Unconstrained by Reality

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A few weeks ago, the House of Representatives' Committee on Education and Labor approved the Student Aid and Fiscal Responsibility Act (SAFRA). It would end subsidies (and insurance for 97 percent of default losses) for private lenders to make student loans under terms and conditions set by Congress. Instead, all federal student loans would be made through an existing program where the government issues all student loans under terms and conditions set by Congress. Students get the same loans* either way, and the government frees up money for grant aid and reform projects because it no longer has to pay subsidies to lenders and lowers its risk of illicit activity.

That sounds like a great deal, but Cato's Neal McCluskey, who has an op-ed in *Forbes* claiming that "SAFRA stinks," is not sold on the bill. His main complaint? The legislation "would destroy what little chance there was of student loans being constrained at all by economic realities."

McCluskey's "economic realities" aren't entirely clear, though he does repeat the phrase twice for emphasis. A best guess is that he means too many unprepared students are enrolling in postsecondary education, aided by available federal student loans.

Yes, students can get loans without checking their credit or their grade point average, but that's the same regardless of which program a students uses to borrow. And the maximum amount they can take out is capped by Congress, not private lenders. Lenders could theoretically deny applications for students who they think may not graduate, but their lack of default risk on a loan means that it rarely happens. And guess what? Even if a student gets denied a loan from a regular lender, there's a non-federal entity called a guaranty agency that will give them one anyway (though, this does not always work out so well for taxpayers).

The simple fact is, the loan programs are designed to be access tools, not to measure success or preparation. Whether that should be the case could certainly be debated, but the lender a student uses is irrelevant to this question.

What if McCluskey's economic realities refers to having the federal government take on all this loan volume at a time of increased government spending and concerns about the debt? That too makes little sense. Student loans in the budget are estimated on a net present value basis—which makes sense sine some or all of the money loaned out today will be repaid in the future, with interest. This means that the actual cost of a loan is less than the value of the money given to a borrower today. (The actual cost to the government is budgeted as negative, but that is a fallacy addressed here.) Regardless of cost estimates, the government still pays for the vast majority of a defaulted loan, regardless of which program it came from.

But McCluskey quickly moves beyond economic realities to an odder point unconstrained by higher education realities. He argues that having the government make all federal loans would likely spell the end of alternative, or private student loans that companies issue without a federal guarantee. Exactly how or why this would occur isn't clear, as these loans carry interest rates that can easily exceed 12 percent—much larger than the special allowance payment given to lenders of commercial paper plus 1.79 percentage points. They also can't be discharged in bankruptcy, giving them a level of protection better than any other consumer debt. And if all these students are borrowing loans that they should not take out, surely many of them are also exceeding the federal limits and turning to the private market.

To his credit, the latter part of the op-ed does bring up some reasonable critiques of the bill regarding its funding priorities and the lack of accountability in some programs. (The exception is the claim that the maximum Pell Grant award is a tuition floor—many institutions, especially community colleges, charge significantly less than the $5,350 award.) These are questions that are worthwhile and should be debated (perhaps even here in a later post). It's just too bad that they get buried

under a deluge of arguments unconstrained by reality.

*The deal for borrowers is actually slightly better if they take out loans made by the government because they have access to an income-based repayment plan. The interest rate on PLUS loans for parents and graduate students is also 0.5 percentage points lower than in the bank-based program.

Posted by Ben Miller at 7:00 pm | Tags: CATO, Neal McCluskey, private loans, Student Aid and Fiscal Responsibility Act, Student Loans | No Comments
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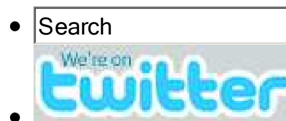
- 

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