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Ending Federal Student Loans

There Is a Small Window of Opportunity to Get the Government out of Student Lending

By Andrew Gillen

The stars have aligned to present the best chance in decades of ending the federal government's student lending and replacing it with a system that harnesses the advantages of a marketplace of private lending. This switch would save $212 billion over the next 10 years (savings that could be used in upcoming reconciliation bills) while benefiting students by helping them avoid risky educational choices. But Congress needs to move fast—the savings from making the switch may disappear due to ongoing court cases and upcoming regulatory changes. This paper explains why, how, and when this opportunity should be seized.

WHY SHOULD FEDERAL STUDENT LENDING BE SHUT DOWN?

Replacing the current student loan system, under which the government is the lender, with a system that uses only private lenders would be beneficial to students and taxpayers.[1]

A Student Loan System Is Necessary

Several factors drive the necessity of student loans. First, college is expensive, costing an average of almost $28,000 per year.[2] Second, many college students enroll right after high school, which makes it difficult to finance college enrollment from current earnings. Third, many potential college students lack assets to use as collateral. For many other types of loans, a valuable asset can serve as collateral, which can substantially reduce the interest rate charged (e.g., compare the typical interest rate on a mortgage, which uses the house as collateral, to the interest rate on credit cards, which have no collateral).[3] Fourth, college is often a good investment from a financial perspective. Because college graduates tend to earn more

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than those who did not go to college, there is ample opportunity for mutually beneficial lending that leaves both borrowers and lenders better off.

Private Lending Would Be Superior to the Current Government-as-Lender System

Just because student loans should exist does not mean that all student loan systems are justified. Case in point, our current system is badly designed largely because students borrow directly from the federal government. Switching to a system that uses private lenders would help mitigate many of the problems with this government-as-lender system.[4]

Less Malinvestment

Avoiding malinvestment (educational spending where the benefits do not justify the costs) is one of the primary benefits of private lending relative to government lending.

A student loan system is fundamentally about addressing a liquidity constraint (a lack of available funds) that prevents worthwhile college enrollment. In other words, student loans help solve the problem of a college education being a good investment in the long term but unaffordable in the present. But just because something is labeled a "college education" does not make it a worthwhile investment. Low-quality college education, academically unprepared students, or unfavorable macroeconomic conditions could all lead to malinvestment in which the costs of an education outweigh the benefits. Thus, the goal of a student loan system is to provide financing for worthwhile investments in education while avoiding malinvestment.

The government-as-lender system utterly fails at this balancing act, providing too much funding for malinvestment. Preston Cooper estimates that around 31 percent of students attend a program with a negative return on investment, and Nobel Prize–winning economist James Heckman and coauthors found programs with a return as low as negative 32 percent.[5] These malinvestments leave students financially worse off after enrollment and impose large costs on taxpayers in the form of loans that are not repaid.

In contrast, private lenders are naturally incentivized to provide financing for worthwhile investments—since they make money on such loans—while avoiding financing for malinvestment—since they lose money on such loans. Lenders that succeed at distinguishing between worthwhile investments and malinvestments would be profitable and grow, while lenders that fail to do so would go bankrupt, providing further market discipline. Moreover, the line between worthwhile investment and malinvestment would not be drawn according to preconceived or ideologically driven notions of what a college education should be but rather by a decentralized, data-driven process focused on student outcomes.

More Accountability for Colleges

Holding colleges accountable is another area where private lending excels relative to government lending.

The three parties to a loan—the student, the lender, and the college—have misaligned incentives under the current government-as-lender system. For example, when a student defaults on a loan, both the student and the government are harmed. The student faces penalty fees, wage garnishment, and lowered credit scores, while the government takes a loss on the loan. But the college still benefits since it is paid up-front and gets to keep all the money. A system in which colleges can still benefit from a loan even when students and taxpayers are left worse off distorts incentives and rewards gaming of the system by colleges. Because the government-as-lender system fails to hold colleges accountable, there are simply too many colleges that profit from providing programs that hurt students and taxpayers.

Under private lending, colleges would be held more accountable because incentives are more aligned. Since private lenders lose money whenever students fail to repay their loans, they would quickly cease working with colleges that game the system, vastly increasing accountability for colleges.

Better Incentives for Students

Private lending would also provide better incentives for students than government lending. Under our current government-as-lender system, all loans have the same terms. Hardworking and high-achieving students pay the same interest rate as slackers and low performers. In contrast, private lending would reward all sorts of beneficial student behaviors and actions. For example, students would have an

incentive to work hard in school since lenders would offer lower interest rates to students with good grades and high test scores.

