The Heritage Foundation

BACKGROUNDER

No. 3203 | APRIL 27, 2017

Private Lending: The Way to Reduce Students' College Costs and Protect America's Taxpayers

Mary Clare Reim

Abstract

Education experts are increasingly noting evidence of a causal relationship between federal lending and the dramatic rise in the cost of higher education. Colleges and universities appear to raise tuition rates in response to the availability of uncapped federal lending. The recent plunge in repayment rates reflects the harmful takeover of market share by the federal government as the financial contagion spreads through the system. The federal government should limit its involvement in student lending to supplemental aid, clearing the field for private lenders with sound lending policies that use innovative risk-assessment tools to gauge appropriate levels of risk. The sound policies and fiscal discipline of the private market would steer students toward wiser overall academic and financial decisions, replacing a taxpayer-funded panacea with a holistic and healthy approach to lending policy.

Under the Administration of former President Barack Obama, the federal government expanded its role in the student loan market dramatically. Today, roughly 90 percent of all student loans are originated by the federal government, leaving a very small share of the market for private lenders. Recent research indicates that the federal government's involvement has done more harm than good. In fact, the exponential rise of college tuition prices has been attributed to unfettered access to federal student aid. Moreover, federal lending has encouraged students to take on more debt for degrees of questionable market value.

In order to address the college cost problem and limit taxpayer exposure to student loan defaults and an overly generous forgiveness policy, the federal government's role in higher education lend-

Key Points

- Takeover of the market and irresponsible lending practices by the federal government have had negative results, including the meteoric rise in higher education costs.
- Students are encouraged to take on large amounts of debt regardless of which institution they attend or their chosen field of study, and such practices encourage colleges and universities to raise their tuition prices.
- Private lending that considers a student's ability to repay before granting a loan, by contrast, encourages students to make wise financial and academic decisions as they consider how to pay for their education.
- Private lenders consider risk before granting loans and can better serve students and taxpayers by using innovative risk-assessment tools to gauge marketability of degrees and a student's future ability to repay.
- The federal government should limit its involvement in student lending, eliminate the Parent PLUS and Grad PLUS programs, and use fair value accounting to assess costs.

This paper, in its entirety, can be found at **http://report.heritage.org/bg3203**

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

ing should be dramatically curtailed to allow for better private lending options. Policymakers should consider removing barriers to the growth of the private lending market by eliminating ineffective and costly programs and simplifying the government's role into a one-loan system.

The Bennett Hypothesis

In 1987, then-U.S. Secretary of Education William J. Bennett, concerned along with others in the Department of Education about the 6 percent increase in college tuition prices, wrote an op-ed for *The New York Times*, "Our Greedy Colleges." Although that type of growth seems modest by today's standards, Bennett's comments sparked an important national debate about the root causes of tuition increases. "Increases in financial aid in recent years have enabled colleges and universities blithely to raise their tuitions, confident that Federal loan subsidies would help cushion the increase," Bennett argued.[1]

Bennett's assessment of the gravity of the situation ran counter to the assertion of many education observers at the time who argued that an increase in the college enrollment numbers would have long-term economic benefits that would outweigh the tax burden. Bennett's idea that federal subsidies are the cause of tuition increases later became known as the Bennett Hypothesis and has been the subject of much debate among education experts and economists for decades. Today, there is more evidence than ever to support Bennett's hypothesis.

In a study that drew particular attention when it was published by the Federal Reserve Bank of New York in July 2015, David Lucca, Taylor Nadauld, and Karen Shen found that increased access to Pell Grants, along with increased access to subsidized and unsubsidized student loans, does in fact increase the cost of college tuition:

> A dollar increase in Pell Grants going to an institution is associated with a higher sticker price of tuition of about 40 cents. The effect of an increase in subsidized loan amounts is higher, at about 63 cents on the dollar, and this effect is estimated to be statistically significant at the 1% confidence level. Finally, we see the effect of a change in unsubsidized loan amounts on the sticker price of tuition to be smaller at about 25% but still highly significant.[2]

The authors note that these findings "provide support to the Bennett Hypothesis, with an average passthrough of increased student aid supply to tuition of around 40 cents on the dollar, although there is substantial heterogeneity across aid types."[3] They conclude that, on average, changes in the sticker price of tuition at universities are sensitive to changes in federal aid.

