Economic Opportunity Institute

May 15, 2015

Rep. Phil Barnhart
Oregon State Capitol, H-279
Salem, Oregon 97301

Re: HB 2662 Pay It Forward Pilot Proposal – Questions from Revenue Committee Hearing

Chair Barnhart and Members of the Revenue Committee:

On Monday, May 11, you heard testimony on House Bill 2662, the Pay It Forward pilot proposal. While almost all of the testimony was in support of the pilot proposal, several questions were posed, some of which were answered during the hearing, and others of which were not. As the organization responsible for developing this policy, including the financial model, known as the Pay It Forward Interactive Calculator, we would like to offer you full answers to your questions and comments here.

Questions from the Committee

1. **Chair Barnhart:** Once a student is admitted to the Pay It Forward program, what is the extent of the state's obligation to that student?

   The state would pay to the institution what would otherwise be the student's tuition, or a proportion thereof chosen by the student, based on the credits that the student chose to be financed through Pay It Forward. These payments would continue as long as the student continued to attend a participating state college or university. At the same time, the student's obligation to provide contributions to the state would continue for twenty years from the last year of attendance, at a percentage of AGI rate that is proportional to the number of credits originally paid for by the state. These contributions would be designed so that in the aggregate for participating students they repaid the state's contributions. They would also be scaled to cover program administrative costs.

   As Mike Selvaggio pointed out during the hearing, the best practice would be to ensure that students who enroll in Pay It Forward have the opportunity to complete their undergraduate education with Pay It Forward available to them for that period.

   That being said, **there is nothing in the program design nor in the pilot that prohibits the state from wrapping up the program at any time** – even after only one year. In that case, the state's only continuing obligation would be to manage receipt of contributions; the state would not be obligated to any additional program funding. The students who participated will still be obligated by contract to make contributions for the 20-year period for the credits which were financed through Pay It Forward.

2. **Chair Barnhart:** How can Pay It Forward sustain itself given some expected level of adverse selection?

   The way adverse selection is taken into account in program design is by reducing the average income series values used to calculate future program contributions. If a higher level of adverse selection is observed in Pilot Program implementation (or assumed from the outset), the percentage of AGI contribution rate can be increased to offset that impact, so the program remains financially sustainable.

   This factor is one of several included in the Interactive Calculator used to evaluate and design the Workgroup's proposed Pilot Program. It was examined carefully, making realistic worst-case assumptions about adverse selection and calculating how much adjustment would be necessary if that case materialized. It was demonstrated to be a manageable risk. As ECONorthwest pointed out in its sensitivity analysis of the Interactive Calculator, a -1% input for adverse selection results in only 1.75% less in net program receipts. <u>Indeed, as the pilot is currently designed, the program could withstand even a -10% adverse selection effect, and the fund would still become self-sustaining by year 25.</u>

   In addition, EOI is available to provide modeling and sensitivity analysis assistance "hands on" with Committee members or staff, to demonstrate the effects of this factor and how Pilot design can be adjusted to accommodate varying level of adverse selection.

3. **Chair Barnhart:** How will dropouts be treated and what effect do they have on Pay It Forward receipts?

   As was described at the hearing, each participant's contribution is based on her individual participation level. When a student drops out, her contribution obligation "plateaus" at the rate determined by her state support to that point. For example, if a student attends OSU for 2 years under Pay It Forward and then drops out, she contributes 2% of her income for 20 years.

   The proposed Pilot Program initial design was developed based on actual past patterns of college completion and corresponding future incomes. The fraction of students who drop out were projected to provide contributions based on the lower future incomes associated with their cohort. Indeed, the model is designed based on 63% of community college students obtaining no degree, and 29% of four-year students obtaining either no degree or less than a Bachelor's degree. Dropouts are thus projected to provide below-average dollar contributions, with that adjustment fully taken into account in deriving the overall percentage of AGI contribution rates.

   As Chair Barnhart correctly pointed out at the hearing, this may create an incentive for the OUS system and the state to provide even more support for students to complete their degrees and earn higher incomes on which to base their Pay It Forward contributions.

4. **Chair Barnhart:** How will graduate degrees and students be treated and what effect do they have on Pay It Forward receipts?

