WebMemo

Published by The Heritage Foundation

No. 2615
September 16, 2009

Student Lending and College Affordability: Alternative Approaches to Reform

by Dan Lips

The U.S. House of Representatives will soon consider H.R. 3221, the "Student Aid and Fiscal Responsibility Act of 2009," legislation that will terminate the Federal Family Education Loan (FFEL) program, expand the Federal Direct Loan program, and increase spending on other post-secondary education programs.[1] If enacted, the legislation will mark a dramatic shift in the federal government's approach to student lending and result in a consolidation of federal power over education financing.

In addition, the legislation proposes to use potential cost savings achieved by these lending reforms to further increase federal subsidies for higher education grants and other spending programs. These spending increases are ostensibly intended to help address the problem of college affordability and access. Unfortunately, past experience suggests that simply increasing government subsidies for student aid and higher education will not solve the issue of college affordability. Policymakers should instead address the real problem: continuously rising college costs.

An Alternative Approach for Student Lending Reform. The primary policy change proposed in H.R. 3221 is the elimination of the FFEL program and the shift toward the Direct Loan program. Under the FFEL, private lenders provide loans to post-secondary education students. The private lenders receive subsidies to make these loans, and the federal government provides a guarantee for the majority of the loan if the borrower defaults. In contrast, under the William D. Ford Federal Direct Loan program, the federal government makes and administers loans to borrowers directly.

H.R. 3221 would end the FFEL program in 2010, shifting all student aid lending into the federal government's Direct Loan program and the Federal Direct Perkins Loan program. This proposed changed is premised on the belief that ending subsidies to private-sector lenders will reduce government costs and that the federal government will administer student loans more efficiently than private lenders do.

The Congressional Budget Office (CBO) has projected that eliminating FFEL would lead to significant cost savings for the government, enough to more than offset increases in the costs of the Direct Loan program and the other spending increases included in the bill.[2] However, there are questions about whether the CBO's projected cost savings will fully materialize if these reforms are enacted.

In July, CBO Director Douglas W. Elmendorf acknowledged that the original CBO projection did not adjust for the cost of market risk of increasing defaults that the federal government will assume with the shift to direct lending.[3] In addition, there is a danger that taxpayers' costs

This paper, in its entirety, can be found at:
www.heritage.org/Research/Education/wm2615.cfm

Produced by the Domestic Policy Studies Department

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
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could balloon if the federal government proves less efficient in administering and collecting loans than current private-sector lenders, which have an incentive to administer and collect loans efficiently in order to maximize profits.

There are also concerns that the elimination of FFEL and shift toward direct loans would lead to worse service for borrowers. Right now, college students have the opportunity to originate loans with the federal government through the Direct Loan program; however, most borrowers choose to take loans from the private-sector providers. If the federal government is given responsibility for making and administering all loans, there the quality of service in loan administration could be poor, presenting challenges for borrowers and colleges.

Instead of simply ending FFEL, Congress could reform the federal government's student lending programs to achieve savings for taxpayers while maintaining a level and competitive playing field between lenders. Instead of eliminating the FFEL program entirely, Congress could reform FFEL to reduce subsidies to lenders to achieve the projected cost savings that CBO estimates would occur if FFEL is eliminated. The private sector lenders should be able to provide lending services at a higher quality and as cost-effectively as the government. By reducing subsidies made to lenders participating in the FFEL program, the less efficient private lenders would be driven from the market while the more efficient lenders would be left to compete with the federal government's Direct Loan program on an equal playing field. Moving forward, this competition would help ensure quality services for borrowers and efficiency for taxpayers, since the private lenders would have an incentive to continuously lower costs to maximize profits. Given the current concerns about the credit market and the challenges that private lenders may be facing in raising capital, these reductions in subsidies could be phased-in over time.

An Alternative Approach for Addressing the Problem of College Affordability. In addition to reforming student lending, H.R. 3221 also includes significant funding increases for current and new federal programs. For example, the legislation includes significant changes for the Pell Grant scholarship program, making it mandatory in the federal budget process in 2010 and requiring that the Pell Grant award would grow by the Consumer Price Index plus 1 percent in future years. These changes guarantee continued spending increases for this program in future years.

The legislation would also create a number of new programs and increase spending on a variety of existing programs. For example, the legislation would provide mandatory funding for new "College Access and Completion Innovation Fund" programs. It also creates new mandatory spending on post-secondary education modernization and repair programs. The legislation even includes mandatory funding for state preschool programs through the Early Learning Challenge Fund, which would receive mandatory funding. The nation's long-term fiscal health is unarguably in serious trouble driven by mandatory entitlement spending. Adding new mandatory programs is a misguided step in the wrong direction.

But federal policymakers should reconsider whether continuing to increase spending on student aid (not to mention unrelated programs) will address the reason for the college affordability problem: continuously rising college costs.

Years of consistent increases in federal spending on higher education have not solved the problem of college affordability. During the 2008–09 school year, total federal spending on student aid programs (including grants, loans, and tax benefits) was $96 billion.[4] Total federal aid in 2007–08 was 84 percent higher than in 1997–98 after adjusting for inflation.[5]

But college costs have continued to rise, too, during that period. The College Board reports that pub-

1. For an overview of H.R. 3221, see David P. Smole *et al.*, "The Student Aid and Fiscal Responsibility Act of 2009," Congressional Research Service, July 31, 2009.
2. *Ibid.*
3. Douglas W. Elmendorf, director, Congressional Budget Office, letter to Senator Judd Gregg, July 27, 2009.

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lished tuition and fees at public and private four-year institutions rose at an average annual rate of 4.2 percent (2.4 percent after inflation) over the past decade.[6] Given past trends, college students and taxpayers should expect college costs to continue to rise along with the growth in federal subsidies in student aid.[7]

Instead of simply increasing subsidies for higher education, policymakers should challenge state governments as well as public and private colleges to improve their efficiency and reduce college costs. One promising strategy for lowering costs and improving efficiency is online learning. As higher education instruction increasingly becomes available online, post-secondary students have growing access to online academic content at significantly lower costs than in the traditional college setting.

Public and private colleges have an opportunity to facilitate this process by making more content available online for lower costs and by establishing partnerships with other higher educational institutions to improve efficiency and facilitate low-cost online learning. While public colleges may resist strategies to improve efficiency (and reduce their budgets), state governments could push these changes in an effort to ease higher education costs that burden state budgets. Regardless of how this transformation happens, the proliferation of low-cost online learning opportunities could be a major factor in solving the problem of college affordability and access.

Smarter Reforms. Inefficiency in student lending and college affordability are important issues that federal policymakers should address. However, expanding the Federal Direct Loan program and increasing spending on other federal student aid programs is not the way to solve these problems.

To reform and improve student lending, Congress should reduce subsidies to private lenders to create a level playing field between the private sector and the federal government to encourage competition, efficiency, and quality customer service. Moreover, experience has shown that simply increasing higher education subsidies has not solved the problem of college affordability and runaway college costs. Solving this problem will require state governments and public and private universities to increase efficiency and lower costs.

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4. College Board, "Trends in Student Aid 2008," at *http://professionals.collegeboard.com/profdownload/trends-in-student-aid-2008.pdf* (August 17, 2009).
5. *Ibid.*
6. College Board, "Trends in College Pricing 2009," at *http://professionals.collegeboard.com/profdownload/trends-in-college-pricing-2008.pdf* (August 20, 2009).
7. See Richard Vedder, "The Real Cost of Federal Aid to Higher Education," Heritage Foundation *Lecture* No. 984, January 12, 2007.