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Subsidized loans drive college tuition, student debt to record levels

By: Veronique de Rugy – July 11, 2013

A proposal to restore the lower interest rate of 3.4 percent on student loans from its recently increased 6.8 percent for another year failed in the Senate on Wednesday. The common response to this vote is that it is a tragedy. It isn't.

First, even the 6.8 percent rate, students are still benefiting from a significant subsidy; the rate on similar loans that students obtain in the private market is about 12 percent.

Second, extending the lower rate would be reckless since it would continue to artificially inflate the student loan bubble. Data from the Federal Reserve Bank of New York shows that over the past decade, student loan debt has increased by 281 percent, from about $260 billion in the first quarter of 2004 to $990 billion in the first quarter of 2013 and is now higher than the country's collective credit card debt. In the past year alone, student loans debt has increased by $20 billion.

In addition, by keeping student loan rates artificially low, the federal government is contributing to the rapid increase in college tuition. 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 $4,602 per 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, will eventually pop. Meanwhile, large numbers of students will graduate with more debt than they would have in an unsubsidized market.

What's the harm in that? First, in the current slow economic growth environment, many recently and expensively graduated students have a hard time finding a job but they still have to repay their loans. As a result, the overall default rate for those receiving a federal student loan is 23 percent.

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.

Also, according to researchers at the New York Fed, another way that the surge in student-loan debt has been turning investment in education for many borrowers from a good investment to a bad one. The rise in student debt followed by a surge in default has damaged the credit scores of student borrowers relative to non-borrowers, a stigma that may pursue them for a while.

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. In fact, according the Congressional Budget Office (CBO), the losses shouldered by taxpayers due to student loans will amount to $95 billion over the next ten years.

Unfortunately, the Senate continues to refute to take up a measure that passed the House that would link interest rates to the financial markets. The bill, which incorporated one of the president's FY2014 budget suggestions, would protect taxpayers from having to guarantee low rates for students at a time when the CBO expects some sort of upward movement in the rates, and hence borrowing costs, faced by the federal government.

It would also provide an important price signal to potential students at the time when they decide whether to go to college or not and whether to borrow and how much to borrow.