

# CUTTING INTEREST RATES, LOWERING STUDENT DEBT

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**An Analysis of the Congressional Proposal to  
Cut Student Loan Interest Rates in Half**

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**CALPIRG**

## ACKNOWLEDGMENTS

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## EXECUTIVE SUMMARY

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In 21<sup>st</sup> century America, a college education is critical for individual success and the strength of our nation. Higher education is associated with better health, greater wealth and more vibrant civic participation, as well national economic competitiveness in today's global environment. As the need for a college degree has grown, however, so has the cost of obtaining that education. The result is rising student debt.

Some in Congress have proposed lowering student loan interest rates to reduce the debt burden facing students and families. This report addresses one specific proposal to cut interest rates on undergraduate subsidized Stafford student loans in half, from 6.8% to 3.4%, over a period of five years.

About 5.5 million students borrow subsidized Stafford loans every year. Of those borrowers, nearly 3.3 million attend four-year public or private non-profit institutions. The vast majority of these borrowers come from low- and middle-income families. According to the Congressional Research Service, 75% of traditional-aged borrowers with subsidized Stafford loans come from families with incomes below \$67,374. The median income for an American family of four is \$65,000.

### **Congressional Proposal: Cut Interest Rates in Half**

Congressional leadership has proposed cutting the fixed interest rate on

subsidized Stafford loans for undergraduates from 6.8% to 3.4% over the next five years. Loans originated during the intervening five years would be set at fixed interest rates of 6.12% in 2007-2008, 5.44% in 2008-2009, 4.76% in 2009-2010, 4.08% in 2010-2011, and 3.4% from 2011 forward. After graduation, students could consolidate their loans into one loan at the weighted average of the interest rates of their various loans.

### **Findings: Students Would Save Thousands of Dollars with Lower Interest Rates**

By lowering interest rates on subsidized Stafford loans, Congress can save college graduates thousands of dollars over the life of their loans. We found:

- The average four-year college student starting school in 2007 with subsidized Stafford loans would save about \$2,280 over the life of his or her loans under the proposed legislation.
- When the interest rate cut is fully phased in, the average four-year college student starting school in 2011 with subsidized Stafford loans would save \$4,420 over the life of his or her loans.
- The average savings for students starting school in 2011 vary slightly from state to state, ranging from \$4,830 for students in California to \$4,020 for students in West Virginia (Table ES-1).

**Table ES-1. States with the Highest Average Student Savings under the Congressional Proposal to Cut Student Loan Interest Rates in Half (for Students Starting School in 2011)**

<b>State</b>	<b>Number of Subsidized Loan Borrowers at 4-Year Institutions (2004-2005)</b>	<b>Average Subsidized Stafford Loan Debt for 4-Year Graduates</b>	<b>Savings for the Average Student Starting School in 2007 over the Life of the Loan</b>	<b>Savings for the Average Student Starting School in 2011 over the Life of the Loan</b>
CA	228,489	\$15,125	\$2,490	\$4,830
OR	40,721	\$14,832	\$2,450	\$4,740
AZ	33,049	\$14,801	\$2,440	\$4,730
DC	16,437	\$14,611	\$2,410	\$4,680
MS	36,603	\$14,640	\$2,420	\$4,680
WA	47,631	\$14,594	\$2,410	\$4,670
NJ	61,221	\$14,367	\$2,370	\$4,600
HI	8,752	\$14,321	\$2,360	\$4,580
SC	48,433	\$14,301	\$2,360	\$4,580
NY	243,696	\$14,276	\$2,360	\$4,570

## INTRODUCTION

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In America, a college education has always served as a passport to success. As America moves to a more knowledge-based economy, a college diploma is becoming more essential than ever for even entry-level jobs.<sup>1</sup>

Higher education is equally critical for the economic, political and social health of our nation. Colleges train the corporate leaders and innovators who drive American and global businesses. They educate our nurses, teachers and public servants. They also offer opportunities for Americans of all backgrounds and thus serve as a force for fairness and equality. An educated American citizenry will continue to be critical for our nation's competitiveness in the global economy.

Despite the growing importance of higher education, many state governments have cut funding for colleges and universities over the past decade. As federal grants have grown slowly or remained stagnant, more students have had to take out larger loans to pay for college. More than two-thirds of students now borrow to pay for college, and their average debt more than doubled between 1993 and 2004.<sup>2</sup>

Student debt can affect a graduate's post-college opportunities. Many college borrowers, for example, have too

much debt to manageably repay on a starting teacher's or social worker's salary.<sup>3</sup> High student debt also can determine whether or when to buy a house, marry or start a family.<sup>4</sup> In the worst cases, high debt can lead to default, ruined credit, and wage garnishment that can take decades to resolve.

