Do Loans Increase Educational Attainment?

BY MOLLY HARNISH

Students at participating colleges who meet a few basic requirements and fill out the Free Application for Federal Student Aid (FAFSA) are eligible for federal loans through the Department of Education's Direct Loan Program. Although students receiving a $0 offer can still apply for loans through the Direct Loan Program, such an offer may discourage them from doing so. This practice is especially prominent at community colleges, where over 5 million students go to schools that either do not mention loans at all or present loan offers of $0.

Colleges may offer $0 in loans out of concern that students, who are often first-time borrowers, will default. If too many students default, the college faces federal sanctions. Yet college loans may also benefit students by allowing them to take more credits, work fewer hours, or acquire less credit card debt (which typically has a higher interest rate than student loans) than they could without a loan.

In an article in the *American Economic Journal: Economic Policy*, Benjamin Marx of the University of Illinois and Lesley Turner of the University of Maryland analyzed the effect of nonzero loan offers on borrowing and educational attainment. Their experimental design incorporated nudge theory, which suggests that policymakers and others can sway, or nudge, a decision toward a desired outcome by restructuring the "choice architecture." This restructuring does not add or remove choices; it simply changes their relative prominence — for example, placing fruit rather than candy bars at eye level in grocery stores. In this case, the "nudge" was the nonzero loan offer, which made the option of taking out federal loans more prominent.

To determine the effect of student loan offers on borrowing, Marx and Turner randomly assigned over 19,000 students at a large community college to receive either a $0 or a nonzero loan offer. (The nonzero offer was $3,500 for freshmen and $4,500 for sophomores.) Students in both groups could still borrow up to the federally specified maximum, and their loan amount defaulted to $0 if they took no action. Marx and Turner found that students receiving a nonzero offer (the treatment group) were 40 percent more likely to borrow than those receiving a zero offer (the control group). In addition, students in the treatment group borrowed $280 more on average than students in the control group.

Marx and Turner suggested two possible explanations for this finding. First, a nonzero loan offer reduces the cost of seeking out information about loan availability. According to the authors, this reduced information cost explains at least 78 percent of why students receiving the nonzero loan offer were more likely to borrow than students in the control group. Second, a nonzero loan offer introduces a salience effect. The loan amount offered to a student becomes the most salient amount in that student's mind, regardless of how much he or she actually needs to borrow. Rather than incurring the extra cost of choosing another amount, the student borrows the exact amount specified in his or her aid award. This explains the spike in borrowing that the authors observed around the amount offered.

For students in both the control and treatment groups, the authors also pointed to the influence of default bias, another aspect of nudge theory. The default loan amount was $0, meaning that regardless of the amount offered, no student actually received a loan unless he or she filled out the necessary paperwork. Thus, students in the study may have been biased against borrowing because of the effort involved in obtaining a loan.

Marx and Turner were interested not only in the effect of nonzero loan effects on borrowing, but also in the effect of borrowing on educational attainment. They found that receiving a nonzero offer tended to increase credits attempted, credits earned, and GPA, although it had no statistically significant impact on degree completion or enrollment. In particular, students who borrowed after receiving the nudge accumulated 3.7 more credits and had 0.6 point higher GPAs on average than students in the control group. In addition, their likelihood of transferring to a four-year public institution after one year increased by 11 percentage points — an increase of 178 percent over the control group.

While increased borrowing might sound like a negative, these findings suggest that nonzero offers in financial aid awards actually benefit students. According to Marx and Turner, receiving a nonzero offer increases students' likelihood of borrowing, which, on average, increases educational attainment. Thus, including nonzero loan offers in financial aid awards could improve students' educational outcomes at low cost. **EF**

Marx, Benjamin M., and Lesley J. Turner. "Student Loan Nudges: Experimental Evidence on Borrowing and Educational Attainment." *American Economic Journal: Economic Policy*, May 2019, vol. 11, no. 2, pp. 108-141.