upend the typical priority of payments notion that borrowers should be able to prioritize more important payments, such as for food and shelter.³⁴⁰ Default, in this sense, is actually an important self-help option for borrowers that would be undermined if debt payments were collected through paycheck withholding.

But this is a legacy of pre-IDR thinking. IDR specifically provides for low, even zero, payments when income is low and also includes a large exemption based off of the federal poverty level³⁴¹—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, the IDR plans are no longer available.³⁴² So the self-help option of nonpayment will put a borrower in a much worse position, particularly because unpaid loans can lead to wage garnishment by the Treasury Department anyway.³⁴³ These rules for default and IDR availability should be changed regardless, but the larger point remains: if IDR continues just as an opt-in plan for relatively sophisticated borrowers, it is likely to exclude those most in need of its relief. Though automatic IDR and withholding could be painful to some borrowers, the lack of it harms many more.

Often what is underlying concerns about automatic payment is not automaticity but rather the calculation of the payment itself. In other words, for some struggling borrowers, even 10% of discretionary income is not reasonably affordable, and the exemption of 150% of the federal poverty line is not sufficient to cover basic living costs.³⁴⁴ We propose in Section V.D a system of graduated rates for income-based payments, and this and the other reforms we propose go hand in hand—for automatic withholding to be fair and effective, the payment calculation must be affordable.

sites/default/files/ed19-0226_hecs-help_booklet_acc.pdf?v=1576816381 [https://perma.cc/F6L3-RK78]; Brooks, *supra* note 33, at 275–77. In the United Kingdom, students can borrow up to £9,250 in 2020 and pay back nine percent of their income above a threshold. Payments are charged interest that varies between 1.1% and inflation plus 3%, depending on circumstances. Payments are collected through the tax system. See *Repaying Your Student Loan*, GOV.UK, <https://www.gov.uk/repaying-your-student-loan/what-you-pay?step-by-step-nav=18045f76-ac04-41b7-b147-5687d8fbb64a> [https://perma.cc/H92Y-MQEN] (last visited Aug. 14, 2020); *Student Finance*, GOV.UK, <https://www.gov.uk/student-finance/new-fulltime-students> [https://perma.cc/Z69T-4Y4A] (last visited Aug. 14, 2020).

340. See, e.g., Press Release, Nat'l Consumer Law Ctr., *The Dark Side of Payroll Withholding to Repay Student Loans* (Feb. 11, 2019), <https://www.nclc.org/media-center/dark-side-of-payroll-withholding-repay-student-loans.html> [https://perma.cc/4CB6-RSBB].

341. See, e.g., 34 C.F.R. § 685.209(a)(2)(i) (2019) (limiting PAYE monthly payments to 10% of the amount by which a borrower's income exceeds 150% of the federal poverty level); *id.* § 685.209(c)(2)(i) (same for REPAYE loans).

342. See, e.g., *id.* § 685.209(a)(1)(ii) (removing defaulted loans from eligibility for IDR); *id.* § 685.211(f)(12) (stating that a loan that has been rehabilitated is not eligible for rehabilitation upon redefault).

343. See 31 C.F.R. § 285.11 (2019) (administrative wage garnishment for nontax debt).

344. See Press Release, Nat'l Consumer Law Ctr., *supra* note 340.

F. MISFRAMED PUBLIC DISCOURSE ON STUDENT LOAN DEBT

Using debt as the policy instrument for income-contingent payments for higher education distorts public discussions, policy debates, and individual decisions. Politicians, academics, journalists, 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 and often misleading comparisons to other types of debt, like home mortgages, car loans, and credit card debt, despite huge differences.³⁴⁵

For example, the headline \$1.5 trillion number is sometimes cited as evidence of an impending financial crisis, along with it exceeding the amount of outstanding credit card debt.³⁴⁶ That \$1.5 trillion student loan debt figure, however, is materially different than, say, \$1.5 trillion in credit card debt. The \$1.5 trillion is a measure of the outstanding principal on student loans, but it is not a measure of what borrowers must actually repay because it does not account for IDR plans that substantially reduce debt burdens. Nor does the \$1.5 trillion account for the repayment period of the loans and the frequent availability of deferment and forbearance. Credit card debt is short-term revolving debt, but student debt is spread over as many as twenty-five years. In economic reality, the \$1.5 trillion figure 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.³⁴⁷ Though \$1.5 trillion may seem concerningly large compared with outstanding credit card debt levels, it is miniscule compared with other federal government expenditures.

Turning to the revenue side of the equation, making an income-based payment to the government is analogous to paying an income tax, yet we would never treat twenty-five years of future income taxes as a “debt” that would show up on an individual’s balance sheet or affect that person’s credit score. This is not to minimize the obligation of course—not paying required taxes is a serious offense and will have credit implications. The point instead is that, in the case of both IDR for student loans and taxes, all a person has promised *ex ante* is to pay a percentage

345. See Glater, *supra* note 17, at 119–31 (discussing specious comparisons between student loans and mortgage debt).

346. See, e.g., Zack Friedman, *This Is What Happens if \$1.6 Trillion of Student Loans Are Forgiven*, FORBES (Dec. 3, 2019, 8:30 AM), <https://www.forbes.com/sites/zackfriedman/2019/12/03/student-loans-debt-forgiven-impact/#74ba23c374e9> [https://perma.cc/J5M9-9B6V]; Healey, *supra* note 15; Josh Mitchell, *The Long Road to the Student Debt Crisis*, WALL ST. J. (June 7, 2019, 12:08 PM), <https://www.wsj.com/articles/the-long-road-to-the-student-debt-crisis-11559923730>.