Better Incentives for Colleges

Colleges would also face better incentives under private lending than government lending. Under the government-as-lender system, all colleges are eligible for loans on the exact same terms. As a result, colleges are not rewarded for improving. But with private lenders, colleges would be rewarded for improving. A college that increased the quality of the education provided or its job placement services would see more successful students who are more likely to repay their loans. This better repayment record would lead to better loan terms, such as lower interest rates for the college's students, which would benefit the college by increasing its pool of potential applicants, allowing the college to either expand enrollment or increase selectivity.

More Informed Decisionmaking

Students often lack the information needed to inform their choices. Students are often told that they need to go to college since it is the ticket to the American Dream, but they are offered little guidance on what to do once in college. Consider interest rates. Like any other price, interest rates can convey useful information. But the government-as-lender's uniform interest rates suppress this useful information. A low-performing student attending a low-performing college and majoring in a field with high unemployment can borrow at the exact same interest rate as a stellar student attending a top college and majoring in a field with low unemployment. But with a private lending system, the vast differences in risk of these students' college paths would be accounted for by lower interest rates for the less risky path. This differential pricing provides valuable information to students on the riskiness and potential profitability of various educational choices.

HOW CAN FEDERAL GOVERNMENT STUDENT LENDING BE SHUT DOWN?

The key to understanding why there is now an opportunity to eliminate the government-as-lender system is to recognize how we ended up with this system in the first place. Bizarrely enough, the best explanation for the evolution of student loans is changes in government accounting standards.

When student loans were introduced in the 1950s and 1960s, government accounting standards would count the full amount of any lending by the government as a cost while ignoring the value of future repayments. This method produced a highly distorted estimate of the cost of government lending, one that made direct government lending look very expensive. The government, therefore, wanted to keep student loans off its books, so early student loan programs relied on private lenders that were offered a federal guarantee.[6]

A few decades later, Congress passed the Federal Credit Reform Act of 1990 (FCRA), which changed government accounting standards for government lending. Under FCRA, future loan repayments would be accounted for using net present value, which uses a discount rate to calculate the value of future loan repayments. For example, the net present value of a $100 payment one year from now at a discount rate of 5 percent would be $95.24. Unfortunately, FCRA mandated the wrong discount rate for student lending, using the risk-free Treasury rate rather than a market-based rate. And because this discount rate was lower than the interest rate charged to students on their loans, this made government lending look profitable. Within a few years, a parallel government-as-lender system was introduced, and in 2010, the Obama administration completely replaced the original system, using the supposed profits from switching to the government-as-lender system to help pay for Obamacare.

But progressives have long sought to make student loans more generous and have partially succeeded, most recently in the form of the various Biden administration student loan forgiveness plans. While these plans suffered from a host of problems and face an uncertain future, they have had a huge impact on the government's cost estimates for student loans, transforming expected profits from government lending into large losses.[7] For example, whereas the government estimated that it made a profit of $0.05 for every dollar lent as recently as 2019, it now expects to lose around $0.19 for every dollar lent over the next decade.[8]

The fact that government accounting estimates that student loans will lose money for the federal government means that ending the government-as-lender system would

Table 1
Student loan cost estimates

Year	Subsidized undergraduate loans	Unsubsidized undergraduate loans	Unsubsidized graduate loans	Grad PLUS loans	Parent PLUS loans	Total cost
2024	$5.51B	$4.74B	$5.42B	$3.39B	−$1.70B	**$17.34B**
2025	$5.49B	$4.57B	$4.88B	$3.36B	−$1.95B	**$16.36B**
2026	$5.55B	$4.75B	$5.03B	$3.63B	−$2.06B	**$16.93B**
2027	$5.73B	$4.99B	$5.43B	$3.86B	−$2.05B	**$17.97B**
2028	$5.87B	$5.18B	$5.67B	$3.98B	−$2.02B	**$18.69B**
2029	$5.96B	$5.23B	$5.85B	$4.18B	−$2.00B	**$19.19B**
2030	$6.11B	$5.33B	$6.06B	$4.44B	−$1.98B	**$20.00B**
2031	$6.26B	$5.49B	$6.17B	$4.74B	−$1.96B	**$20.73B**
2032	$6.36B	$5.56B	$6.31B	$4.98B	−$1.94B	**$21.27B**
2033	$6.46B	$5.66B	$6.32B	$5.18B	−$1.96B	**$21.72B**
2034	$6.50B	$5.75B	$6.33B	$5.29B	−$1.99B	**$21.84B**
Total cost	**$65.80B**	**$57.25B**	**$63.45B**	**$47.04B**	**−$21.61B**	**$212.06B**