As with dropouts, the proposed Pilot Program initial design was developed based on actual past patterns of college completion and corresponding future incomes for those pursuing graduate studies. The students who pursue advanced degrees were assumed to provide above-average dollar contributions, consistent with the empirically documented higher incomes such students receive on average. With the four-year program only, the model conservatively assumes 4% will obtain a master's degree, 1% will obtain a professional degree, and another 1% will obtain a doctorate degree.

In addition, those students' contributions were projected including a "zero income period" for the extra years they would be in school before beginning to realize their higher incomes - two years for Masters students and four years for Doctoral and professional program students. Also, as with dropouts, these adjustments were fully taken into account in deriving the overall percentage of AGI contribution rates.

The income data used for projections can be found on Income Series tab of the Interactive Calculator, which was made available to the committee by Mike Selvaggio via e-mail on Monday, May 11.

In addition, there is nothing that precludes the state from offering this or another Pay It Forward pilot to graduate students. The financial model can be customized to any level of higher education.

5. **Chair Barnhart:** What level of funding constitutes "sufficient funds" to implement the pilot?

   As Mike Selvaggio noted during the hearing, the workgroup's finding was that a cohort of 400 students would be sufficient to gather useful data for this particular pilot. By pooling data for similar cohorts from multiple years, it would be possible to obtain statistically significant information from smaller annual cohorts as well.

   While Pilot data and findings would be less robust with Pay It Forward limited to a small cohort, there is nothing that precludes it from being offered to a smaller cohort of students.

6. **Chair Barnhart:** Are Pay It Forward obligations dischargeable in bankruptcy?

   No, Pay It Forward obligations are not dischargeable in bankruptcy. There is no principal to repay, and therefore no debt to discharge in bankruptcy. As Mike Selvaggio testified at the hearing, if a student is indeed bankrupt, his obligation is the same: to make a contribution based on his income. If he has $0 income, then his contribution is $0.

7. **Vice-Chair Bentz:** Are Pay It Forward contributions tax-deductible?

   No, contributions are not tax-deductible. Participants' contributions are based on a combination of their adjusted gross income, as defined by Oregon law, and any amount described as "gross income" under section 103, subsections (b) and (c) of the Internal Revenue Code of 1986.

8. **Vice-Chair Bentz:** This program shifts risk from students to the state. Given some level of delinquency, there is an assumption that the state will have to put more money into the program than it gets out. How does the program calculate and respond to this degree of risk?

To the first point, the Pay It Forward program results not in risk-shifting but in risk reduction through pooling the risks of individual students, some of whom will later receive above-average incomes and some of whom will receive below-average incomes. The state essentially acts as the insurer, and as with all insurance is positioned to offset individual low revenue outcomes (*i.e.*, individual student contributions) with comparable or higher volumes of high revenue outcomes.

To the second point, some level of non-payment is inevitable, and has already been accounted for. The Interactive Calculator provides the ability to account for a non-payment rate, and the workgroup has already built in a 4% non-payment rate. This can be adjusted by the HECC and/or OSAC either before the implementation of the pilot or after data is collected that suggests a higher or lower rate is appropriate.

As the pilot is currently designed, this risk is already accounted for in the contribution rate. Should the administrators feel the need to account for a higher rate of non-payment, then the contribution rates and/or periods can be increased for new Pay It Forward participants to account for that. The increase would be minimal. <u>As the pilot is currently designed, it could withstand a non-payment rate of up to 15% and still become self-sustaining by year 25.</u>

In addition, we can expect a lower delinquency rate in a Pay It Forward program than with student loans. First, state agencies, including the Department of Revenue, have several tools to ensure that contributions owed to the state are paid, for instance, by withholding income tax refunds. Student loan companies do not have this capability. Second, because Pay It Forward contributions are tied directly to income, there is less risk of participants being unable to make their contributions, as is the case with loan payments.

9. **Vice-Chair Bentz:** In terms of risk pooling, how does the program account for variability in incomes based on different majors and career paths?

<u>Dropouts and graduation rates are accounted for.</u> As is described in responses to questions 3 and 4, the income data on which the model bases projections account for a large degree of variation in education levels, with a large proportion expected to drop out without earning a degree at all.

