Research

Class Warfare and Student Loans

CHAD MILLER | JUNE 10, 2014

Senator Elizabeth Warren (MA) recently introduced legislation, the *Bank on Students Emergency Loan Refinancing Act* (S.2432), to allow borrowers of both federal and privately held student loans to refinance their student loans using taxpayer dollars. Despite its welcome reception by some groups, it's a flawed bill that raises serious questions about the merits of federal activity in student lending. Absent from the discussion is the risk it will transfer to taxpayers, the inequalities it threatens to exacerbate, and the limited impact it would have on college access.

Missing the Point

Senator Warren's bill expropriates private financial accounts and hands them over to the Treasury at a substantial cost to taxpayers. But worse, the legislation does nothing to improve access to higher education today. Rather than fund programs that might improve access, such as the federal Pell grant program, Sen. Warren's proposed legislation would focus benefits on those who have already entered repayment – students who have graduated or dropped out. It would also do little or nothing to curb the rapid expansion of college costs, reduce the growing tide of student loan debt, or address the problems of persistence and completion.

In some respects, the legislation may actually have the counter-productive effect of encouraging more borrowing. The borrower's disincentive to take on more debt is the added burden of repaying interest associated with the loan. Reduce the interest rate and the borrower's loan gets less expensive, which may serve as a reverse incentive, helping a borrower to feel more comfortable taking on additional loans.

Costs to the Government

The legislation allows borrowers with college debt to obtain a lower interest rate by refinancing with the government. In order to pay off the current holder of the loan (even if the current holder is the U.S. Treasury) and to refinance at a lower rate, the government takes on the loss by paying fair value (principal, interest, late fees and administrative fees that may have accrued) and reissues a new loan at a lower interest rate. The Congressional Budget Office estimates that the legislation would increase direct spending by $58 billion over ten years.

The Table below shows a simplified example of two comparable loans, issued at the prevailing rate prior to last year's *Bipartisan Student Loan Certainty Act*, which reduced the interest rate for borrowers originating new loans. Under these two scenarios, borrowers take out a loan and sign on to pay the interest on that loan over the period of their repayment.

	Original Loan A	Original Loan Interest Rate	Reissued Loan Value	Reissued Loan Interest Rate	Net Loss to the Government

Principal	$10,000	6.8%	$10,000	4.66%	$1,280
Interest	$3,809		$2,529		
Total Value	$13,809		$12,529		
	Original Loan B	Original Loan Interest Rate	Reissued Loan Value	Reissued Loan Interest Rate	
Principal	$25,000	6.8%	$25,000	4.66%	$3,201
Interest	$9,524		$6,323		
Total Value	$34,524		$31,323		

Senator Warren's bill would be a substantial burden on the federal budget and a large net loss for taxpayers. If any loans eligible for refinancing are currently pegged at an interest rate higher than the rate proposed in Warren's legislation, the government will take a loss. The lender will be compensated for the fair value of the loan, and the Treasury will take the hit. This is a great deal for private lenders, but a very bad deal for taxpayers.

When looking at a portfolio of more than $1 trillion in outstanding student loans, it's easy to see how the Warren legislation could have the potential of writing down tens of billions of dollars in losses overnight. To offset the tremendous cost of the legislation, the pay for is a tax on high incomes.   That's what some might call a double whammy – higher federal debt offset by tax increases.

Exacerbating Inequities

An immediate challenge with Senator Warren's legislation also worth considering, is that take up of the refinancing eligibility is inevitably going to be uneven. More informed borrowers with better resources who are more likely to understand their options would be in a better position to take advantage of the proposed flexibility, while other, less informed borrowers would continue to pay higher rates on their loans. Hardly an equitable, or desirable, outcome.

The borrowers taking on student loans are likely to: 1) be attending higher cost institutions, 2) have exhausted their federal student loan eligibility, and 3) enjoy high enough credit scores (or have parents willing to cosign) to be eligible for private student loan financing. Most students taking out private student loans have either borrowed their limit in federal loans or, in the case of a very small minority, prefer not to borrow from the federal government. These students may have higher debt loads, but they have also chosen higher cost institutions that exhaust their federal loan eligibility faster than lower cost alternatives.

Conclusion

Whenever there is a proposal for the federal government to assume control of private financial assets, it’s a worthy question to ask whether the government is overstepping its bounds. There are some things the federal government is uniquely positioned to provide – a national defense or the protection of individual rights. For the remainder, and vast majority of services, the government should not be competing with private businesses that tend to price risk more appropriately, in the case of student debt.

What’s more, it comes with a hefty price tag for taxpayers, does nothing to improve access for low-income borrowers, and threatens to exacerbate inequalities between more and less-informed students.

Some bills are viewed as win-win propositions. This one is definitely a lose-lose.