

WebMemo



Published by The Heritage Foundation

No. 1308
January 16, 2007

Halving Student Loan Interest Rates Is Unaffordable and Ineffective

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We will broaden college opportunity, and we will begin by cutting interest rates for student loans in half.

—Incoming House Speaker Nancy Pelosi (D-CA)

The House of Representatives will likely vote this week on a proposal to halve the 6.8 percent interest rate on subsidized student loans as part of the new congressional majority's 100-Hour agenda. Parents and students can surely appreciate Congress's concern about the rapidly increasing cost of a college education and the importance of access to higher education, but this proposal is unaffordable and ineffective. The measure could cost \$18 billion over five years, at a time when federal student financial aid spending has already surged 400 percent since 2001 and loan consolidation costs are set to soar. Federal grant and loan limits have recently increased, and interest rates are at historically low levels. Worse, increases in federal student aid often lead to tuition hikes, leaving college equally unaffordable. Most importantly, reducing interest rates does not increase college access for prospective students, but merely subsidizes loan repayments after college. Enhancing college affordability and access will require different solutions—ones that recognize that boosting federal subsidies is counterproductive.

In addition, the current budget context is daunting. Federal spending has surged by 42 percent since 2001 to over \$23,000 per household, and spending is projected to drive the budget deficit to approximately \$800 billion within a decade.¹ The coming retirement of 77 million baby boomers threatens to push Social Security, Medicare, and

Medicaid spending to levels that, without reform, could force lawmakers to either double income tax rates or eliminate every remaining federal program. Defense, homeland security, K-12 education, and health research also must compete for funding.

The loan proposal will intensify that competition. Halving the interest rates on student loans is estimated to cost \$18 billion over five years. Representative Pelosi's pledge to re-implement pay-as-you-go budgeting rules (PAYGO) means that taxpayers will expect the cost of the rate change to be offset elsewhere in the budget so as to not increase the budget deficit.

Six Problems with Halving Student Loan Interest Rates

1. **Federal spending on student financial aid is already skyrocketing.** The myth of education budget cuts is perhaps the most persistent budget myth today. Since 2001, federal education spending has grown a staggering 167 percent from \$35 billion to \$95 billion. Most of this

This paper, in its entirety, can be found at:
www.heritage.org/research/education/wm1308.cfm

Produced by the Center for International
Trade and Economics (CITE)

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002-4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

new spending goes to financial aid for college students, which has skyrocketed 400 percent, from \$9.6 billion \$48.0 billion (plus \$10 billion per year in related tax breaks).² A temporary surge in student loan consolidations is responsible for a large part of this new spending. However, student aid spending is expected to level off at nearly \$25 billion—nearly triple the 2001 spending level. The education budget's growth rate since 2001 is not only the fastest in the federal budget, but is also nearly unprecedented for any Cabinet department in American history.

In line with spending, the total amount available for grants and loans has more than doubled since 2001, from \$66 billion to \$136 billion—or, excluding consolidation loans, from \$52 billion to \$78 billion. During this period, the number of students receiving aid increased from 7.6 million to 10.1 million, and the number of annual loans and grants provided to those students leaped from 15.4 million to 24.7 million.³

2. **Students already have many options for federal grants and low-interest loans.** Today's college students are offered more grants and loans with lower interest rates than in the past. True, the maximum Pell Grant of \$4,050 is just \$300 over the 2001 cap. However, the 2005 Deficit Reduction Act created SMART Grants of

up to \$4,000 annually for students majoring in math, science, engineering, or a foreign language critical to U.S. security. This effectively doubles the Pell Grant for many students.⁴

Today's students can also borrow more. The Deficit Reduction Act increased subsidized student loan borrowing caps for freshmen and sophomores from \$2,625 and \$3,500, respectively, to \$3,500 and \$4,500. Graduate student loan limits were increased from \$10,000 to \$12,000 annually.⁵