Student debt is determined by three main factors: the amount you borrow, the interest rate at which you repay your loans, and the length of the repayment period. Students taking out loans with higher interest rates end up paying more each month and more overall. Unfortunately for students, as overall loan volume has increased, so have interest rates on loans. Last summer, Congress locked in the interest rates on federal Stafford student loans at a fixed 6.8%.

Some members of Congress have proposed cutting interest rates on some federal student loans. This report looks at the benefits to students of cutting interest rates on subsidized Stafford undergraduate loans from 6.8% to 3.4% over a period of five years. Overall, lowering interest rates on these loans will help those most affected by rising student debt: students from low- and middle-income families.

## BACKGROUND: STAFFORD STUDENT LOANS

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The Stafford loan began as a program for students who needed to make up the shortfall between what they could pay and the cost of going to college. To ensure that banks would offer loans to students, the federal government provided lenders two guarantees: they would always make a profit even if it meant government subsidization and the government would repay the loan in case the student defaulted. The government set an interest rate at which students would repay their loans and a guaranteed rate of return for lenders. When the student interest rate was lower than the guaranteed return rate for lenders, the government agreed to pay the difference. In addition, the government agreed to pay the interest payments on Stafford loans while the student remained in college. As college attendance and the cost of college increased during the 1970s and 1980s, Stafford loans became more common.

As part of the 1993 reauthorization of the Higher Education Act, Congress expanded the Stafford program to offer loans to all college students, regardless of demonstrated financial need. To ensure that federal subsidies remained focused on students with the greatest need, Congress called these new, non-need based Stafford loans “unsubsidized” loans, and the original Stafford loans “subsidized.” The government does *not* pay for the interest on “unsubsidized” Stafford loans while students are in school. Instead, the

interest accrues and is added to the loan principal when borrowers graduate.

When a student applies for financial aid he or she fills out the Free Application for Federal Student Aid (FAFSA), which asks for information such as family income, student savings, family size, and number of children in college. The data is used to determine the Expected Family Contribution (EFC), the amount that the student and parents are supposed to pay toward tuition and fees, as well as eligibility for federal and state grant aid. For students with an Expected Family Contribution and grant aid totaling less than the cost of attending college, federal student loans can help fill the gap.

Eligibility for subsidized Stafford loans depends not only on a family’s income but also on the cost of college. Therefore, a student from an upper income family making \$90,000 a year may be eligible for subsidized Stafford loans if he or she is attending a more expensive institution. By contrast, a student from a family making \$40,000 may not be eligible if his or her Expected Family Contribution is higher than an inexpensive college’s cost of attendance.

### **Undergraduate Subsidized Stafford Loan Borrowers**

About 5.5 million students borrow subsidized Stafford loans every year, and 3.3 million of them attend four-year

public or private nonprofit institutions.<sup>5</sup> These borrowers overwhelmingly come from low- and middle-income families.

For purposes of calculating federal student aid, the government categorizes students as either “dependent” or “independent.” For dependent students, the government expects parents to help their children pay for college and thus counts their income toward the family’s expected contribution. By default, anyone under the age of 24 is considered a dependent. Independent students are 24 or older. Younger students may be considered independent only if they are a graduate or professional student, are married, have a dependent of their own, or are on active military duty, a veteran, orphan, or ward of the court until age 18. Parent unwillingness to pay for college is insufficient to be declared independent.<sup>6</sup>

### *Dependent Students*

The average family income of an undergraduate subsidized Stafford loan borrower is similar to that of the average middle class American. In 2003-2004, the median income of families with children taking out subsidized Stafford loans was \$44,000 (Table 1).<sup>7</sup> According to the Congressional Research Service, 75% of dependent borrowers with subsidized Stafford loans come from families with incomes below \$67,374.<sup>8</sup> The median income for an American family of four is \$65,000.<sup>9</sup>

**Table 1. Family Income of Dependent Stafford Student Loan Borrowers (2003-2004)**

	<b>Average Income</b>
10th percentile	\$14,553
25th percentile	\$26,353
50th percentile	\$44,681
75th percentile	\$67,373
90th percentile	\$91,468

*Source: Calculations completed by the Congressional Research Service at the request of the Committee on Education and the Workforce, December 2006.*

The spread in income is due in part to the variation in the cost of college at different types of institutions. Because private four-year institutions tend to cost more than public institutions, the median family income for subsidized Stafford borrowers is higher for those attending private colleges.