<u>Under- and unemployment are accounted for.</u> Because the census earnings data used are for "total work experience," rather than incomes of people who worked full-time all year, the income series also accounts for under- and unemployment.

<u>All career paths are accounted for, with higher earners likely underrepresented in the data.</u> Because the data are national average earnings data, all majors – and their resulting disparate incomes – are represented.

In addition, as the pilot is currently designed, only 6% of participants are expected to obtain a post-Bachelor's degree. In reality, over 12% of the general population holds a master's, professional, or doctorate degree. This is equivalent to assuming adverse selection by about half of the most highly educated would-be participants, which provides a conservative estimate of contribution receipts.

10. **Rep. Johnson:** OSU testified that Pay It Forward would be more expensive than paying off student loans.

    Kate Peterson from OSU testified in the Higher Education, Innovation, and Workforce Development Committee on March 6 that OSU students would likely pay more under Pay It Forward than they do now with student loans. <u>Her testimony was inaccurate and reflects a significant misinterpretation of how Pay It Forward contributions work.</u> In fact, as Mike Selvaggio testified on Monday, students with incomes within the band of 40% to 120% of mean incomes for the Pay It Forward cohort would pay *less* under Pay It Forward, OSU students included.

    Peterson's inaccurate and incomplete calculations were pointed out and corrected in Mike Selvaggio's testimony during the Revenue Committee Hearing on Monday, May 11. Peterson's errors were also clarified in a letter from the Economic Opportunity Institute to the Higher Education Committee dated March 12, 2015. That letter is attached here for your review.

    To summarize the inaccuracy of Peterson's calculations:

    - First, they compare the cost of financing 63% of OSU tuition with a loan to financing 100% of OSU tuition with Pay It Forward, biasing the numbers against Pay It Forward by 37%
    - Second, they fail to discount future streams of payment to reflect the time value of money, a fundamental feature of the financial sector of higher education and the entire economy.
    - Third, her examples exaggerate Pay It Forward contributions (*e.g.*, by using higher-than-average incomes) and understate typical loan repayment obligations (*e.g.*, by using the lowest interest rates available for the entire loan amount).

    At the average projected income of the Pay It Forward cohort (about $49,000), the lifetime cost of Pay It Forward is about $4,000 less than that of a federal loan for the average OSU debt load.

11. **Rep. Johnson:** What kind of longitudinal data system does Oregon have to track data of participants?

    Much of the data the workgroup used in its study of Pay It Forward and development of a pilot was from the Oregon University System and the Department of Community Colleges and Workforce Development, both of which already have an interest in – and the ability to administer – higher education data collection and maintenance. In addition, as Bob Brew noted at the hearing, OSAC has administered dozens of financial aid and loan programs over the years. The bill provides OSAC and HECC with broad authority to call on other state agencies, like the Department of Revenue, for data-sharing and collection as well.

12. **Rep. Johnson:** Who will be responsible for ensuring contributions are collected?

The HECC has broad authority to set rules for administration of the Pay It Forward pilot. It is anticipated that OSAC will administer the fund, which includes collection of contributions to the fund.

13. **Rep. Johnson:** Is there anything that precludes students from using Pay It Forward in addition to maximum loan levels?

    In the pilot developed by the HECC workgroup, lifetime Pay It Forward contribution rates are capped at 5% – which effectively limits participation to five years of full-time enrollment at a four-year institution. There are parallel limits for community college participation. Participation could also be capped based on the cost of attendance less certain other types of aid.

14. **Rep. Whitsett:** How does a Pay It Forward contract differ from a loan contract? Might a Pay It Forward contract be challenged legally as a gift to a person under the age of 21, pursuant to ORS 126.805 through 126.886?

    It is expected that the HECC will request a legal analysis by the appropriate state agency before implementing the Pay It Forward pilot.

    Without having conducted a legal analysis of the chapter in question, it seems that Rep. Whitsett's concern would only apply to this pilot if the state's provision of tuition on behalf of the Pay It Forward participants were to be legally characterized as a gift. Using similar programs like the Oregon Opportunity Grant as a guide, it can be expected that Pay It Forward participation would not constitute such a gift.