Source: "Federal Student Loan Programs," Congressional Budget Office, June 2024.
Note: Any loan type that imposes costs on taxpayers is subsidized in the common usage of the term, but "Subsidized" and "Unsubsidized" in the column labels refer to the official loan program names, which distinguish between programs where interest is waived while the borrower is enrolled (Subsidized) or not (Unsubsidized).

save massive amounts of money. Table 1 uses Congressional Budget Office (CBO) estimates of loan volume and the subsidy rate, which measures the expected cost of loans, to show how much money would be saved by replacing the government-as-lender system.

Over the next 10 years, there will be $1.1 trillion in new student loans, and the government is projected to lose an average of $0.19 for each dollar lent. Thus, eliminating all federal loan programs would save the government $212 billion over the next 10 years.

Table 1 also shows the savings from eliminating individual loan programs instead of the whole portfolio (except for one loan program). For example, eliminating Parent PLUS (the one loan type that is still profitable for the government) and Grad PLUS loans would save $25 billion. Eliminating all graduate and parent lending would save $89 billion. The exception is subsidized loans for undergraduate students (interest is waived while the borrower is enrolled for "Subsidized loans" but not for "Unsubsidized loans"). Since eliminating that program would most likely convert that lending volume into unsubsidized loans, the savings estimate should rely on the subsidy rate for unsubsidized loans, which means that eliminating subsidized loans would save a little over $14 billion over the next 10 years.

There are two methods to switch from government to private lending. The first would eliminate new lending under existing government programs. The second would leave the basic structure of the Direct Loan program in place but replace government lending with a marketplace of private lending for future loans.

WHEN SHOULD FEDERAL STUDENT LENDING BE SHUT DOWN?

While the savings from eliminating federal student loans are large, this is likely to be a temporary opportunity. The reason is that various student loan forgiveness plans from the Biden administration are on the books. For example, the Saving on a Valuable Education (SAVE) Plan massively increased the subsidy rate for student loans by reducing the share of income owed from 10 percent to 5 percent, increasing the income exemption from 150 percent of the poverty line to 225 percent, and reducing the length of required repayment from 20 years to 10 years for some

students.[9] The SAVE Plan is currently paused while the courts determine if the plan is legal or not. But because the regulations that created the SAVE Plan have been finalized, its costs are partially baked into the CBO modeling of the costs of student loans. This largely explains why the government went from making money on loans to losing money. But it also means that if the SAVE Plan is eliminated by a court ruling or the Trump administration rescinding the regulations via a new rule, then much of the savings from eliminating the government-as-lender system would disappear.

If all the Biden administration's changes in repayment plans and student loan forgiveness proposals are tossed aside by courts or rescinded by the new administration through the rulemaking process, the cost of student lending would likely revert to something like the cost in 2019 (meaning the subsidy rate would fall from around 19 percent to around negative 5 percent). This implies that eliminating federal student loans would go from saving $212 billion over the next 10 years to costing $55 billion under current CBO scoring rules. Thus, if Congress wishes to use the savings from eliminating student loan programs to pay for other spending or tax cuts in a reconciliation bill, it is imperative to move quickly.

TRANSITION TIPS

The tips below seek to ensure as seamless a transition as possible from the government-as-lender system to a system relying on private lenders.

Strengthen the Foundations of the Market for Student Lending

Markets require strong foundations, such as the enforcement of contracts, to operate effectively. There are two areas where the foundation for private student lending could use reinforcement.

First, the most natural structure for student lending is income-contingent repayment, in which instead of repaying a fixed amount for a predetermined length of time, borrowers repay a percentage of their income until the loan is repaid. These loans essentially let borrowers use their future earnings (presumably enhanced by their college education) as collateral, making the loan less risky for lenders and lowering interest rates for borrowers.[10] But the legal status of income-contingent repayment for private lenders is hazy, particularly if a borrower declares bankruptcy. Thus, the interaction of private income-contingent lending with "consumer protection laws, credit reporting laws, bankruptcy laws, and income tax provisions for both students and investors," as well as consumer disclosure requirements, need to be clarified.[11]

Second, many of the streamlined mechanisms used to ensure repayment for government lending should be extended to private lenders. For example, if a borrower fails to repay their loan to the government, the government can start garnishing a portion of their wages without first needing to sue and win in court. Extending protections like this to private lenders would dramatically reduce transaction costs, which would result in more mutually beneficial loans.

