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Federal Student Aid and the Law of Unintended Consequences

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The following is adapted from a speech delivered on May 10, 2012, at Hillsdale College's Allan P. Kirby, Jr. Center for Constitutional Studies and Citizenship, in Washington, D.C.

Federal student financial assistance programs are costly, inefficient, byzantine, and fail to serve their desired objectives. In a word, they are dysfunctional, among the worst of many bad federal programs.

These programs are commonly rationalized on three grounds: on the grounds that assuring more young people a higher education has positive spillover effects for the country; on the grounds that higher education promotes equal economic opportunity (or, as the politicians say, that it is "a ticket to achieving the American Dream"); or on the grounds that too few students would go to college in the absence of federal loan programs, since private markets for loans to college students are defective.

All three of these arguments are dubious at best. The alleged positive spillover effects of sending more and more Americans to college are very difficult to measure. And as the late Milton Friedman suggested to me shortly before his death, they may be more than offset by *negative* spillover effects. Consider, for instance, the relationship between spending by state governments on higher education and their rate of economic growth. Controlling for other factors important in growth determination, the relationship between education spending and economic growth is negative or, at best, non-existent.

What about higher education being a vehicle for equal economic opportunity or income equality? Over the last four decades, a period in which the proportion of adults with four-year college degrees tripled, income equality has *declined*. (As a side note, I do not know the socially optimal level of economic inequality, and the tacit assumption that more such equality is always desirable is suspect; my point here is simply that, in reality, higher education today does not promote income equality.)

Finally, in regards to the argument that capital markets for student loans are defective, if financial institutions can lend to college students on credit cards and make car loans to college students in large numbers—which they do—there is no reason why they can't also make student educational loans.

Despite the fact that the rationales for federal student financial assistance programs are very weak, these programs are growing rapidly. The Pell Grant program did much more than double in size between 2007 and 2010. Although it was designed to help poor people, it is now becoming a middle class entitlement. Student loans have been growing eight to ten percent a year for at least two decades, and, as is well publicized, now aggregate to one trillion dollars of debt outstanding—roughly $25,000 on average for the 40,000,000 holders of the debt. Astoundingly, student loan debt now exceeds credit card debt.

Nor is it correct to assume that most of this debt is held by young people in their twenties and early thirties. The median age of those with loan obligations today is around 33, and approximately 40 percent of the debt is held by people 40 years of age or older. So when politicians talk about maintaining low interest loans to help kids in college, more often than not the help is going to middle-aged individuals long gone from the halls of academia.

With this as an introduction, let me outline eight problems with federal student grant and loan programs. The list is not exclusive.

(1) Student loan interest rates are not set by the forces of supply and demand, but by the political process. Normally, interest rates are a price used to allocate scarce resources; but when that price is manipulated by politicians, it leads to distortions in the use of resources. Since student loan interest rates are always set at below-market rates, too much money is borrowed for college. Currently those interest rates are extremely low, with a key rate of 3.4 percent—which, after adjusting for inflation, is approximately zero. Moreover, both the president and Governor Romney say they want to continue

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that low interest rate after July 1, when it is supposed to double. This aggravates an already bad situation, and provides a perfect example of the fundamental problem facing our nation today: politicians pushing programs whose benefits are visible and immediate (even if illusory, as suggested above), while their extraordinarily high costs are less visible and more distant in time.

(2) In the real world, interest rates vary with the prospects that the borrower will repay the loan. In the surreal world of student loans, the brilliant student completing an electrical engineering degree at M.I.T. pays the same interest rate as the student majoring in ethnic studies at a state university who has a GPA below 2.0. The former student will almost certainly graduate and get a job paying $50,000 a year or more, whereas the odds are high the latter student will fail to graduate and will be lucky to make $30,000 a year.

Related to this problem, colleges themselves have no "skin in the game." They are responsible for allowing loan commitments to occur, but they face no penalties or negative consequences when defaults are extremely high, imposing costs on taxpayers.