### *Independent Students*

The median income for independent students is lower than the family income of dependent students, typically because they are earlier in their careers or may be working only part time (Table 2). Independent borrowers at private four-year institutions tend to have higher family incomes.<sup>10</sup>

**Table 2. Family Income of Independent Stafford Student Loan Borrowers (2003-2004)**

	<b>Average Income</b>
10th percentile	\$3,335
25th percentile	\$8,924
50th percentile	\$19,034
75th percentile	\$32,272
90th percentile	\$51,228

*Source: Calculations completed by the Congressional Research Service at the request of the Committee on Education and the Workforce, December 2006.*



## CONGRESSIONAL PROPOSAL TO CUT STUDENT LOAN INTEREST RATES

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The Congressional Democratic leadership has proposed new legislation to cut interest rates on subsidized Stafford undergraduate loans in half: from a fixed rate of 6.8% to a fixed rate of 3.4%. The specific proposal phases in the cut over five years, lowering the interest rate on those loans by .68% each year (Table 3).

**Table 3. Congressional Proposal to Cut Interest Rates on Subsidized Stafford Loans Over Five Years**

School Year	Subsidized Stafford Loan Interest Rate
2007-08	6.12%
2008-09	5.44%
2009-10	4.76%
2010-11	4.08%
2011-12	3.40%
After 2011-12	3.40%

Student borrowers traditionally take out a new loan before every semester. Since the proposed legislation phases in the interest rate cut, student borrowers will graduate with loans at a variety of interest rates. Students will be able to simplify their loan repayment by consolidating their loans into one payment, as many students do already.

The interest rate for a consolidated loan is set at the “weighted average of the interest rates on the loans being consolidated, rounded up to the nearest 1/8 of a percent and capped at 8.25%.”<sup>11</sup> Students who are already in school and would borrow for only one or two years at a lower interest rate would receive some modest benefit, while students starting school after the policy is fully phased in would receive the greatest reduction in their loan payments.

## FINDINGS: STUDENTS WOULD SAVE THOUSANDS OF DOLLARS WITH LOWER INTEREST RATES

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By lowering interest rates on federally-subsidized Stafford loans, Congress can save college graduates thousands of dollars over the life of their loans. Under the proposed legislation, a student borrower starting a four-year program in the fall of 2007 could take out two loans at 6.12%, two loans at 5.44%, two loans at 4.76% and two loans at 4.08% over his or her college career.

Assuming that the student borrowed the same amount for each semester, he or she would be able to consolidate these loans at a 5.1% interest rate. (See the methodology for a detailed discussion.)

Students would save thousands of dollars under the proposed interest rate cuts. Specifically:

- The average four-year college student starting school in 2007 with subsidized Stafford loans would save \$2,280 over the life of his or her loans under the proposed legislation.
- When the interest rate cut is fully phased in, the average four-year

college student starting school in 2011 with subsidized Stafford loans will save \$4,420 over the life of his or her loans.

See Table 4 for how these savings break down by state.

## OTHER BORROWING

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Most subsidized Stafford loan borrowers also will take out other loans to pay for college. These loans may include unsubsidized Stafford loans or federal Perkins loans, or less regulated “alternative” loans from private lenders. While some students will take out other loans, this policy will offer meaningful

help to students with subsidized Stafford loans. To help protect all borrowers from unmanageable debt payments, Congress should pass additional student loan reforms, including limits on the percent of income that graduates must devote to loan repayment.

## CONCLUSION

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About 5.5 million undergraduate borrowers took out subsidized Stafford loans in 2005-2006. Most of these borrowers came from predominately low- and middle-income families. As a first step toward making college more affordable, cutting interest rates on subsidized Stafford student loans will result in significant savings, even for students borrowing while the policy is

phased in over the next five years. Increasing need-based federal student aid and passing broad protections for student borrowers, such as limits on the percent of income that a student must earmark for loan repayment, in conjunction with interest rate cuts, will help make college more accessible and affordable for millions of American students.