Keep It Simple

While there are good reasons to undertake a radical overhaul of more aspects of student loans, this urge should be resisted. The focus at this point should be on seizing the opportunity to replace the current government-as-lender system with a marketplace in which private lenders can compete. Other aspects of the system should be left unchanged, to be reformed later. In particular, eligibility and loan limits should remain unchanged. Changes to either of those would entail additional delays and controversy that could endanger the transition, given the short-lived window of opportunity.

Watch Out for Red Flags

There are a host of red flags that would indicate the transition from government to private lending is being sabotaged by opponents or hijacked by crony capitalists. The main red flags to look for are loan guarantees, price fixing, interest rate subsidies, and a lack of competition.

Loan Guarantees

Loan guarantees, in which the government steps in to repay the lender when the student fails to do so, are a huge red flag. Loan guarantees have two negative consequences.

First, they neuter one of the main benefits of private lending. For a normal private loan, the lender will conduct due diligence to ensure that any loan made is expected to be repaid. Thus, a low-performing student attending a low-performing college and majoring in a field with high unemployment is an extremely high risk and unlikely to be able to find a lender willing to let them borrow. But if lenders have a loan guarantee, their incentives change dramatically. By removing the risk that the lender will not be repaid, a loan guarantee changes the lender's incentive from making as many profitable loans as possible to making as many loans as possible, regardless of their likelihood of repayment. The low-performing student attending a low-performing college and majoring in a field with high unemployment will have no trouble getting a loan if there are loan guarantees.

The second problem with loan guarantees is that they impose costs on taxpayers. A loan guarantee does not eliminate the financial losses when a student does not repay their loan; it merely shifts those losses from the lender to the taxpayer. By letting lenders profit when students repay, and bailing them out when students do not, loan guarantees privatize profits while socializing losses, a recipe for financially reckless decisionmaking that will lead to massive losses for taxpayers.

Price Fixing

Another red flag is price fixing, which for student loans would typically take the form of setting interest rates or origination fees. This type of price fixing neutralizes one of the main benefits of private lending—differential pricing, which facilitates more informed decisionmaking. In a competitive market, interest rates will adjust to reflect the risk of various choices. At a personal level, a student would see different interest rates based on the quality of the college and the labor market for the major chosen, which provides valuable information to students on the riskiness of different college choices. At a societal level, differential interest rates would help expand enrollment in high-demand fields while reducing enrollment in low-demand fields, since the high-demand fields would have lower interest rates, and the low-demand fields would have higher interest rates. For example, if the interest rate for engineering students were much lower than for music majors, more students would gravitate toward engineering. Fixing prices to ensure a uniform interest rate would forgo these benefits for students and society.

Interest Rate Subsidies

Another red flag is interest rate subsidies. The government often sets interest rates below market rates in a misguided attempt to subsidize college. But as Susan M. Dynarski and Daniel Kreisman note, "The government should seek neither to make nor to lose money from student loans . . . [student loans] solve a liquidity problem, not a pricing problem. Student loans are appropriate neither for raising revenue nor for subsidizing college."[12] Trying to subsidize college via student loans makes two large mistakes. First, it provides a subsidy only to those who borrow, and second, it provides the largest subsidy to those who borrow the most, typically relatively well-off graduate students. Private lenders would not subsidize interest rates.

Lack of Competition

Perhaps the biggest red flag of all is a lack of competition. Replacing the current government lending monopoly with a private lender monopoly would do little to help students or improve higher education and may even be worse since private lenders would seek to maximize profits, whereas the government seems content to lose money on loans. In a private lending system, borrower protection comes almost entirely from competition among lenders. Any borrower that is being exploited by their current lender presents a profitable opportunity for competing lenders to offer a better loan. To ensure that borrowers receive the protection provided by competitive lending, contract terms that unnecessarily lock in students—such as prepayment penalties, account closure fees, and explicit lock-in periods—should be banned.