347. Government outlays currently run about \$4 trillion per year. See CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: 2020 TO 2030, at 7 (2020), <https://www.cbo.gov/system/files/2020-01/56020-CBO-Outlook.pdf> [https://perma.cc/36FN-YE33]. Assuming that outlays grow at a rate similar to the rate of overall economic growth, we can treat the present value of future outlays as also roughly equivalent to \$4 trillion per year.

of income to the government for some future years. Indeed, student debt is in some ways *less* of an obligation than taxes because it will cease at some point (at forgiveness or when the loan balance is paid), whereas most tax obligations 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 reauthorize the HEA would have dramatically scaled back the amount of debt that a graduate or professional student could borrow from the federal government, capping it at \$28,500 per year.³⁴⁸ Graduate students currently can borrow a lot of money through the federal loan program—sometimes up to \$100,000 or more per year³⁴⁹—so it is understandable that policymakers would focus on graduate students if the overriding goal is to reduce the overall debt level. But the consequences of doing so would have been to make the loan program *less* financially stable and potentially *increase* the burden on taxpayers. Graduate student borrowers have the lowest default rates and pay the highest interest rates.³⁵⁰ Although the news sometimes features dramatic stories of huge, unpayable debts,³⁵¹ the average graduate borrower will have a high income and the ability to pay back any loans fully.³⁵² Grad PLUS Loans are the most profitable class of student loan for the government,³⁵³ and thus help to cover the IDR relief for lower income borrowers. In other words, graduate student borrowers are subsidizing borrowers for undergraduate and nondegree education. Without those payments to subsidize the weaker performing loans, overall subsidy rates for the loan program would increase.

348. PROSPER Act, H.R. 4508, 115th Cong. § 465 (2018) (proposing new Higher Education Act Section 465(b)(2)(A)(ii)).

349. Recall that Grad PLUS Loans are available up to the program’s “cost of attendance.” See Higher Education Amendments of 1992, Pub. L. No. 102-325, sec. 422, § 428H(c), 106 Stat. 448, 535; *supra* notes 122–24 and accompanying text. The cost of attendance of some law schools now exceeds \$100,000. See, e.g., *Costs and Budgeting*, COLUM. L. SCH., <https://www.law.columbia.edu/about/offices-and-departments/office-financial-aid/costs-and-billing/costs-and-budgeting> [<https://perma.cc/J2PY-U2N3>] (last visited Aug. 15, 2020) (2020–2021 cost of attendance: \$104,420); *Student Expense Budget*, N.Y.U. L. SCH., <http://www.law.nyu.edu/financialaid/budgetandbudgeting/studentexpensebudget> [<https://perma.cc/C2FC-S8LL>] (last visited Aug. 15, 2020) (2020–2021 cost of attendance: \$104,113).

350. See 34 C.F.R. § 685.202(a)(7)–(9) (2019) (showing that Grad PLUS rate is always more than undergrad rates); DEP’T OF EDUC., STUDENT LOANS OVERVIEW: FISCAL YEAR 2020 BUDGET PROPOSAL, at Q-35 (2019), <https://www2.ed.gov/about/overview/budget/budget20/justifications/q-sloverview.pdf> [<https://perma.cc/D7CZ-DLAX>] (comparing default rates among categories of loans).

351. See, e.g., Josh Mitchell, *Mike Meru Has \$1 Million in Student Loans. How Did That Happen?*, WALL ST. J. (May 25, 2008, 10:41 AM), <https://www.wsj.com/articles/mike-meru-has-1-million-in-student-loans-how-did-that-happen-1527252975>.

352. Average incomes for those with graduate degrees significantly exceed those with just bachelor’s or lower degrees. See Elka Torpay, *Measuring the Value of Education*, U.S. BUREAU LAB. STAT.: CAREER OUTLOOK (Apr. 2018), <https://www.bls.gov/careeroutlook/2018/data-on-display/education-pays.htm> [<https://perma.cc/4EUT-9FTR>].

353. See DEP’T OF EDUC., *supra* note 350, at Q-25 (showing high, negative subsidy rates for Grad PLUS Loans). Parent PLUS Loans are even more profitable, in part because they mostly do not qualify for the IDR plans. See *id.*

At the same time, there are calls on the left for debt cancellation,³⁵⁴ which alone would do little to manage the costs of higher education going forward. Moreover, because IDR is already available, the incremental benefit of outright cancellation would accrue disproportionately to higher income graduates. The loan system is far from perfect (as we try to make clear here), but policy solutions that focus only on the existence or nominal amount of debt miss the larger issues.³⁵⁵

Finally, but most importantly, at the level of the student, the psychological effects of debt for individuals can lead to stress and distorted and inefficient decisions.³⁵⁶ Stress alone can be a real cost to many, in health and other outcomes. There is also evidence that student loans may be connected to slower rates of home buying, retirement savings, and other features of long-term personal investment.³⁵⁷

To the extent that borrowers focus on the total stock of their debt, rather than on the monthly flows, and fail to consider the impact of IDR on total payment obligations, they may overestimate their debt burdens and make suboptimal consumption decisions as a result. The debt framework emphasizes stocks, rather than flows, which may have unintended behavioral consequences.

IV. CONSIDERING THE TAX ALTERNATIVE

The biggest problems in the student loan system stem from the frictions between the economic reality of the loans—grants plus income-based taxes—and the legacy infrastructure of debt. 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, and the legal and institutional structures of debt are a poor fit for the policies of the student loan program. Continuing to treat student loans as typical debt belies their unique status and leads to many of the problems in the loan program as currently operated.