A recent report by Mark Warshawsky and Ross Marchand released by the Mercatus Center at George Mason University takes a fresh look at the Bennett Hypothesis, given the latest data, and concludes that:

> The real cost of a college education, gross or not, has risen rapidly. Federal support to university systems, in the form of both loans and grants, has also steadily increased, exploding in the past 20 years with major expansions in federal financing programs. According to the most recent empirical analyses, which exploit new datasets and better methodologies than do older studies, these two trends are closely related.[4]

Some have argued that the Bennett Hypothesis does not explain why college prices have skyrocketed in recent decades, pointing instead to a reduction in state higher education appropriations as the reason for rising costs for students. This argument assumes that universities have raised their tuition prices to make up for lost state funds.

1. William J. Bennett, "Our Greedy Colleges," *The New York Times*, February 18, 1987, http://www.nytimes.com/1987/02/18/opinion/our-greedy-colleges.html (accessed March 2, 2017).
2. David O. Lucca, Taylor Nadauld, and Karen Shen, "Credit Supply and the Rise of College Tuition: Evidence from Expansion in Federal Student Aid Programs," Federal Reserve Bank of New York *Staff Report* No. 733, July 2015, revised October 2016, p. 3.
3. Ibid., p. 21.
4. Mark J. Warshawsky and Ross Marchand, "Dysfunctions in the Federal Financing of Higher Education," Mercatus Center at George Mason University, January 2017, p. 42, https://www.mercatus.org/system/files/mercatus-warshawsky-financing-higher-education-v1.pdf (accessed March 9, 2017).

Yet the evidence that state disinvestment has led to increases in college tuition prices is weak. The authors of the New York Federal Reserve study, for example, controlled for changes in state budgets, yet still found overwhelming evidence to support the Bennett Hypothesis. Additionally, the Cato Institute's Neal McCluskey found that the argument that state disinvestment has led to tuition increases does not hold up when one considers that private universities, which receive little state and local funding, also have seen dramatic price increases. McCluskey further found that the impact of cuts in higher education at the state and local levels are often exaggerated:

> In the aggregate, state and local support for higher education has risen over the last 25 years, and "cuts" mainly appear on a per pupil basis because enrollment has increased significantly. Even then, for the average state only around 57 percent of annual increases in per pupil tuition and fee revenue covered per student drops in state and local appropriations—a far cry from the notion that colleges have had to raise prices just to keep their heads above water.[5]

Federal Lending Crowds Out the Private Market

For decades, federal lending has slowly been crowding out the private lending market. When President Obama took office in 2008, his expansion of the federal government's lending practices made federal loans virtually the only option for students. During the 2015–2016 academic year, students and their parents borrowed more than $95 billion from the federal government, including more than $59 billion in loans to undergraduate students and their parents (up from $31 billion in 2000–2001) and more than $35.5 billion in loans to graduate students (up from $14 billion in 2000–2001).[6] The federal government currently originates and distributes roughly 90 percent of all student loans,[7] making private lending (which accounts for roughly $11 billion in loan volume) a secondary consideration.

A near-monopoly federal lending market can have many negative effects on students, taxpayers, and the economy. More federal aid encourages colleges and universities to raise tuition. Additionally, when the federal government provides subsidized student loans without considering creditworthiness, and when Congress sets interest rates for federal student loans rather than allowing them to be determined by the market, policymakers hide the true cost of the investment from education consumers.

In a private market, students can see interest rates that reflect certain choices they have made, as well as certain personal characteristics,[8] such as credit history and choice of university, and make a more informed risk assessment based on those numbers. It is possible that interest rates set without such proper risk assessment are partially to blame for the large number of students taking on debt for degrees with limited utility in the market, in turn making repayment more difficult after graduation. This important screening measure—used elsewhere in the lending market—is particularly important because taxpayers bear the responsibility for a student's inability to repay.