**Table 4. Student Savings under Congressional Proposal to Cut Student Loan Interest Rates in Half:  
By State**

<b>State</b>	<b>Number of Subsidized Loan Borrowers at 4-Year Institutions (2004-2005)</b>	<b>Average Subsidized Stafford Loan Debt for 4-Year Graduate</b>	<b>Savings for the Average Student Starting School in 2007 over the Life of the Loan</b>	<b>Savings for the Average Student Starting School in 2011 over the Life of the Loan</b>
AK	5,119	\$12,854	\$2,120	\$4,110
AL	62,996	\$13,572	\$2,240	\$4,340
AR	39,385	\$13,022	\$2,150	\$4,170
AZ	33,049	\$14,801	\$2,440	\$4,730
CA	228,489	\$15,125	\$2,490	\$4,830
CO	45,588	\$13,455	\$2,220	\$4,310
CT	33,567	\$14,263	\$2,350	\$4,560
DC	16,437	\$14,611	\$2,410	\$4,680
DE	9,534	\$13,927	\$2,300	\$4,460
FL	125,475	\$13,663	\$2,260	\$4,370
GA	83,942	\$13,234	\$2,190	\$4,230
HI	8,752	\$14,321	\$2,360	\$4,580
IA	53,285	\$13,944	\$2,300	\$4,460
ID	26,305	\$13,221	\$2,180	\$4,230
IL	128,765	\$14,111	\$2,330	\$4,510
IN	94,267	\$12,967	\$2,140	\$4,140
KS	42,932	\$13,827	\$2,280	\$4,420
KY	46,963	\$13,026	\$2,150	\$4,170
LA	68,261	\$13,077	\$2,160	\$4,180
MA	98,990	\$13,994	\$2,310	\$4,470
MD	48,484	\$14,096	\$2,330	\$4,510
ME	21,210	\$13,173	\$2,170	\$4,210
MI	143,699	\$13,256	\$2,190	\$4,240
MN	67,468	\$13,480	\$2,220	\$4,310
MO	82,921	\$13,305	\$2,190	\$4,250
MS	36,603	\$14,640	\$2,420	\$4,680
MT	16,212	\$12,587	\$2,080	\$4,030
NC	92,244	\$13,332	\$2,200	\$4,270
ND	17,358	\$12,890	\$2,130	\$4,120
NE	28,021	\$13,248	\$2,190	\$4,240
NH	20,317	\$13,853	\$2,290	\$4,430
NJ	61,221	\$14,367	\$2,370	\$4,600
NM	20,899	\$12,792	\$2,110	\$4,090
NV	10,545	\$13,655	\$2,250	\$4,370

State	Number of Subsidized Loan Borrowers at 4-Year Institutions (2004-2005)	Average Subsidized Stafford Loan Debt for 4-Year Graduate	Savings for the Average Student Starting School in 2007 over the Life of the Loan	Savings for the Average Student Starting School in 2011 over the Life of the Loan
NY	243,696	\$14,276	\$2,360	\$4,570
OH	173,312	\$13,495	\$2,230	\$4,320
OK	47,528	\$13,535	\$2,230	\$4,330
OR	40,721	\$14,832	\$2,450	\$4,740
PA	211,832	\$13,866	\$2,290	\$4,440
RI	19,649	\$13,822	\$2,280	\$4,420
SC	48,433	\$14,301	\$2,360	\$4,580
SD	19,727	\$13,122	\$2,170	\$4,200
TN	67,410	\$13,886	\$2,290	\$4,440
TX	205,508	\$14,233	\$2,350	\$4,550
UT	35,000	\$12,988	\$2,140	\$4,160
VA	73,696	\$13,842	\$2,280	\$4,430
VT	13,575	\$13,671	\$2,260	\$4,370
WA	47,631	\$14,594	\$2,410	\$4,670
WI	75,905	\$13,379	\$2,210	\$4,280
WV	35,194	\$12,579	\$2,080	\$4,020
WY	3,904	\$13,836	\$2,280	\$4,420
<b>U.S. Average</b>	<b>3,301,841</b>	<b>\$13,821</b>	<b>\$2,280</b>	<b>\$4,420</b>

*See the Methodology section for a discussion of the data sources and calculations.*

## METHODOLOGY

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To calculate the average savings of a student borrower, we used the Economic Diversity of Colleges Database of higher education institutions (including two and four-year public and private institutions) from The Institute for College Access and Success (TICAS). The data file (available at <http://www.economicdiversity.org>) comes from five main sources from 2004-2005, four of which are compiled by the federal government.<sup>12</sup>

To calculate the per student savings under the proposed legislation for the average four-year student, we first used the TICAS data set to total all subsidized Stafford loan dollars (SSTOTC) in each state and subsidized Stafford borrowers (SSNUMC) in each state at four-year public and private schools.<sup>13</sup> We then divided state volume by state borrowers to generate the average annual subsidized Stafford loan debt for a four-year student in that state. (For convenience, we will refer to this number as “annual per student borrowing.”) We followed the same process to come up with an annual average subsidized Stafford loan debt by campus. To estimate the average four-year subsidized Stafford total loan volume of a student we multiplied average per student borrowing by 4.