In this Part, we briefly consider, but reject, the idea of a wholesale shift to a true grant-and-tax model. That is, we consider the policy alternative of applying the grant-and-tax metaphor literally—replacing student loans with a system of up-front *grants* to pay tuition fees and a *tax* on grant-recipients that is a function of a person's income, the size of the initial grant, and time. Thus, instead of

354. See, e.g., *College for All and Cancel All Student Debt*, FRIENDS BERNIE SANDERS, <https://berniesanders.com/issues/free-college-cancel-debt> [<https://perma.cc/W4AH-S6XP>] (last visited Aug. 15, 2020); *My Plan to Cancel Student Loan Debt on Day One of My Presidency*, WARREN DEMOCRATS, <https://elizabethwarren.com/plans/student-loan-debt-day-one> [<https://perma.cc/Q7JD-P7UH>] (last visited Aug. 15, 2020); Shahien Nasiripour, *Trump Student Loan Official Quits, Calling for Debt Forgiveness*, BLOOMBERG (Oct. 24, 2019, 3:41 PM), <https://www.bloomberg.com/news/articles/2019-10-24/trump-student-loan-official-quits-calling-for-debt-forgiveness>.

355. See Glater, *supra* note 19, at 1217–18 (criticizing regulatory responses that focus on financial outcomes as a measure of education quality).

356. See, e.g., Glater, *supra* note 58, at 1580–96 (discussing negative effects of shifting education risk to students).

357. See *id.* at 1588 (citations omitted).

receiving a loan and paying it back through IDR, a student would receive a *grant* and then pay a *tax* of ten percent of discretionary income annually until either the total taxes paid equaled the initial grant plus interest or twenty years had passed. That would be essentially the cash-flow equivalent to the current IDR plans.³⁵⁸

This grant-and-tax approach is different than direct tax-funded higher education (“free college”). The grant-and-tax model would make explicit what is now implicit with IDR-based student loans—that the federal government provides funds up front for higher education, paid for by a ten-percent income surtax on borrowers. The “free college” alternative would instead raise additional, general revenue with the federal income tax and use that revenue to directly fund higher education institutions.³⁵⁹ That policy is beyond the scope of this Article, which is concerned with redesigning and reforming our current system of education finance.

Though student loans have many similarities to taxes, they also differ from traditional taxes in important ways. We briefly discuss some of the differences below in Section IV.A. Moreover, taxes have their own institutional, psychological, and economic downsides. We review some of those downsides below in Section IV.B. Although conceptualizing student loans as taxes helps to solve some problems with the system and points the way toward worthwhile reforms, a complete shift to a grant-and-tax model would bring with it a new set of political, institutional, and budgetary issues that could be worse than the disease. For this reason, we ultimately reject a formal transition to grant-and-tax and instead propose a hybrid paradigm in Part V.

In Section IV.C, we compare the income-based repayment feature of student loans to public income share agreements (ISAs), in which the financing of education is undertaken in exchange for a fixed percentage of the borrower’s income over a minimum amount for a fixed number of years. Public ISAs would work similarly to a grant-and-tax system but with total repayment unmoored from the amount of financing provided, which can create its own set of problems.

A. GRANT-AND-TAX COMPARED TO TRADITIONAL TAXES

A central part of our argument is that an income-based payment to the government in exchange for receiving a share of public goods is conceptually similar to paying an income tax to fund the activities of government. But there are nonetheless some important differences between this grant-and-tax model and traditional income taxes. We discuss two in particular.

First, the federal income tax applies, essentially, to all citizens and residents of the United States, whereas the income surtax in the grant-and-tax model would apply only to those who receive grants to pay for higher education. This model would mean that two individuals with the same income from the same source

358. Assuming we also account for the different ways interest is charged, accrued, and capitalized. See *supra* Section II.D.

359. For an example of such proposals, see *College for All and Cancel All Student Debt*, *supra* note 354.

might face different marginal income tax rates based on whether they had used the tuition grant or not. Although the United States has taxes that are focused only on particular public goods—such as the payroll tax for Social Security—or that apply only to particular subsets of U.S. persons—like the corporate tax or bank contributions to the Federal Deposit Insurance Corporation—there are fewer examples of an income surtax that apply to individuals based on their *activities* rather than only their *income*. That said, the primary other example of different rates applying to the same income based on a non-income-generating activity is marriage,³⁶⁰ so this is hardly unheard of. Nonetheless, such a policy would be a departure from how an income tax typically operates.

A grant-and-tax model like this is sometimes conceptualized as a “graduate tax.” Some, particularly in the United Kingdom, have thus proposed taking the grant-and-tax model further and simply funding higher education through a uniform tax on college graduates in place of income-based loans.³⁶¹ This sort of a model would lie somewhere between grant-and-tax and free college on the spectrum between fully private and fully public funding.

Second, although monthly or annual payments would be a function of income, *total* payments over a lifetime would be capped either at an amount equal to the original grant (perhaps with interest) or after a certain number of years. In contrast, the individual income tax applies every year for life. The payroll tax for Social Security flips this somewhat—an annual cap but no lifetime cap³⁶²—but an income tax for a fixed number of years would be novel.

B. PROBLEMS WITH THE TAX PARADIGM

In addition to the conceptual differences discussed above, there are political and institutional issues that would arise from a shift to a true grant-and-tax model.

1. Budget Politics

Perhaps the biggest problem with a wholesale shift to grant-and-tax would be the change to budgetary procedures and appropriations. As noted above, federal credit programs, including the student loan program, have a budget cost only of the present value difference between outlays and expected receipts.³⁶³ That has two main advantages over traditional tax-and-spend programs. First, it means that the budget item is small, and often even shows positive net revenue for the government. Second, it matches outlays to receipts over the full life of a loan, all in one net budget item in the initial year of outlay.

360. The individual income tax rates apply at different bands of income depending on whether the taxpayer is married or single. See I.R.C. § 1(a)–(c) (2018). Thus, two taxpayers with the same income from the same source could pay different amounts of tax if one is single and one is married.