Don't Resurrect the Federal Family Education Loan Program

If one created a private lending system that ignored all these red flags, it would essentially resurrect the original

quasi-private student loan system in place until 2010, the Federal Family Education Loan Program (FFEL). FFEL (originally called the Guaranteed Loan Program) combined aspects of government lending and private lending, resulting in a corrupt entity with the worst of each system. In particular, the government determined eligibility and fixed prices, while private lenders lobbied for and received generous subsidies.

FFEL lenders benefited from loan guarantees—if a borrower defaulted on a loan, the lender would typically be paid 97 percent of the amount owed, which was ultimately paid for by federal taxpayers (after being routed through a guarantee agency). Interest rates were fixed at a uniform level across FFEL loans. In addition to the loan guarantee, lenders received interest rate subsidies called special allowance rates, which varied based on the difference between the interest rate on the student loan and a commercial interest rate.[13] And while there was competition among FFEL lenders, since the government set uniform interest rates, the competitive pressure tended toward corruption, with lenders bribing college administrators to get on preferred lending lists.[14] In other words, FFEL provides almost a perfect road map of mistakes to avoid when designing a private lending system.

CONCLUSION

Replacing the current government-as-lender system with one that relies on private lenders would improve higher education because it would finance less malinvestment, hold colleges more accountable, provide better incentives for students, provide better incentives for colleges, and facilitate more informed decisionmaking by students.

Despite the advantages of a private lending system, Congress has been reluctant to move away from government lending in recent decades because under current accounting standards, it would have cost money to do so. But recent policy changes, especially the loan repayment and forgiveness changes implemented by the Biden administration, have made student loans extremely expensive for the government, which means that transitioning from the government-as-lender system to a system that uses private lenders would save massive amounts of money, around $212 billion over the next 10 years.

Congress will need to move quickly to seize this opportunity, because if the repayment and loan forgiveness changes put in place by the Biden administration are overturned in court or rescinded by the incoming Trump administration, the savings from transitioning away from government lending could not be used in a reconciliation bill.

NOTES

1. This paper uses "student loans" as shorthand for all the federal loan programs (Subsidized, Unsubsidized, Grad PLUS, and Parent PLUS). These programs account for 87 percent of all college borrowing and require students to submit the Free Application for Federal Student Aid, or FAFSA, to determine eligibility. Other types of loans entail borrowing from states, colleges, or private organizations. Since these loans do not involve the federal government, they have little budgetary or policy relevance for this paper and are excluded.

2. "Table 330.10: Average Undergraduate Tuition, Fees, Room, and Board Rates Charged for Full-Time Students in Degree-Granting Postsecondary Institutions, by Level and Control of Institution: Selected Academic Years, 1963–64 Through 2022–23," Digest of Education Statistics, Department of Education, December 2023.

3. Milton Friedman, "The Role of Government in Education," in Robert A. Solo, ed., *Economics and the Public Interest* (Rutgers University Press, 1955), pp. 123–44.

4. Andrew Gillen, *Unleashing Market-Based Student Lending* (Texas Public Policy Foundation, May 2020).

5. Preston Cooper, "Does College Pay Off? A Comprehensive Return on Investment Analysis," Foundation for Research on Equal Opportunity White Paper, May 8, 2024; and Pedro Carneiro, James J. Heckman, and Edward J. Vytlacil, "Estimating Marginal Returns to Education," National Bureau of Economic Research Working Paper no. 16474, October 2010.

6. Josh Mitchell, *The Debt Trap: How Student Loans Became a National Catastrophe* (Simon and Schuster, 2021).

7. For a detailed list of problems with student loan forgiveness, see Andrew Gillen, *The Problems with Student Loan Forgiveness* (Texas Public Policy Foundation, April 2022).

8. "Details About Baseline Projections for Selected Programs," Congressional Budget Office.

9. "The Saving on a Valuable Education (SAVE) Plan Offers Lower Monthly Loan Payments," Federal Student Aid, Department of Education.

10. Andrew Gillen, *Unleashing Market-Based Student Lending* (Texas Public Policy Foundation, May 2020).

11. Richard Price, *Unlocking the Potential of ISAs to Tackle the Student Debt Crisis* (Christensen Institute, August 15, 2019).

12. Susan M. Dynarski and Daniel Kreisman, "Loans for Educational Opportunity: Making Borrowing Work for Today's Students," Hamilton Project, October 21, 2013.

13. Deborah Lucas et al., "Costs and Policy Options for Federal Student Loan Programs," Congressional Budget Office, March 2010.

14. See, for example, Andy Guess, "'Consumer Reports' for Student Loans," Inside Higher Ed, October 21, 2007.

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