Further, student loan interest rates, the target of the House Democrats' 100-hour agenda, are low by historical standards. This school year, as required by 2002 legislation, the variable interest rate was replaced with a fixed 6.8 percent rate. While this is above last year's 5.3 percent rate under the variable rate formula, such low student loan rates were a temporary anomaly due to the economy's low interest rates. In fact, were the variable rate formula still in effect, student loan interest rates would have jumped to 7.14 percent this year. By locking in the 6.8 percent rate, lawmakers actually lowered student interest rates. Furthermore, this 6.8 percent rate is lower than the student loan interest rate was in all but six of the past 42 years.⁶

Altogether, today's students are eligible for as much as \$8,050 in grants and increasing levels of student loans. Most loans accrue no interest

1. Brian M. Riedl, "Federal Spending: By the Numbers," Heritage Foundation *WebMemo* No. 989, February 6, 2006, at www.heritage.org/Research/Budget/wm989.cfm.
2. Education spending for 2001 located at the Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2007* (Washington, D.C.: U.S. Government Printing Office, 2006), pp. 55–72, Table 3.2. Estimates for 2006 come from the U.S. Treasury Department Office of Public Affairs, "Preliminary Statement of Budget Results for Fiscal year 2006," October 11, 2006, at www.fms.treas.gov/mts/10-11-06-Budget-Results.pdf. The tax expenditure figure comes from George Krumbhaar, "Losing Out on Higher Education Costs," Gallerywatch.com, June 26, 2006.
3. Data from 2001 located at the Office of Management and Budget, *Appendix, Budget of the United States Government, Fiscal Year 2003* (Washington, D.C.: U.S. Government Printing Office, 2002), pp. 363–365. Data from 2006 located at the Office of Management and Budget, *Appendix, Budget of the United States Government, Fiscal Year 2007* (Washington, D.C.: U.S. Government Printing Office, 2006), pp. 360–362.
4. P.L. 109-171, The Deficit Reduction Act of 2005, as summarized by the Congressional Budget Office at www.cbo.gov/ftpdocs/70xx/doc7028/s1932conf.pdf.
5. *Ibid.*
6. "2002 Student Loan Law Takes Effect, Lowers Interest Rates," Senate Budget Committee *Budget Bulletin*, August 4, 2006, at <http://budget.senate.gov/republican/analysis/2006/bb08-2006.pdf>.

until graduation and even then are locked in at a low interest rate. Students can even deduct student loan interest costs on their tax returns.

3. **Student aid subsidies are already set to increase much further.** A large portion of the recent surge in student aid comes from the 2.2 million college graduates annually consolidating their existing student loans—up from 676,000 in 2001. Consolidation loans allow students who borrowed at variable interest rates as low as 3.5 percent to lock in those low rates permanently by converting to long-term fixed loans. This could become enormously expensive for the federal government. Washington promises a certain rate of return to banks that make guaranteed student loans, and if market interest rates rise up above these very low fixed rates, the federal government pays banks the difference to protect their profits. Kevin Hassett of the American Enterprise Institute has calculated that if interest rates spike, the cost to taxpayers could be tens of billions of dollars.⁷ Furthermore, locking in current and future students at reduced 3.4 percent interest rates could add another generation of expensive consolidation loan candidates. Addressing these costs, which could potentially rival those of the savings and loan scandals, should be a top education policy priority.
4. **Tuition costs rise with financial aid.** Students and parents are well aware that tuition is soaring. The average college tuition, adjusted for inflation, has leaped 86 percent for public colleges and 52 percent for private colleges since the 1991–92 school year.⁸ However, endless student aid increases may not only fail to deal with rising tuition; evidence suggests they actu-

ally contribute to tuition increases. Richard Vedder, among other economists, has shown that college tuition increases follow student aid increases.⁹ Colleges, like businesses, charge as much as their customers are able to pay. So when student aid increases, colleges raise tuition accordingly to capture the additional aid. This suggests that increases in federal student aid effectively subsidize colleges, not students.