361. See, e.g., Jessica Shepherd, *Student Leaders Call for Graduate Tax to Replace Tuition Fees*, GUARDIAN (June 10, 2009, 5:18 AM), <https://www.theguardian.com/education/2009/jun/10/nus-tuition-fees-graduate-tax> [<https://perma.cc/9WSJ-C3XG>].

362. See 42 U.S.C. § 430 (2018).

363. See *supra* note 96 and accompanying text.

In contrast, a traditional tax-and-spend program will have large gross outlays and gross revenue numbers listed separately, making overall spending and taxing look larger (even though the cash flows are roughly the same as for a loan and repayment). Moreover, the outlay years will be front-loaded, but the revenue from the offsetting tax will be spread out over twenty or twenty-five years. Because much of the revenue will occur outside of the ten-year “budget window,” it would make a grant-and-tax program look much more expensive, and also like a money-loser, relative to student loans. The accounting for federal credit programs has its problems,³⁶⁴ and the Department of Education has been criticized for its methods of estimating costs.³⁶⁵ But the “net subsidy” approach arguably does a better job of balancing the revenue and outlay sides of the equation than typical tax-and-spend accounting.

Furthermore, a grant-and-tax model could default to being an annual appropriation, in contrast to the entitlement structure of the current student loan program. That could result in disruptive uncertainty regarding timely funding availability for the entire higher education sector. This would depend on the actual language of any bill, but if the grants end up being discretionary spending, they would be more at risk of political attack, given our broken budget politics.

For these reasons, a grant-and-tax program would be significantly disadvantaged in the budget and political process compared to a federal credit program. Of course, Congress could do what it wants and could call for special budget treatment or for setting up a grant-and-tax model as an entitlement. But the current program already has those features, and it may be more effective to reform the loan program toward our hybrid model, rather than to replace it wholesale. The loan program as it stands today generates around \$100 billion of funding for higher education,³⁶⁶ and it is hard to imagine that an on-budget discretionary appropriation could approach that scale.

2. Public Policy Discourse and Framing

We have shown that the rhetorical frame of “debt” creates a destructive burden for the student loan program, including the psychological overhang of a balance-sheet liability for taxpayers and public discourse that treats loans either as predatory lending on the one hand or financially irresponsible borrowing on the other. Because taxes are measured as a financial flow, rather than a stock—no one conceives of future income tax payments as a liability on personal balance sheets—a shift to a tax model could correct some of these problems. That said, the political and legal consequences of labeling something a “tax” are not without cost.

364. See, e.g., Stanton, *supra* note 96, at 396.

365. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-17-22, FEDERAL STUDENT LOANS: EDUCATION NEEDS TO IMPROVE ITS INCOME-DRIVEN REPAYMENT PLAN BUDGET ESTIMATES 52–53 (2016).

366. See OFFICE OF MGMT. & BUDGET, *supra* note 27, at 2.

For example, taxes often carry a “punishment” valence in public discourse,³⁶⁷ and a student tax could be framed as punishing the inability to pay for college. We reject this framing normatively—with the exception of “sin” and other Pigouvian taxes, the tax policy 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 actually perceived, and what behavioral effects flow from that. The politics and rhetoric of appearing to tax the inability to pay for school out of pocket could be blistering.

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 that might inhibit students from using the grants. How that barrier would compare to the psychological barrier of borrowing is an empirical question, but it could have important consequences.

It is also possible that labeling the student payments as a “tax” could lead to a disconnection between the payment and the benefit of reduced or free tuition. 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.³⁶⁸ That could affect the political stability of the tax portion of the grant-and-tax program. If the grant and tax become disconnected from each other in students’ minds, that may allow policymakers to tinker with one or the other, instead of managing them together.³⁶⁹ For example, Congress could end up reducing the grant size without adjusting the tax, or vice versa.

A related objection is that if we are going to have a tax, it should be not a linked separate surtax but instead a small increase in our existing income tax, thus falling on everyone, not just those who cannot pay for college up front (or, alternatively, as an additional tax on the most well-off, such as a wealth tax or higher top marginal income tax rate). The equity and timing issues of tax-funded free (or heavily subsidized) college are complicated and beyond the scope of this Article.³⁷⁰ Our project here is to redesign and reform the current system of education finance, but other reform options are possible. If our proposal encourages 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.

367. See, e.g., Ben Stein, *Ben Stein: Raising My Taxes Is a Punishment*, CBS NEWS (Sept. 19, 2010, 10:14 AM), <https://www.cbsnews.com/news/ben-stein-raising-my-taxes-is-a-punishment> [<https://perma.cc/ZK8T-D8ZQ>].

368. See Brooks et al., *supra* note 177, at 1257–58.

369. See Jason S. Oh, *Will Tax Reform Be Stable?*, 165 U. PA. L. REV. 1159, 1176–78 (2017) (arguing that policies are more stable when linked with others because changing one requires changing multiple).

370. For a partial analysis of these issues, see Brooks, *supra* note 33, at 268–74.

3. Tax Enforcement

A wholesale shift to a grant-and-tax model would imply that the government could use its full tax-enforcement powers to ensure compliance. That may appear harsh relative to using debt. Wage withholding, for example, would leave no options for students to avoid payments, and nonpayment could theoretically lead to criminal sanctions.³⁷¹

We think that is an extreme case, however. In the typical situation, an individual would not be treated all that differently than that person is today. The vast majority of people who underpay taxes simply owe interest and penalties, just as those who default on loans do.³⁷² The government can already garnish wages and tax refunds for student loans in default, so a person's financial exposure is not materially different.³⁷³ And in many cases, unpaid taxes are treated as just another uncollected debt anyway.³⁷⁴ That said, the perception of extreme enforcement and the possibility of criminal sanctions under the grant-and-tax model may still be counterproductive. The first case of a former student being criminally prosecuted for avoiding the grant surtax would likely have serious negative repercussions for the whole system, and the alternative of the government *not* using its full enforcement powers for fear of bad publicity could also weaken the system. Thus, even if the actual degree of enforcement under the grant-and-tax model would not be so different than that under other models, a perception of harshness could lead in turn to a perception of illegitimacy.