This government monopoly on student loans also puts taxpayers on the hook for borrower defaults and increasingly generous loan forgiveness policies. *The Wall Street Journal*, for instance, recently reported that the average three-year repayment rate for undergraduate borrowers is much lower than expected at only 46 percent.[9] This means that most undergraduate borrowers are not paying down their debt at all, exposing taxpayers to some $200

5. Neal McCluskey, "Not Just Treading Water: In Higher Education, Tuition Often Does More than Replace Lost Appropriations," Cato Institute *Policy Analysis* No. 810, February 15, 2017, p. 1, https://object.cato.org/sites/cato.org/files/pubs/pdf/pa-810.pdf (accessed March 9, 2017).
6. College Board, *Trends in Student Aid 2016*, Trends in Higher Education Series, October 2016, pp. 9, 17, https://trends.collegeboard.org/sites/default/files/2016-trends-student-aid.pdf (accessed March 9, 2017).
7. Lucca, Nadauld, and Shen, "Credit Supply and the Rise of College Tuition," p. 1.
8. Andrew P. Kelly and Kevin J. James, "Looking Backward or Looking Forward? Exploring the Private Student Loan Market," American Enterprise Institute, Center on Education Reform, June 2016, p. 11, https://www.aei.org/publication/looking-backward-or-looking-forward-exploring-the-private-student-loan-market/ (accessed March 9, 2017)
9. "Obama's Student-Loan Fiasco," *The Wall Street Journal*, January 22, 2017, https://www.wsj.com/articles/obamas-student-loan-fiasco-1485126310 (March 2, 2017).

billion in outstanding loan debt.[10] It is past time for policymakers to consider whether the federal government's large share of the student loan market is doing more harm than good.

Advantages of Private Lending

Both students and taxpayers would be better served by a restoration of the private lending market, for several reasons. Primarily, taxpayers would be relieved of much of the financial burden currently placed on them by student loan defaults, delayed payments, and loan forgiveness policies.

The U.S. Government Accountability Office recently reported that American taxpayers will forgive $108 billion over the next 10 years due to these policies.[11] Additionally, the U.S. Department of Education released a statement shortly before President Obama left office revealing that the federal college scorecard, which ranks universities on a range of metrics, massively underreported student loan repayment rates.[12] *The Wall Street Journal* has reported that "the new average three-year repayment rate has declined 20 percentage points to 46%.... It means that fewer than half of undergraduate borrowers at the average college are paying down their debt."[13]

These figures do not bode well for American taxpayers and should catalyze reform efforts.

Policymakers should work to restore a truly private market. The federal government should not reinstate its practice of subsidizing private lenders, nor should the government itself be the primary lender. Students should be empowered to finance their higher education through diverse lending options in a robust market of private lenders, with federal involvement remaining as a supplementary option for students who require further assistance.

This restoration would also benefit students. A private lender could consider a student's creditworthiness, field of study, academic history, and institution of choice when considering the terms of a loan, likely encouraging students to consider whether or not it is wise to pursue degrees that may not prepare them for careers or to pursue their life goals.

In a June 2016 report published by the American Enterprise Institute, Andrew Kelly and Kevin James discuss how private lenders can examine both "backward-looking" and "forward-looking" measures when reviewing an applicant. They note that "a growing number of newer lenders...are using a wider array of forward-looking criteria such as institutional quality and the likely return on investment of the student's program of study" and conclude that "a private finance market built around a broader set of underwriting criteria has the potential to expand opportunity while strengthening market discipline in the sector."[14]

With respect to low-income students specifically, a small set of private lenders are exercising forward-looking measures that enable these students to receive a loan based on future earning potential. As Kelly and James note, however, current federal policies such as the generous lending practices of the PLUS loan program or restrictions under fair-lending laws prevent such practices from growing in the market.[15] Limiting federal lending could allow more private lenders into the market, enabling them to employ these forward-looking practices and serve the needs of students of *all* economic backgrounds.

What Should Be Done

To make space for private lending, provide relief to taxpayers, and lower costs for students, federal policymakers should:

- **Eliminate the PLUS loan program.** Policymakers should eliminate both the Parent Loan for Undergraduate Students (PLUS) and Graduate

10. Josh Mitchell, "More than 40% of Borrowers Aren't Making Payments," *The Wall Street Journal*, April 7, 2016, https://www.wsj.com/articles/more-than-40-of-student-borrowers-arent-making-payments-1459971348 (accessed March 2, 2017).
11. U.S. Government Accountability Office, *Federal Student Loans: Education Needs to Improve Its Income-Driven Repayment Plan Budget Estimates*, GAO-17-22, November 2016, p. 51, http://www.gao.gov/assets/690/681064.pdf (accessed March 16, 2017).
12. Lynn Mahaffie, "Updated Data for College Scorecard and Financial Aid Shopping Sheet," U.S. Department of Education, Office of Federal Student Aid, January 13, 2017, https://ifap.ed.gov/eannouncements/011317UpdatedDataForCollegeScorecardFinaidShopSheet.html (accessed March 16, 2017).
13. "Obama's Student-Loan Fiasco."
14. Kelly and James, "Looking Backward or Looking Forward?," pp. i and 18.
15. See, for example, ibid., p. 5.

