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Student loan scam: why are today's poor subsidizing tomorrow's rich?

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THE INTEREST RATE for the main federal student loan program was set to double on July 1, from 3.4 percent to 6.8 percent. Even in this contentious election year, there was one thing everyone in Washington could agree on: The rate hike should be avoided at all costs. The only disagreement was where to extract the $6 billion annually that would be needed to make up the difference.

But extending the lower rate, which was instituted by the College Cost Reduction and Access Act of 2007, is foolhardy. By keeping student loan rates artificially low, the federal government is contributing to the rapid increase in college tuition and forcing today's workers to subsidize the educational choices of tomorrow's big earners.

According to the latest data available from the U.S. Department of Education's National Center for Education Statistics, 39 percent of all undergraduates at four-year colleges had student loans in 2007-08. For full-time undergraduates the number was 53 percent. The overwhelming majority--93 percent--of these loans are subsidized by the federal government. And even the 6.8 percent rate that Democrats and Republicans were determined to avoid would still represent a significant subsidy; the rate on similar loans that students obtain in the private market is about 12 percent.

There are many other ways to help pay for a college education: You can work through college, choose to attend a cheaper state school, or take time off to earn money before or during school. So the decision to take on student debt is a personal choice, and the reward from getting a college degree is also personal. People making this choice have a responsibility to understand the costs and risks.

While aggregate student debt has reached $829 billion, which is higher than the country's collective credit card debt, the burden faced by individual students coming out of college is relatively small. According to the Department of Education, the typical college graduate who borrows money for attendance ends up owing about $22,000. The standard repayment period is 10 years, but terms can be renegotiated if needed, especially by people who choose to go into public service or teaching. According to the repayment calculator at Mapping Your Future, an online resource sponsored by student loan guaranty agencies, it would cost $253 a month over 10 years to repay $22,000 in principal at a rate of 6.8 percent.

Everyone wants to borrow money at the lowest rate possible. But it is important to keep in mind that today's student loan recipients are tomorrow's big earners. Using the most recent data from the Bureau of Labor Statistics (BLS), the editors of the economics policy website e21 compared the earnings of the most successful college graduates with those of the most successful high school graduates. A worker in the top 10 percent of bachelor's degree holders earns an average of $2,310 a week. That's 1.8 times as much as the $1,316 earned by the average worker in the top 10 percent of high school degree holders.

The gap between typical workers in those education categories is even more significant. BLS data show that the weekly earnings of the median worker with a bachelor's degree is $1,051, compared to $450 for the median high school graduate.

That means federal student loans force lower-income taxpayers to subsidize the education of future U.S. elites. Why should a grocery store clerk pay taxes to help the store's owner send his kids to a selective out-of-state school?

This burden is not trivial. As e21 noted, "since 2008 the Federal Government has effectively socialized the student loan market by enacting laws to eliminate private lender participation in administering Federal loans." As a result, e21 notes, the amount of outstanding student loans owned by the federal government has grown from $III billion at the end of 2008 to $425 billion in 2011, a compound annualized growth rate of 56 percent.

Unfortunately, taxpayers probably will have to pay a significant share of those outstanding loans. In a September 12, 2011, press release, Secretary of Education Arne Duncan announced that the share of federal student loan borrowers who default within the first two years of repayment is 8.8 percent. The overall default rate for those receiving a federal student loan is 23 percent. That's huge. To put this number in perspective, at the peak of the housing crisis in May 2009, first-mortgage default rates reached 5.7 percent; the default rate for second mortgages reached its high-water mark two months earlier at 4.7 percent.

There is another reason to look twice at the massive subsidies for education loans. As it did in the housing market, free or reduced-priced money has artificially inflated the price of a college education.

Federal student aid, whether in the form of grants or loans, is the main factor behind the runaway cost of higher education. As **Cato Institute** economist Neal McCluskey explained in an April 2012 article for U.S. World & News Report: "The basic problem is simple: Give everyone $100 to pay for higher education and colleges will raise their prices by $100, negating the value of the aid. And inflation-adjusted aid--most of it federal--has certainly gone up, ballooning from $4,602per undergraduate in 1990-91 to $12,455 in 2010-11."

Thus begins a classic upward price spiral caused by government intervention: Subsidies raise prices, leading to higher subsidies, which raise prices even more. Yet this higher education bubble, like the housing bubble before it, will eventually pop. Meanwhile, large numbers of students will graduate with more debt than they would have in an unsubsidized market. More important, taxpayers face two equally bad outcomes: They are subsidizing millions of dollars in interest for student loans that they shouldn't have to shoulder, and they likely will pick up the tab for underpaid student loans.

Given that President Barack Obama and his presumptive opponent, Mitt Romney, agree that the student loan rate should not rise, it is unlikely that Congress will let the rate float back up. But the whole enterprise of federally subsidized college loans is dysfunctional and should be ended. American taxpayers--especially today's working poor--should not have to subsidize tomorrow's big earners while pricing themselves out of a better education.

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