Why on Earth Do We Have a "Student Loan Crisis"?

BY GEORGE C. LEEF

Amid all our other crises, you may have missed the student loan crisis. It isn't nearly so life-threatening as global warming, nor as financially alarming as the subprime-mortgage collapse, but it does have a lot of politicians clamoring that the country needs them to prevent serious harm. That's because—for reasons I'll get to soon—many of the firms that lend American college students money are struggling. Long-faced politicians are gravely concerned that unless they do something fast, some students won't be able to borrow for the academic year.

What is going on? Student loans for college are largely a creature of federal intervention. Decades ago, politicians decided that it would be good to have more people go to college, and they created a system of grants and subsidized loans to make that possible. As we have (or should have) learned from the great economist Ludwig von Mises, government intervention nearly always has unanticipated consequences that create the apparent need for still more intervention. That is exactly what we see when it comes to higher education and its financing.

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Federal Intervention in Higher Education

Before World War II the federal government had virtually nothing to do with higher education. It had no regulations that colleges and universities had to obey and it paid for no one's college attendance. Occasionally, it commissioned some scientific research from professors, but otherwise it played no role. Only a small percentage of the population pursued college studies; most people didn't think it was worth the cost.

Things changed with the passage of the GI Bill in 1944, since that law provided, among other things, that returning soldiers would be eligible for federal grants if they enrolled in college. Many took advantage of that subsidy, and the government's interventionist course was set. Almost immediately, the heads of colleges realized that this new revenue source could be tapped endlessly. Expand the student body and rake in the dollars! What had been a quiet backwater of American society would become a sizzling growth industry.

During the "Great Society" presidency of Lyndon Johnson, government intervention took several giant steps into student finance. After all, if going to college was good for those who had served in the armed forces, why not help make this good generally available? So Congress passed and LBJ signed the Higher Education Act of 1965, which established several grant and loan programs to make it easier for students to go to college. In particular, the Act created what is now called the Stafford Loan program. Stafford loans are made by private institutions. The government sets the interest rate at a level that is supposed to keep higher education "affordable"—currently 6.8 percent. And to make these fairly risky loans interesting to lenders, the government guarantees repayment. Until recently, lenders could recover 97 cents on the dollar on defaulted loans, but in

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2007 Congress cut that to only 95 cents. (More on that later.)

With subsidies now flowing for a wide swath of the college-age population, expansion really took off. Before World War II, only 10 percent of high-school graduates enrolled in some sort of higher education. By the 1990s that figure was 70 percent. Americans were getting hooked on higher education and the idea that without a college degree a person would be hopelessly mired at the bottom of the labor market. It didn't particularly matter *what* one studied or how diligently. Simply having a college degree was assumed to guarantee at least a good middle-class job.

Credential Inflation

The college mania was also fed by employers. First, with an ever-growing pool of people with college degrees to choose from, many firms adopted personnel policies that made the possession of a college degree a requirement for applicants—even for jobs that could easily be learned by anyone with a decent high school education. As James Engell and Anthony Dangerfield write in their book *Saving Higher Education in the Age of Money*, "Another reason students and parents choose as they do is that the United States has become the most rigidly credentialized society in the world. A B.A. is required for jobs that by no stretch of the imagination need two years of full-time training, let alone four."

Presumably, college graduates are somewhat more reliable and easily trained than people with only high-school diplomas, so if there is a large enough number of applicants with college degrees, employers don't have to bother with people who don't have them.

The second reason for credential inflation is that in 1971 the U.S. Supreme Court issued a ruling (*Griggs v. Duke Power*) saying that if companies use aptitude testing to screen potential employees, they must be prepared to show that their tests are precisely calibrated to the needs of the job. Otherwise, they will be guilty of employment discrimination if their tests screen out minority workers who might have been able to do the work. Rather than face discrimination suits by the federal government, most employers started using a less precise but legally safe method of screening applicants—college degrees.

So thanks to the "generosity" of Congress and the Supreme Court's willingness to unleash the demon of litigation, college degrees became more and more sought after. Politicians could not resist the urge to buy votes from families with college students (and children who might be heading for college) by increasing the size of federal grants and loans so as to make college "more affordable." Not surprisingly, college administrators realized that when the subsidies went up, they could charge more in tuition. After a few years of tuition increases, politicians would proclaim that subsidies had to be raised to keep college "affordable" and to "increase access" for students. The subsidy dog was chasing its tuition tail. Our already bloated higher-education sector just kept happily growing, ingesting ever-increasing amounts of borrowed money.