4. Transition

Shifting to a grant-and-tax model would also require addressing the enormous question of what to do with the existing \$1.5 trillion in outstanding student loans—it is not realistic or fair to imagine that the old loans would just continue as they are when they are in massive need of repair.

Transitioning old loans to a new program is possible—for example, by issuing grants to current borrowers equal to the value of the outstanding loans and then continuing forward from there. But if, as we propose, interest terms were changed, it could be worthwhile to recalculate the old loans as if interest had not been charged or were not accruing. The math is not difficult, but structuring it into a new program could be complicated.

These transition issues do not go away under our preferred approach but are made somewhat simpler by reforming, rather than replacing, the whole program.

371. See I.R.C. § 7203 (2018) (authorizing a \$25,000 fine and one-year imprisonment for failure to pay taxes).

372. In Fiscal Year 2018, the latest data available, there were just 1,714 criminal tax investigations initiated. IRS, IRS: CRIMINAL INVESTIGATION: ANNUAL REPORT 2018, at 9 (2018), https://www.irs.gov/pub/irs-utl/2018_irs_criminal_investigation_annual_report.pdf [<https://perma.cc/Y8PW-CQQN>].

373. See 31 C.F.R. § 285.2 (2019) (tax return offset); *id.* § 285.11 (wage garnishment); *How TOP Works*, U.S. DEP'T TREASURY: BUREAU OF THE FISCAL SERV., <https://fiscal.treasury.gov/top/how-top-works.html> [<https://perma.cc/DLC2-XDM7>] (last visited Aug. 16, 2020).

374. See *Topic No. 201 The Collection Process*, INTERNAL REVENUE SERV., <https://www.irs.gov/taxtopics/tc201> [<https://perma.cc/DD74-3RYN>] (last updated July 17, 2020).

C. REJECTING OTHER MODELS: THE INCOME SHARE AGREEMENT ALTERNATIVE

Before turning to our proposed approach to student loans, it is important to briefly address another reform proposal: replacing the loan model with some version of an income share agreement, or ISA. An ISA is an agreement between a student and a funder. The funder pays the student's tuition and fees in exchange for the student committing to pay the funder a set percentage of income (typically over a minimum amount) for a set number of years.³⁷⁵

Although the ISA concept has been around for some time, relatively few examples exist. Yale University provided a "Tuition Postponement Option" in the 1970s that we would today call an ISA. It provided that students would pay 0.4% of their future income for each \$1,000 borrowed for the lesser of thirty-five years or until their whole loan cohort had paid off its debt.³⁷⁶ The plan was offered only from 1971 to 1978, and in 1999, Yale canceled all the outstanding debt even though no class had fully paid off its debt.³⁷⁷

The most prominent example today is Purdue University's "Back a Boiler" program, which asks students to pay a percentage of their incomes for a set number of years, with the percentage and term determined case-by-case depending on the student's major and likely future income.³⁷⁸ There is little information on actual terms and examples on the program's website and informational materials, though they do offer a "Comparison Tool."³⁷⁹ Other ISA programs today can be found at missionary schools, such as Messiah College,³⁸⁰ and nondegree coding camps.³⁸¹

Existing ISA programs all have private funding, but some commentators have called for replacing the federal student loan program with something closer to an ISA system.³⁸² Because ISAs require repayment based on a percentage of income, rather than a fixed amount of principal plus accrued interest, they are inherently a

375. See Kevin Carey, *New Kind of Student Loan Gains Major Support. Is There a Downside?*, N.Y. TIMES: THE UPSHOT (Dec. 16, 2019), <https://www.nytimes.com/2019/12/16/upshot/student-loan-debt-devos.html>.

376. See *A Tax Shelter for Students: Yale's Tuition Postponement Option*, 81 YALE L.J. 1392, 1396 (1972); Brooks, *supra* note 33, at 274–75; Shireman, *supra* note 134, at 188–90.

377. See Bret Ladine, *'70s Debt Program Finally Ending*, YALE DAILY NEWS (Mar. 27, 2001, 12:00 AM), <http://yaledailynews.com/blog/2001/03/27/70s-debt-program-finally-ending> [<https://perma.cc/L34A-FCGX>].

378. See *Back a Boiler Program Overview*, PURDUE U., <https://www.purdue.edu/backaboiler/overview/index.html> [<https://perma.cc/37Y9-XR7L>] (last visited Aug. 16, 2020).

379. See *id.*

380. See *Messiah College Announces New Financing Model to Align Cost of Education with Student Outcomes*, MESSIAH U. (May 1, 2018), https://www.messiah.edu/news/article/264/messiah_announces_new_financing_model_to_align_cost_of_education_with_student_outcomes [<https://perma.cc/9S5N-GWBU>].

381. See, e.g., *Financing Your Education with an Income Share Agreement*, DIGITAL CRAFTS, <https://perma.cc/5QQH-CZUA> (last visited Aug. 16, 2020).

382. See JASON D. DELISLE, AM. ENTER. INST., *STUDENT AND PARENT PERSPECTIVES ON HIGHER EDUCATION FINANCING: FINDINGS FROM A NATIONALLY REPRESENTATIVE SURVEY ON INCOME-SHARE AGREEMENTS 12* (2017), <https://www.luminafoundation.org/files/resources/student-and-parent-perspectives-on-higher-education-financing-1.pdf> [<https://perma.cc/M4H3-4MVZ>].

type of income-driven repayment program. Given that all private ISAs of which we are aware do not require repayment absent a certain minimum level of income in a repayment period, they also all incorporate some degree of a back-end ability-to-repay standard. Existing ISA programs typically do not, however, cap the total amount of payments, and if they do, the cap is not at a level that closely corresponds to the amount of funding (effectively the principal). The funder gains the upside of the student's higher income during the repayment period.