In calculating this average, we grouped freshmen, sophomores, juniors, seniors and fifth-year seniors together, although loan limits on Stafford borrowing set the maximum loan for freshmen at \$2,625, for sophomores at \$3,500, and for juniors and seniors at \$5,500. Because students borrow different amounts in different school years, annual per student borrowing is not a useful way to calculate how much any individual student will borrow in a given year. By multiplying annual per student borrowing by 4, however, we provide an estimate for total per student borrowing over a four-year college career. Because the annual per student borrowing averages students from different years, it closely approximates the total borrowing of one student over a four year college career.

We calculated the expected student debt of a borrower under current law using the following formula to generate cumulative subsidized Stafford debt:

$$\frac{[\text{loan amt} * (\text{rate}/12)] * [1 + (\text{rate}/12)]^{(\# \text{ of years to repay} * 12)}}{[(1 + (\text{rate}/12))^{(\# \text{ of years to repay} * 12)} - 1]} \times (\# \text{ years to repay}) \times 12$$

In addition to the average subsidized Stafford loan debt, we assumed 6.8% fixed interest rate repayment and a 15-year repayment period, which is standard under student loan consolidation.

To calculate the savings generated for students starting school in 2007, we first calculated the average interest rate under which they would repay after graduation. We assumed that their loan volume would remain constant over the course of their college careers. This likely underestimates the potential savings, as freshmen and sophomores have lower borrowing limits than juniors and seniors. Because the interest rate cut will be phased in, the later the borrowing in their college careers, the lower the consolidated interest rate. We use the following formula to estimate the interest rate at which a 2007 freshman would repay his or her loan.

$$\frac{(\text{loan amt.} \times 6.14\%) + (\text{loan amt.} \times 5.44\%) + (\text{loan amt.} \times 4.76\%) + (\text{loan amt.} \times 4.08\%)}{(\text{avg. loan amt.}) \times 4}$$

With loan volume remaining constant, the repayment rate for students starting school in 2007 would be 5.1%. For students starting school in 2011 or after, we used the interest rate of 3.4%. For both situations, we plugged this new interest rate into the debt formula above to calculate repayment costs over 15 years at these lower interest rates.

Our methodology does not address the fact that many students will take out other Stafford, Perkins or private student loans to pay for college. However, while those loans are necessary to assess a student's average monthly loan payments, they are not necessary to determine the savings under a lower interest rate.

## END NOTES

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<sup>1</sup> Donna Desrochers, *Higher Education's Contribution to the Knowledge Economy*, Solutions for Our Future Project. Accessed June 20, 2006 at [www.solutionsforourfuture.org/site/DocServer/08.Knowledge-Economy.pdf?docID=103](http://www.solutionsforourfuture.org/site/DocServer/08.Knowledge-Economy.pdf?docID=103).

<sup>2</sup> National Center for Education Statistics (NCES), National Postsecondary Student Aid Study (NPSAS), 1993 and 2004 undergraduates, Data Analysis System (DAS); calculations by the Project on Student Debt.

<sup>3</sup> Luke Swarthout, State PIRGs' Higher Education Project, *Paying Back, Not Giving Back*, 9.

<sup>4</sup> *Ibid.*, 9.

<sup>5</sup> U.S. Department of Education, Office of Postsecondary Education, National Student Loan Data System.

<sup>6</sup> FinAid.com Glossary, accessed at <http://www.finaid.org/questions/glossary.phtml>

<sup>7</sup> Calculations completed by the Congressional Research Service at the request of the Committee on Education and the Workforce, December 2006.

<sup>8</sup> Calculations completed by the Congressional Research Service at the request of the Committee on Education and the Workforce, December 2006.

<sup>9</sup> U.S. Census Bureau, *Median Income for 4-Person Families, By State*. Accessed December 28, 2006 at <http://www.census.gov/hhes/income/4person.html>.

<sup>10</sup> Calculations completed by the Congressional Research Service at the request of the Committee on Education and the Workforce, December 2006.

<sup>11</sup> Finaid.com, *Student Loan Consolidation*. Accessed January 2, 2007 at <http://www.finaid.org/loans/consolidation.phtml>.

<sup>12</sup> The Institute for College Access and Success, *Sources*. Accessed December 13, 2006 at <http://www.economicdiversity.org/sources.php>.

<sup>13</sup> The Institute for College Access and Success, *Code Book*. Accessed December 13, 2006 at [http://www.economicdiversity.org/economic\\_diversity\\_codebook.pdf](http://www.economicdiversity.org/economic_diversity_codebook.pdf).