    If the state's attorneys feel that the collection enforceability is questionable, the Legislature can certainly recommend clarifying legislation and/or establish provisions such as co-signing.

Questions contained in Bob Brew's testimony

Many of the administrative questions contained in Bob Brew's testimony are good, pragmatic questions. While not highlighted in his testimony, most of them were discussed and addressed by the Workgroup, with its answers providing underpinnings to the overall Pilot Program design. In addition, most of the answers are provided in the HECC's Final Pay It Forward Report. For those who wish to see more extensive explanations, citations to the HECC's Final Pay It Forward Report can be provided.

15. Will students be able to drop in and drop out of participation, term by term?

    Yes, as the pilot is currently designed, students will be able to use Pay It Forward for any number of credits they wish to (up to program limits), each term.

16. Will students be able to attend any public college or university, or will participation be limited to a subset of schools?

    As the pilot is currently designed, students that wish to participate in Pay It Forward will be able to attend any public college or university.

17. How will participants be selected, and how can we assure selection is fair and equitable while ensuring financial sustainability of the program?

    As the pilot is currently designed, students will be selected by stratified random sampling based on the level of funding provided; in the event of applications exceeding funded slots, a lottery will be used to select within each income stratification. In addition, the pilot proposes offering Pay It Forward to all of the graduates of one or two high schools, to be determined by OSAC.

18. How will we treat the income of students who get married and file taxes jointly, particularly if the Pay It Forward participant is not a significant wage earner?

    The workgroup used federal student loan rules as a guideline. Pay It Forward participants who file jointly make contributions on their joint income, but the percentage is reduced to reflect Pay It Forward participation. In the simplest case where one Pay It Forward participant marries a non-participant, the contribution is made on the full joint income, with the Pay It Forward percentage reduced by half.

19. Will students in educational programs or schools that have significantly different tuition and fees be treated the same in the "contribution" or "repayment" phase?

    Contributions are differentiated only between OUS and community college programs. As the pilot is currently designed, all OUS participants will contribute at one rate, and all community college participants will contribute at another rate.

20. Will these obligations be eligible to be discharged through bankruptcy or death?

    The obligations are not dischargeable in bankruptcy, just as income taxes are not dischargeable. In the event of death, obligations will be discharged.

21. How will we be able to efficiently collect from students who leave Oregon for other states or countries, particularly if we don't have any reciprocity agreement with them?

    The bill gives OSAC broad authority to authorize "any appropriate conditions of payment during the payment period." The pilot contemplates relationships and formal agreements between OSAC, the Department of Revenue, and the IRS to obtain federal income tax returns.

22. Will collections be sufficient to fund the administration of the repayment program, even if the pilot does not evolve into a long-term program?

    Yes. Contribution percentages have been selected to produce sufficient revenues to break even, including covering annual administrative costs estimated by OSAC. If the pilot continues for the long-term, those administrative costs would require approximately 3-4% of annual program revenues at maturity (depending on program size). Were the program terminated after a period of years, revenue from contributions would continue for another 20-23 years, in proportion to the number of participants involved prior to termination, and administrative requirements would decline substantially since there would not be new annual cohorts to enter, track and manage.

23. How will these obligations be treated by regulators vis a vis consumer protection law?

    These obligations will be treated in the same manner as other obligations to the State of Oregon, such as income taxes. In many cases, the workgroup has done as much as it can with current information. Some questions will not be answerable until the pilot is implemented. That information-gathering is precisely one of the reasons for implementing Pay It Forward as a pilot.

24. How will these contracts be treated by creditors and the Internal Revenue Service?

    The IRS will likely treat these obligations similarly to state taxes. As stated above, the workgroup has done as much as it can with current information. Some questions will not be answerable until the pilot is implemented. That information-gathering is precisely one of the reasons for implementing Pay It Forward as a pilot.

25. Will the program withstand legal challenge, and if not, what becomes of the outstanding obligations?

    We anticipate the program will withstand legal challenge, but some questions will not be answerable until the pilot is implemented. That information-gathering is precisely one of the reasons for implementing this as a pilot.

We want to reiterate how much we appreciate your consideration of this innovative pilot proposal. We are available for any additional questions or concerns you may have.

Thank you,

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cc: House Committee on Revenue