



The Simple Economics of Student Loan Crises

By [Donald Marron](#) | Sep 15, 2009, 4:24 AM

Yesterday, my students heard my second lecture on supply and demand. You know, the one in which we examined how government policies like rent control and the minimum wage can affect market outcomes. Those are important examples, and I dutifully discussed both of them. But I must admit they also feel a smidgen stale – how many millions of students have seen a lecture on rent control and the minimum wage?

To spice things up, I threw in a third example of government intervention: the market for guaranteed student loans. As I mentioned a few weeks ago, the government has a major program in which it provides guarantees for private student loans. Under the program, lenders are protected against the risk of future defaults by the student borrowers. In return for providing these loans, the lenders receive interest payments that are limited by a formula that is specified in law. (These payments are determined completely separately from the amounts that are charged to students which, for simplicity, I will ignore in what follows.)

This program is currently the focus of a major political battle: the Obama administration has proposed eliminating the program and replacing it with direct loans from the government (which currently account for a much smaller portion of the market). But I didn't get into that larger debate in class. Instead, the reason I focused on this program is that it has experienced two crises in recent years:

In 2006 and 2007, the crisis was kickbacks. In their enthusiasm to win more business, private lenders were offering "inducements" to schools and student loan officers in order to get preferred access to students who wanted loans.

In 2008, the crisis was a lack of lending. In large part because of the financial crisis, private lenders had no enthusiasm whatsoever for making loans. As a result, there was a real risk that students might not be able to get loans.

As I told my students, I think both of these crises had the same root cause: the fact that the government, rather than market forces, determined how much lenders were paid for making guaranteed student loans. In both cases, the government got the payment levels wrong, and the crises followed soon thereafter.

Back in 2006 and early 2007, the government had set payment rates too high. Lenders thus competed aggressively among themselves to win as much of the market as they could. Some of that competition had arguably beneficial effects (e.g., some lenders passed benefits on to students), albeit at a notable cost to the taxpayer. But the competition also took on unsavory characteristics, as in the kickbacks to the university officials in charge of deciding which lenders would get preferred access to students.

To their credit, the folks in Washington correctly diagnosed this problem. Late in 2007, the Congress passed and the President signed a bill that reduced the amount that lenders were paid.

Unfortunately, those reductions happened at the start of a financial crisis that dramatically increased the cost of private lending. In micro-speak, the private lending market experienced a negative supply shock. And all of a sudden, lender payments were too low. Lenders thus threatened to flee the student loan market, which could have left millions of students without funding for their education.

Again to their credit, the folks in Washington stepped up and eventually found a solution to this problem (which involved more financial engineering than I want to discuss right now). But it was a painful process.

To me, one attraction of this (admittedly simplified) description of recent student loan crises is that it focuses on a different type of government price-setting than the usual examples. Rent control and the

minimum wage are situations in which policymakers believe that market prices are “wrong” (either too low or too high), and the point of the policies is to try to correct that (which turns out to be easier said than done).

The point of the student loan example, however, is that similar problems arise even when the government is trying to get prices “right”(i.e., to choose prices that are just high enough to get private lenders to provide all the guaranteed loans that students want). In practice, the government is hard-pressed to know what the “right” price is, and thus even sincere efforts will often result in prices that are too high (spawning kickbacks) or too low (spawning shortages).

I did not have time to get into this in class, but this line of reasoning ends up quite agnostic about the future role of government in the student loan market. Someone with a free market perspective could easily conclude: aha, government price-setting doesn’t work, so we should allow the marketplace to determine the interest rate that is paid to lenders. At the same time, however, someone more amenable to government intervention could easily conclude: aha, this system of setting payments for private lenders is fundamentally flawed, we might as well have the government make the loans itself (as the Obama administration has proposed).

The direct loan approach would certainly eliminate the Goldilocks question of whether private lenders are being paid too much, too little, or just enough. But a full comparison of the two programs should consider many other factors, e.g., budget costs and the relative capability of private lenders and the government in making loans and managing loan portfolios. I will leave such a comparison for another day. For now, my point is simply to suggest this might be an interesting example for other micro classes.

Note: I have, of course, skimmed over some pesky details of how this works in the real world.

First, I chose to present this as a situation in which the government is trying to set the “right” price, but sometimes makes errors. Of course, one could also portray this as a situation in which interest groups compete to influence the payment rates. In that case, the payments are the result of a political process in which charging the “right” price is only one consideration. (That changes the story, but not the underlying microeconomic message.)

Second, one could argue that the private loan market wouldn’t have worked in the depths of the financial crisis even if market forces were in full force. After all, many other financial markets seized up at the same time, without any government price-setting. Fair point. However, the fact of government price-setting meant that the payment rates couldn’t move up at all to address even part of the crisis. Even if market forces alone couldn’t have avoided the entire crisis, the absence of those forces made the crisis more severe (until the government stepped in with plan B).