In an ISA, a successful student can end up paying well more than the amount of the original funding, even plus interest. This "upside risk," in combination with degree-specific terms, is likely to create adverse selection and moral hazard problems that could undermine the overall program.³⁸³ For example, students are likely to have better private information about their future incomes than funders. Those who rationally anticipate higher incomes would be less likely to take ISAs, whereas those who rationally anticipate lower incomes would continue to take ISAs. Moreover, once in an ISA, a student would be more likely to underreport income, relative to IDR loans, particularly when approaching the end of the ISA term. Whether this would occur in practice is an empirical question, but it is telling that ISAs are often marketed as supplements to, rather than replacements for, federal loans (which have superior terms).

* * *

For the reasons above, we conclude that, although a grant-and-tax model is a better conceptual description of the student loan program than is true debt and would arguably improve many of the biggest problems with the program as currently designed, the political economy and budget politics of a wholesale replacement of a debt paradigm with a tax paradigm would be too costly and could create a new set of problems to address. Likewise, the public ISA model presents its own set of problems of moral hazard and adverse selection because of the disconnect between the amount of financing received and the total amount that will be repaid.

V. A HYBRID PARADIGM FOR EDUCATION FINANCE

Because student loans carry features of both debt and tax, and because fully adopting either paradigm entails large costs, we propose instead treating student loans as a hybrid instrument that is still labeled as a credit program for public and budgetary purposes but adopting many of the institutional tools and design features normally associated with taxation and leaving behind the most damaging features of debt. This new paradigm both better matches the reality of what student loans have become and sets student loans on a path toward increased fairness, simpler administration, and longer term sustainability.

This is, by its nature, a first exploration into developing a hybrid category of instrument, and we hope that this Article can set an agenda for future research and policymaking. In large part, this shift means simply accepting the reality that

383. See Shireman, *supra* note 134, at 190.

student loans are different—they are unlike any other government program or institutional arrangement. The law and institutions of student loans already differ substantially from those for traditional debt arrangements, so it is only a small step further to divorce them entirely. Student loans could still be treated as a federal credit program, and thus technically as a loan and repayment for federal budgeting purposes, but the structure of the cash flows, the legal obligations, and the enforcement mechanisms would draw much more from taxation. The end result would be a new category of public finance instrument, neither debt nor tax but a hybrid of both.

To make this happen, we propose the following four changes to the student loan program: first, making income-based payments the automatic (indeed, the only) option; second, collecting payments through the tax withholding and return filing system; third, having students pay the “tax” until the original grant amount, adjusted for inflation, is repaid (that is, removing both market interest and loan forgiveness); and fourth, imposing a graduated schedule of marginal repayment rates. We elaborate on these proposals below.

Along with these four specific proposals is a broader, but more diffuse, task of gradually dismantling the other legal and cultural appurtenances of debt. Small changes will be needed throughout the law to remove, for example, notions of default and liability. Banks and rating agencies will need to have new regulatory guidance on how to consider student loan payment obligations (short answer: as flows, like tax obligations, rather than as balance sheet liabilities). The full range of these changes is beyond the scope of this Article, but we hope legislators, regulators, and courts will begin working toward the proper results.

In sketching out these proposals, we adopt a loose constraint of revenue-neutrality, that is, we imagine a system of higher education finance that redesigns and reforms the current system without dramatic effects on other aspects of government finance. We say “loose” because, of course, this constraint is not required, and there are compelling reasons to support additional public subsidies for higher education. But, as we have noted, that is an argument beyond the scope of this Article—our main argument here is that dramatic improvements can be made in higher education finance through legal, institutional, and structural reforms irrespective of the level of public subsidy.³⁸⁴

A. AUTOMATIC INCOME-BASED REPAYMENTS

In the current system, borrowers default to a standard loan amortization schedule and have to affirmatively opt in to an IDR option. 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 repayment plan. As a result, many borrowers who should be in an IDR plan are not—indeed, many seem to not even know that the option exists.

384. Within our framework, additional subsidies could come from, for example, lower monthly repayment rates, a higher income exemption (currently set to 150% of the federal poverty level, *see, e.g.*, 34 C.F.R. § 685.209(a)(2)(i) (2019)), or the reintroduction of loan forgiveness.

There is little reason not to have income-based payments as the default—or, indeed, the only—option for student repayments. As the plans are currently designed, IDR dominates the standard loan repayment schedule for all borrowers. They pay no more, and perhaps less, under one of the IDR plans.³⁸⁵ 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,³⁸⁶ meaning that those borrowers who most need IDR are precisely those who are shut out of the plans. If we truly have a policy commitment to IDR, there is no reason for continuing to use the old standard repayment schedule. Only our commitment to treating a student loan as a “loan” stops us from making IDR the default option.

Our proposal would instead make income-based payments the only option, built into the terms of the loans from day one. If we make no other changes to the loan program, payments for nearly all borrowers would be either the same or less compared to the current program.³⁸⁷ 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.

B. COLLECTION THROUGH TAX WITHHOLDING

If the student loan payments are more akin to a tax, then the obvious way to collect the payments is through the tax system, with wage withholding and tax return filing. This would address several problems with the current system. First, it would make income calculation and verification easier, and it would use 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.³⁸⁸ 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 be based instead on a decent approximation of current-year income, with any corrections handled through tax return filing, just like we do for income tax (and also for income-based health insurance premiums through the Affordable Care Act marketplaces).³⁸⁹

385. Under REPAYE, high-income borrowers will still pay ten percent of their discretionary incomes, rather than defaulting back to standard loan payments, but as discussed, that will often result in lower lifetime payments because of less interest accrual. *See supra* notes 170–72 and accompanying text.