(3) Perhaps most importantly, federal student grant and loan programs have contributed to the tuition price explosion. When third parties pay a large part of the bill, at least temporarily, the customer's demand for the service rises and he is not as sensitive to price as he would be if he were paying himself. Colleges and

universities take advantage of that and raise their prices to capture the funds that ostensibly are designed to help students. This is what happened previously in health care, and is what is currently happening in higher education.

(4) The federal government now has a monopoly in providing student loans. Until recently, at least it farmed out the servicing of loans to a variety of private financial service firms, adding an element of competition in terms of quality of service, if not price. But the Obama administration, with its strong hostility to private enterprise, moved to establish a complete monopoly. One would think the example of the U.S. Postal Service today, losing taxpayer money hand over fist and incapable of making even the most obviously needed reforms, would be enough proof against the prudence of such a move. And remember: because of highly irresponsible fiscal policies, the federal government borrows 30 or 40 percent of the money it currently spends, much of that from overseas. Thus we are incurring long-term obligations to foreigners to finance loans to largely middle class Americans to go to college. This is not an appropriate use of public funds at a time of dangerously high federal budget deficits.

(5) Those applying for student loans or Pell Grants are compelled to complete the FAFSA form, which is extremely complex, involves more than 100 questions, and is used by colleges to administer scholarships (or, more accurately, tuition discounts). Thus colleges are given all sorts of highly personal and private information on incomes, wealth, debts, child support, and so forth. A car dealer who demanded such information so that he could see how badly he could gouge you would either be out of business or in jail within days or weeks. But it is commonplace in

higher education because of federal student financial assistance programs.

(6) As federal programs have increased the number of students who enroll in college, the number of new college graduates now far exceeds the number of new managerial, technical and professional jobs—positions that college graduates have traditionally taken. A survey by Northeastern University estimates that 54 percent of recent college graduates are underemployed or unemployed. Thus we currently have 107,000 janitors and 16,000 parking lot attendants with bachelor's degrees, not to mention bartenders, hair dressers, mail carriers, and so on. And many of those in these limited-income occupations are struggling to pay off student loan obligations.

Connected to this is the fact that more and more kids are going to college who lack the cognitive skills, the discipline, the academic preparation, or the ambition to succeed academically. They simply cannot or do not master well much of the rather complex materials that college students are expected to learn. As a result, many students either do not graduate or fail to graduate on time. I have estimated that only 40 percent or less of Pell Grant recipients get degrees within six years—an extremely high dropout or failure rate. No one has seriously questioned that statistic—a number, by the way, that the federal government does not publish, no doubt because it is embarrassingly low.

Also related is the fact that, in an attempt to minimize this problem, colleges have lowered standards, expecting students to read and write less while giving higher grades for lesser amounts of work. Surveys show that students spend on average less than 30 hours per week on academic work—less than they spend on recreation. As Richard Arum and Josipa Roksa show in their book *Academically Adrift: Limited Learning on College Campuses*, critical thinking skills among college seniors on average are little more than among freshmen.

(7) As suggested to me a couple of days ago by a North Carolina judge, based on a case in his courtroom, with so many funds so readily available there is a temptation and opportunity for persons to acquire low interest student loans with the intention of dropping out of school quickly to use the proceeds for other purposes. (In the North Carolina student loan fraud case, it was to start up a t-shirt business.)

(8) Lazy or mediocre students can get greater subsidies than hard-working and industrious ones. Take Pell Grants. A student who works extra hard and graduates with top grades after three years will receive only half as much money as a student who flunks several courses and takes six years to finish or doesn't obtain a degree at all. In other words, for recipients of federal aid there are disincentives to excel.

* * *

If the Law of Unintended Consequences ever applied, it is in federal student financial assistance. Programs created with the noblest of intentions have failed to serve either their customers or the nation well. In the 1950s and 1960s, before these programs were large, American higher education enjoyed a Golden Age. Enrollments were rising, lower-income student access was growing, and American leadership in higher education was becoming well established. In other words, the system flourished without these programs. Subsequently, massive growth in federal spending and involvement in higher education has proved counterproductive.

With the ratio of debt to GDP rising nationally, and the federal government continuing to spend more and more taxpayer money on higher education at an unsustainable long-term pace, a re-thinking of federal student financial aid policies is a good place to start in meeting America's economic crisis. ■

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