
Let Them Go Bankrupt

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Most student loans in the United States are guaranteed by the federal government. The main difference between private loans and the guaranteed loans is that the former usually come with a higher interest rate: Students generally don't seek these out until they cannot access guaranteed loans any longer. However, neither type can normally be discharged via bankruptcy.

The problem with government-backed loans is that the guarantee creates a moral hazard of the same sort that bedeviled mortgage markets before and during the Great Recession. A college can treat a guaranteed student loan as a sure thing with no attendant obligations: The school admits the student, cashes the loan check, and need not concern itself with whether he graduates or gets a job that allows him to pay the loan back.

Recently the Department of Education proposed making it easier to discharge private student debt via bankruptcy. While the knee-jerk reaction is that doing so will be disadvantageous for students who need to borrow money, that's not necessarily true. Doing such a thing — especially if we expanded it to all student loans— would drive up interest rates. But it would not be a bad outcome if students were forced to make better college choices and economize on how much they borrow. It would likely also increase graduation rates and reduce the total amount of student debt.

That colleges now lack a financial incentive to push their students to succeed is just part of the problem: Because the student cannot discharge student loan debt via bankruptcy, neither the lender nor the college need worry about default. Admitting (or lending to) students at an institution where they are unlikely to succeed is a regular occurrence that goes well beyond the suspect trade schools and for-profit colleges.

A common — but mistaken — contention is that public universities lose money on each student and thus have no financial incentive to expand their enrollment. It may be true that, in the aggregate, tuition does not entirely cover expenses at most schools — endowment funds and grants from the state and federal government also defray costs at most colleges — but it's irrelevant: Additional students, at the margin, can be quite lucrative for a well-managed university.

The cost of adding one more student to a university is close to zero: The enrollment in

each of his classes goes up by one, a previously empty dorm bed is filled, and the cafeteria throws out less food. Colleges know this and work hard to fill their classes. It's why enrollment in most colleges and universities has crept upward during the last two decades: Colleges have a high fixed cost but the variable costs are much lower.

Some colleges take it even further. Both of the state universities at which I once taught offered a special three-semester program for high-risk students whose test scores and high school performance suggested that their potential to succeed in a university setting was low. The classes were taught not by Ph.D.s but by graduate students or retired high school teachers, paid well below what any professor made. That made sense because the curriculum was far from being college-level rigor: The three semesters of math culminated in algebra I, something their classmates outside of their program had probably completed in 8th or 9th grade. The students in these special programs lived together, ate meals together, and studied together, remaining perpetually apart from the rest of the student population. And within a semester or two of joining the rest of the student body they failed out together as well: At each school only a handful of students from the special program managed to graduate.

Their education was funded mainly with a combination of Pell grants and guaranteed student loans that more than covered the modest additional costs of admitting this cohort. While the colleges boasted that these programs were a manifestation of their concern for children from marginal neighborhoods and weak high schools, they were also cash cows.

Whether this was a societally beneficial investment is dubious. Did the kids get anything from their college experience? We know that attending college even without graduating does boost incomes — having it on a résumé can open doors. Later on in life a few of them did reenroll and complete college somewhere else. And of course, college can be fun. But were these experiences worth the student-loan obligations they were left with? It may be an overstatement to say these students were simply being exploited by the university, but it is a little too close for comfort.

If we made student debt dischargeable in bankruptcy (like nearly all other debt) then the banks that make these loans would do their best to lend to people who have a reasonable chance at succeeding at the educational institution they choose. The data support this: Private student loans, which are easier to discharge in bankruptcy than government student loans, have lower default rates.

Would an expanded market for private student loans deny the poor and disadvantaged a college education? Not by a long shot — what it would do is nudge marginal students

a college education. Not by driving students towards institutions that are less expensive and where they have a better chance at succeeding.

Senator Elizabeth Warren recently wondered why minority students are much more likely to leave college with debt than other students. Her solution — which is simply to bail out students with loans they can't easily repay — doesn't fix the inherent problem, although to be fair, she's at least asking the right questions. Adam Levitin, a professor at Georgetown Law School, has suggested that the fact that student loans guaranteed by the federal government have stronger bankruptcy protection than private loans makes them superior to those issued by private lenders, because they charge the same interest rate to all borrowers, which reduces potential income inequality.

It's a position that is mystifying. The bankruptcy exclusion for most student debt is bad policy and leads to lousy outcomes. The market discipline that would be engendered by making all student loans dischargeable via bankruptcy would result in students making better educational decisions while giving heretofore insulated colleges a desperately needed dose of market discipline. It's something we ought to encourage in this day and age, when the cumulative student debt exceeds \$1 trillion.

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