PLUS (Grad PLUS) programs. PLUS loans, now offered to both graduate students and parents of undergraduate students, allow borrowing up to the full price of attendance. This encourages families to take on excess debt to send their children to college and enables graduate students to pursue fields they otherwise might not have chosen absent the federal loan. Additionally, PLUS loans appear to be one of the most egregious drivers of tuition increases and tend to create the largest debt burden for borrowers.

According to UCLA economists Mahyar Kargar and William Mann, colleges that were subject to changes that limited eligibility for the PLUS loan program experienced a net drop in tuition. Colleges that were deemed "high exposure" universities, meaning those that were significantly affected by the policy change, saw a net tuition reduction of $487 and a published tuition reduction of $1,372.[16] This finding further supports the Bennett Hypothesis: Unfettered access to federal aid increases tuition prices.

The Grad PLUS loan program, with its high borrowing cap, adds significantly to this problem. Although graduate loans represent just 15 percent of loans, they make up more than one-third of total loan volume.[17] The federal government should not encourage students to borrow such substantial amounts of money through overly generous programs that place virtually no limit on borrowing. Discontinuation of the PLUS loan program would enable private lenders to compete with federal lenders and offer more transparency to students regarding their financial future.

- **Restructure existing loan programs into a one-loan system.** The federal government should consolidate all federal loan programs into a single loan option with an interest rate that better reflects market value. Additionally, policymakers should place an annual and lifetime cap on the single federal student loan to prevent excessive borrowing and hedge against further inflation of college prices. To inform policymaking in the future, it would be wise to set the annual cap at the current borrowing average. When coupled with a lifetime borrowing cap that would limit the amount that can be borrowed from the federal government for all higher education expenses including graduate school, these reforms would help to rein in price inflation while reducing student loan defaults.

- **Use fair value accounting to measure impact on taxpayers.** The federal government's outdated accounting methods mask the true cost of federal student loan programs.[18] Current practices fail to account for market risk and therefore underestimate the true cost of federal student loans to taxpayers. Fair value accounting, by contrast, has been accepted by most economists and the Congressional Budget Office as a more accurate measure of cost. By using fair value accounting, policymakers could make more informed decisions about federal student loan programs.

Conclusion

The federal government's expansive role in student lending has inserted perverse incentives into the marketplace. Students are encouraged to take on large amounts of debt regardless of which institution they attend or their chosen field of study, and the evidence suggests that such practices encourage colleges and universities to raise their tuition prices.

Restoration of the private lending market could put downward pressure on the increasing price of tuition as universities would no longer consider the availability of federal financing to be guaranteed. Private lending that considers a student's ability to repay before granting a loan encourages students to make wise financial and academic decisions as they

16. Mahyar Kargar and William Mann, "Market Power and Incidence in Higher Education," SSRN, January 17, 2017, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2814842 (accessed March 9, 2017).

17. CBO's January 2017 Baseline Projections for the Student Loan Program (January 25, 2017) Table 2, https://www.cbo.gov/sites/default/files/recurringdata/51310-2017-01-studentloan.pdf (accessed April 26, 2017).

18. Lindsey Burke, "Any Loan Proposal Must Incorporate Fair Value Accounting," Texas Public Policy Foundation, SeeThruEdu, May 31, 2013, http://www.seethruedu.com/updatesany-loan-proposal-must-incorporate-fair-value-accounting/ (accessed March 9, 2017).

consider how to pay for their education. Elimination of the PLUS loan program, along with other needed reforms, would be an important first step in clearing the way for restoration of the private lending market.

*—**Mary Clare Reim** is a Policy Analyst in the Center for Education Policy, of the Institute for Family, Community, and Opportunity, at The Heritage Foundation.*