Unfortunately, students, taxpayers, and policymakers are often unable to determine the real reason for increasing tuitions. “Institutions of higher education, even to most people in the academy, are financially opaque,” according to the National Commission on the Cost of Higher Education. “Academic institutions have made little effort, either on campus or off, to make themselves more transparent, to explain their finances.”¹⁰

5. **Lower interest rates will not increase access to college.** The House Democrats propose to cut student loan interest rates as a means of “making college more accessible.” This does not make sense. College accessibility depends on whether current and prospective students can fund their tuition and other expenses, not the interest rate at which they will repay the loans after leaving college. Telling students who currently cannot afford college that they will receive lower post-graduation student loan interest rates is putting the cart before the horse. It is true that society has an interest in making sure qualifying prospective students can access sufficient student aid to enroll in college. This is accomplished by ensuring that borrowing caps are in line with the amount necessary to afford

7. Kevin Hassett, “Tales Out of School: The Financial Disaster Everyone Missed,” Tech Central Station, March 10, 2004, at www.tcsdaily.com/article.aspx?id=031004j.
8. College Board calculations cited by Jay Mathews, “Spike in College Price Tags Not So Sharp,” *The Washington Post*, October 25, 2006, at www.washingtonpost.com/wp-dyn/content/article/2006/10/24/AR2006102400524.html.
9. “College Access: Is Government Part of the Solution, or Part of the Problem?” Testimony of Richard K. Vedder, Committee on Education and the Workforce, U.S. House of Representatives, April 19, 2005, at www.house.gov/ed_workforce/hearings/109th/fc/collegeaccess041905/vedder.htm.
10. National Commission on the Cost of Higher Education, “Straight Talk about College Costs and Prices,” American Institutes for Research, 1998, p.6.

tuition, room, and board. The 2005 Deficit Reduction Act already addressed this issue by raising the borrowing caps by about 30 percent. Such policies help students afford college without shifting large costs to taxpayers (as with grants) or merely subsidizing college graduates (as with reducing interest rates). However, Congress should take care to ensure that these policies do not continue to induce tuition increases.

6. **Most college graduates can afford to repay their student loans.** The effect of reducing student loan interest rates will be to subsidize college graduates while leaving current college students no closer to affording their tuition. Today, college graduates enter the workforce with an average student loan debt of \$17,500. This is not a crisis worthy of federal handouts. That debt level, consolidated into a 30-year loan at a 6.8 percent interest rate, represents a monthly payment of only \$114, \$12 of which is recouped through the student loan interest tax deduction.¹¹ Halving the interest rate would shave just \$36 off the monthly payment but also reduce the tax deduction to \$5 per month. A college degree raises an individual's lifetime earnings by over \$1 million, on average, and so \$114 per month is clearly an affordable payment on a very profitable educational investment. Furthermore, it is unclear why Congress would burden the population as a whole (76 percent of whom do not have college degrees¹²)

with the costs of subsidizing the minority of adults who have college degrees and so can expect higher lifetime earnings.

A Better Proposal

Rather than providing billions in new federal subsidies, Congress should instead focus on the fundamental problem of college affordability: out-of-control higher education costs. Congress should determine whether ever-increasing federal subsidies for higher education contribute to increasing college costs.

Conclusion

America's economic future depends on having an educated and productive workforce. The federal government has already invested unprecedented sums on financial aid for college students and created a system that provides large amounts of aid at low interest rates. Halving student loan interest rates will subsidize college graduates repaying their aid, without significantly improving current and future students' access to higher education. Importantly, halving student loan interest rates will not address the ever-increasing cost of higher education. Congress should instead examine whether federal subsidies are a part of this problem.

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11. Tax deduction savings are based on a taxpayer filing in the 15 percent marginal income tax bracket for the first 15 years and in the 25 percent tax bracket for the final 15 years. Total tax savings are then averaged over the 360-month length of the loan.
12. U.S. Census Bureau, "The Big Payoff: Educational Attainment and Synthetic Estimates of Work-Life Earnings," July 2002.