386. *See, e.g.*, 34 C.F.R. § 685.209(a)(1)(ii) (2019) (defaulted loans not eligible for IDR); *id.* § 685.211(f)(12) (loan that has been rehabilitated is not eligible for rehabilitation upon redefault).

387. Again, the possible exception is a high-income borrower in a REPAYE-like plan. *See supra* note 385.

388. Payments are based on adjusted gross income as reported on the borrower’s tax return, which usually will be filed in the year after the income is actually earned. *See, e.g.*, 34 C.F.R. § 685.209(a)(1)(i) (2019).

389. *See* I.R.C. § 36B(f) (2018) (reconciling the difference between the advanced premium-assistance tax credits and the actual credits based on current year income).

Second, using the tax system would lessen the administrative burden of making payments and obviate the need for a separate loan servicing system. Under the current system, private loan servicers do not even collect payments, which are instead sent directly to the Department of Education, and the servicers already use IRS data to determine income-based payments.³⁹⁰ Shifting to collection through the tax system would remove this unnecessary and antiborrower layer of administration.

Third, using the withholding system would virtually eliminate default as a problem, especially combined with income-based payments being the only possibility. As noted in Section III.E, 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.³⁹¹ Although we acknowledge that this could be the case for a small subset of borrowers, we think that the other aspects of our proposal minimize that risk and that the benefits greatly outweigh the costs. In particular, we further propose below the elimination of interest and the introduction of a graduated repayment schedule, which should provide additional relief to low-income borrowers. Additional reforms, such as raising the exemption level could also be considered.

Finally, our proposal does not eliminate self-help. Our current system of tax withholding allows individuals to adjust their withholding away from the default,³⁹² and that would be true for these payments as well. Students who would owe additional amounts at tax return filing could extend filing or even choose not to pay. Finally, this proposal could be further modified to include some escape hatch relief if necessary, such as deferred payments with interest accrual.

C. ELIMINATION OF INTEREST AND FORGIVENESS

We propose that student loan payments be collected until the student has paid back the original loan amount (or until death), adjusted for inflation. Put another way, we would remove both forgiveness and interest rate charges. We understand that eliminating forgiveness may appear harsh, but these two features work together still to 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, for 2020–2021, range from 2.75% (for undergraduate Direct Loans) to 5.30% (for PLUS Loans).³⁹³ These relatively high interest rates are a

390. See OFFICE OF FED. STUDENT AID, *supra* note 273, at 5; *If Your Federal Student Loan Payments Are High Compared to Your Income, You May Want to Repay Your Loans Under an Income-Driven Repayment Plan.*, U.S. DEP'T EDUC.: OFFICE OF FED. STUDENT AID, <https://studentaid.gov/manage-loans/repayment/plans/income-driven> [<https://perma.cc/NFX4-4LLP>] (last visited Aug. 17, 2020).

391. See *supra* note 340 and accompanying text.

392. See, e.g., IRS, OMB No. 1545-0074, FORM W-4: EMPLOYEE'S WITHHOLDING CERTIFICATE 2-3 (2020).

393. *Understand How Interest Is Calculated and What Fees Are Associated with Your Federal Student Loan.*, U.S. DEP'T EDUC.: OFFICE OF FED. STUDENT AID, <https://studentaid.gov/understand-aid/types/loans/interest-rates> [<https://perma.cc/7PK5-NDUQ>] (last visited Aug. 17, 2020).

source of revenue for the government, a source of pain for borrowers, and a source of mind-boggling complexity for everyone.³⁹⁴ A virtue of shifting away from a debt framework and toward a grant-and-tax framework is the opportunity to rethink how interest could work.

We propose abolishing the interest charges and instead indexing the unpaid grant amounts to inflation, following the Australian model.³⁹⁵ This would lower the amount paid by students in real terms and make obsolete all of the complicated and varied (and little-understood) interest subsidies in the various IDR plans. It would also alleviate the psychological costs of seeing a debt balance grow even while making regular payments (if, for example, the income-driven payments are not sufficient to cover any principal).

Lowering the interest rate to the rate of inflation would slow the growth of the amount owed more than any of the existing IDR plans, which in turn would make it less necessary to stop the payments after a fixed number of years. Furthermore, indexing to inflation is equivalent to an interest-free loan, so having a long repayment period is not a particular hardship because the present value of the amount paid will decrease as the length of the repayment period increases. Indeed, an interest-free loan with a long repayment period should actually promote saving and wealth building beyond simply the investment in human capital. Finally, extending the repayment period allows us to use a schedule of low, graduated rates, as we describe below.

Eliminating loan forgiveness implicitly solves the problem of the tax treatment of forgiveness,³⁹⁶ although that is not the motivation. To the degree that loan cancellation remains an option in other circumstances, such as for closed schools or for total and permanent disability, that forgiveness must be excluded from gross income for tax purposes.

As noted above, we aim in these proposals for a primarily self-financed system, like the current student loan system. We think it is valuable politically for the student loan system to be fully or almost fully self-financing—that is, to not require a large net subsidy from general tax revenues. Higher education is in large part a public good, and heavy government subsidies and investment are still good policy. Other policy instruments, such as direct student grants, investments in basic research, and tax subsidies for charitable giving, must remain and likely should increase. But the student fee portion of any cost-sharing also recognizes that there are large private benefits from higher education, and it is appropriate to ask college graduates—most of whom go on to be the most privileged members of our society—to bear some direct costs, even while still sharing and spreading risk among themselves. But shifting too much of that risk onto taxpayers who received no benefit from college could undermine higher education financing

394. *See supra* Section II.D.

395. *See supra* note 339.