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A volcano erupted in 2007 that sent shockwaves through the student-lending industry. New York's attorney general, Andrew Cuomo, who was investigating allegations of corruption in the industry, said he had uncovered a mass of favoritism and underhanded dealing. For example, many of the lenders had established cozy relationships with college officials; the lenders bribed them to refer students to the lenders for financial aid. Some top financial-aid officials at major universities had profited through their stock ownership in firms they put on their schools' "preferred lender" list. Those practices were nothing new, but previously the lenders had managed to protect their sheltered high-profit business through their political influence.

Writing in April 2008, Peter Wood, executive director of the National Association of Scholars, summed up the situation: "The 'free market' in this case was never anything close to lean and efficient. To the contrary, it was (and still is) inefficient and frequently corrupt, dominated by players who found it easy to bribe college officials, wring favors from politicians by means of campaign contributions, bilk the Department of Education, and live off generous subsidies."

Cuomo's revelations brought swift political retribution from the Democrats who had taken control of Congress following the 2006 elections. Capitalizing on the bad odor in which the student lenders had put themselves, Congress passed the College Cost Reduction and Access Act of 2007. The bill, which President Bush signed in September 2007, was intended to score political points with angry voters by cutting the lenders' subsidies. No longer would the government cover defaults at 97 cents on the dollar; the new law reduced that to only 95 cents. (Defaults were as high as 20 percent in the early 1990s, but currently are around 5 percent.) Among other provisions, the loan-origination fees lenders pay the government were doubled, and the allowable interest rate on federally backed loans was cut from 6.8 percent to 3.4 percent. In one fell swoop, the bad lenders were spanked and college was made more affordable for students.

Remember, though, what Mises said about intervention—always expect some unexpected reactions. That's what happened in the student-lending industry.

A Fateful Coincidence

The developments in the student-lending industry happened to coincide with the cataclysm in the subprime-mortgage business. (There are strong similarities between the two. In both, government policy was responsible for the overexpansion of an industry that became dependent on cheap credit.) When the financial markets suddenly became leery of packages of mortgage loans that looked bad, causing some of the big mortgage lenders to take huge losses, the markets also became leery of packages of student loans. Big lenders that had counted on selling bonds backed by student loans found investors giving them the cold shoulder. Also, quite a few announced that they were exiting the student-loan business because Congress has taken the profit out of it.

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Therefore, last spring the "student loan crisis" appeared—at least in the minds of politicians. Talk that some students might be unable to obtain loans was enough to cause another flurry of action. Bills named the Ensuring Continued Access to Student Loans Act were introduced in both the House and Senate in April with overwhelming bipartisan support and passed as rapidly as possible. President Bush signed the legislation on May 7 to the applause of Democrats and Republicans alike. This Christmas-tree bill does a lot of costly things to shore up the student-loan industry and further subsidize students who go to college. Most important, it authorizes the Department of Education to bail out the student lenders by buying up the portfolios of loans they couldn't sell in the market. Other provisions expand student eligibility for "need-based" aid, allows parents who have taken out federally guaranteed, low-interest PLUS loans to defer payment until six months after their children graduate, and increase the amount of direct student lending the federal government does.

In other words, the politicians used the "crisis" they created as an excuse to throw still more taxpayer money into the black hole of college subsidies.

Is there any alternative? Most people are so accustomed to thinking that government is *the* solution to every problem that they can't imagine anything else. There is at least one college—Hillsdale—that runs a successful student-aid program without taking a single dollar of government money. If the government had never blundered into the student-lending business, no doubt there would be much more reliance on market mechanisms than we now have. Freedom works when people bother to try it.

Intervention in the free market always leads to problems, and politicians invariably try to solve those problems by ratcheting up the degree of intervention. Here we have a perfect illustration. As the result of the College Cost Reduction and Access Act and the

Ensuring Continued Access to Student Loans Act, the federal government is more deeply involved than ever in the business of college subsidies. The foolish notion that the government needs to help as many people as possible get college degrees has gotten another boost. Taxpayers will be shorn of more of their money so that no student who feels like getting a degree is left behind.

Most people now see college as an entitlement to be provided largely at "public" expense. It shouldn't be. If we hadn't made the blunder of getting government involved in college education, it would today cost much less and deliver more value. That's because it would be subject to the test of the market. Instead, it's like an overweight gorilla that has been stuffing itself on taxpayer dollars for many years. FEE