396. *See supra* Section III.D.

more broadly, ultimately to the detriment of those borrowers who most need support.³⁹⁷

The current loan system is close to self-financing, partly because the high interest rate payments from some borrowers subsidize those with lower, income-based payments and potential forgiveness. If we lower the interest rates to the rate of inflation, we lose that revenue and risk increasing the net subsidy. Removing cancellation and extending the time period for repayment makes up for some or all 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 shares.

As a first approximation, any net subsidy would just be a result of the difference between the rate of inflation (that is, the rate at which future payments increase) and the present value discount rate (to discount those future payments back to the current period). Ignoring defaults, if those two rates are the same, there is zero net subsidy. The discount rate used now is just the risk-free federal borrowing rate, which at the time of this writing, is within 0.5% of the inflation rate.³⁹⁸ In other words, the net subsidy would be close to zero.

Removing the interest charge also fixes the problem with REPAYE—that income-based payments for high-income borrowers is actually a net benefit because it helps them to avoid high interest charges. If there is no interest, then the optimal financial strategy shifts to delaying payment as long as possible, instead of accelerating it. (We propose graduated repayment rates below to progressively remove this benefit from high-income borrowers).

As a final point, we should note that eliminating forgiveness also implicitly repeals the ten-year forgiveness for PSLF. A full examination of PSLF is beyond the scope of this Article, but we question whether starkly different treatment of borrowers based on a somewhat arbitrary definition of “public service” is justified. A low-income borrower is not less deserving of support and relief simply because of the tax status of the borrower’s employer, and many workers in nominally private sector jobs contribute to the public good.

D. PROGRESSIVE, GRADUATED REPAYMENT RATES

The current IDR system uses a flat repayment rate—ten percent of “discretionary income.” Although that makes payments affordable for many borrowers (as shown by the low default rates for those in IDR), it can still be difficult for some

397. That said, current targeted forms of forgiveness, such as for closed schools and total and permanent disability, see 34 C.F.R. §§ 685.213–214 (2019), should remain, and Congress should consider whether additional targeted relief is justified for noncompleters and other specific cases.

398. The discount rate used in calculating loan subsidy cost is the “average interest rate on marketable Treasury securities of similar maturity to the cash flows of the direct loan or loan guarantee for which the estimate is being made.” 2 U.S.C. § 661a(5)(E) (2018). In 2020, rates on twenty-year Treasuries were in the neighborhood of one percent. See *Daily Treasury Yield Curve Rates*, U.S. DEP’T TREASURY, <https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield> [<https://perma.cc/ZXX5-55Z8>] (last visited Aug. 17, 2020). The standard inflation measure (CPI-U) was at 1.6% in July 2020. See *Databases, Tables & Calculators by Subject: CPI for All Urban Consumers (CPI-U)*, U.S. BUREAU LAB. STAT., https://data.bls.gov/timeseries/CUUR0000SA0L1E?output_view=pct_12mths [<https://perma.cc/5VMD-EK3M>] (last updated Aug. 17, 2020).

low-income borrowers, particularly those in financial distress who are already missing rent and other necessary payments.³⁹⁹ For a system of automatic withholding and payment through the tax system to work well, it must be certain that the payments are affordable and will not be overly taxing on low-income or liquidity-constrained borrowers. Moreover, if we are correct that the student loan system has tax-like qualities and is in essence a progressive income-based payment for a public good, then it may be desirable to shift the degree of progressivity closer to that of the tax system itself. (That was in part the purpose of removing the monthly payment cap for REPAYE, after all—even if it was not effective in achieving that purpose.)

Therefore, we propose to institute a system of progressive, graduated repayment rates to replace the flat ten-percent rate. Additional modeling and access to nonpublic data would be necessary to develop with precise rates, and we hope to address this in future work, but we suspect that starting at rates more like one to two percent of discretionary income for low incomes, gradually working up to ten percent, would not greatly change the overall economics of the program, particularly if combined with removing the interest charge. Under the current IDR terms, lowering the repayment rate could backfire by increasing any negative amortization (though it would be partially addressed by the interest capitalization limits under PAYE and REPAYE). Removing interest charges (and extending the repayment term) should make it easier to accommodate lower rates without excessive build-up of loan balances.

CONCLUSION

Student loan debt is simply different. It has evolved over time to operate unlike any other kind of debt. The role of the federal government, the public goals of the program, and its use of income-contingent payments make student debt more closely resemble a progressive, tax-funded grant program than a typical consumer loan. Yet education finance remains clothed in the legal structures, financial concepts, and institutions of debt. The frictions generated by the mismatch between the federal student loan program's economic reality and its legal and institutional apparatus are the source of the most significant problems in the education finance system, ranging from the level of defaults, to abusive servicing, to the very idea that there is an imminent student debt crisis.

Fixing education finance requires a closer match between the economic reality encouraged by the public policy behind federal educational finance assistance and the legal and institutional structure of the program. A wholesale transformation of education finance into a tax program, however, would introduce its own problems and complications, and student debt does retain some aspects of debt, in particular the varied and capped amounts of borrowing. Likewise, a shift to an "equity"-based education finance system through public ISAs presents its own problems of moral hazard and adverse selection.

399. See Press Release, Nat'l Consumer Law Ctr., *supra* note 340; *supra* Section III.E.

The solution lies in recognizing that education finance does not neatly fit into existing paradigms of debt, equity, or tax. Instead, it is a hybrid that deserves its own category. Effectuating this hybrid system can be accomplished through a relatively discrete set of targeted reforms that would make IDR the automatic default, ensure affordability through graduated repayment rates and the substitution of inflation adjustment for interest accrual, and eliminate servicing problems by shifting collection to the tax system. Eschewing the student loan program's legacy "debt" framework and treating education finance as an independent financial and fiscal arrangement enable the legal and institutional changes necessary to ensure that federal education finance programs fulfill their policy goal of providing affordable educational finance.