

STRAIGHT TALK ON STUDENT LOANS *

2004

Robert Shireman †

Visiting Scholar, Center for Studies in Higher Education, UC Berkeley
Director, The Institute for College Access and Success (TICAS)

Copyright 2004 Robert Shireman, all rights reserved.

ABSTRACT

The federal government provides student loans for college and graduate school in two ways: by guaranteeing bank loans, and by lending directly to students. In the guaranteed loan program, banks lend students money and profit from the interest payments while the government guarantees the loans against default and makes subsidy payments to the banks. In the direct loan system, the government provides low-interest loans directly to students, using borrower interest payments to help cover the costs of the program. There have been numerous audits and investigations of both the direct and guaranteed student loan programs, and in every case the auditors have agreed: Direct lending is *much* more cost effective. Switching completely to direct lending would save billions of dollars a year. Congress should move all campuses to direct lending and turn the savings over to colleges and states for programs that ensure that all Americans have access to higher education.

The federal government provides student loans for college and graduate school in two ways: by guaranteeing bank loans, and by lending directly to students. Approximately three-quarters of federal student loans are guaranteed and one-quarter are direct. In the guaranteed loan program, a 40-year-old system, banks lend students money and profit from the interest payments while the government guarantees the loans against default and makes subsidy payments to the banks. In the direct loan system, which President William J. Clinton proposed in 1993, middlemen are cut out of the system. The government provides low-interest loans directly to students, using borrower interest payments to help cover the costs of the program.

* A version of this paper has also been made available online by the Progressive Policy Institute at http://www.ppionline.org/documents/studentloans_0914.pdf.

† Robert Shireman is a Visiting Scholar at U.C. Berkeley's Center for Studies in Higher Education, and he directs The Institute for College Access and Success and its StudentLoanWatch project (<http://www.StudentLoanWatch.org>). Shireman served as an education advisor at the White House National Economic Council during the Clinton Administration.

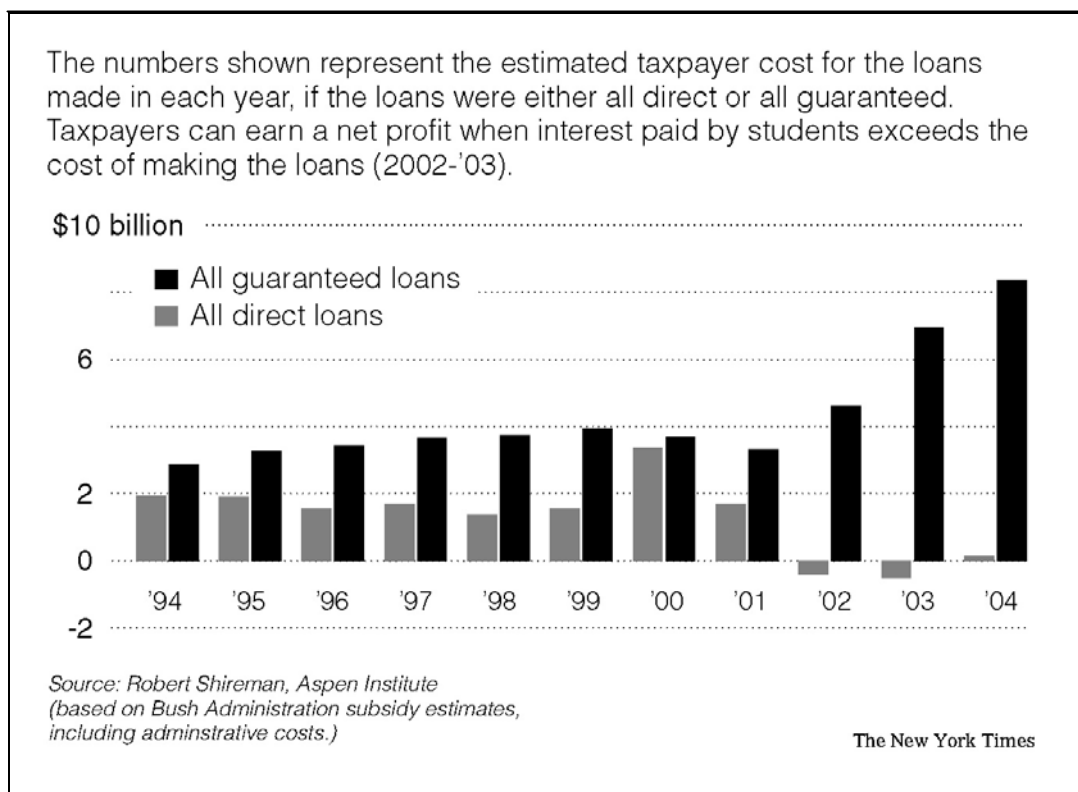
In the 10 years since the beginning of Clinton's initiative, there have been numerous audits and investigations of both the direct and guaranteed student loan programs, and in every case the auditors have agreed: Direct lending is more cost effective. *Much* more cost effective.

The General Accounting Office (GAO), the Congressional Budget Office (CBO), and the Office of Management and Budget (OMB) have all found that switching completely to direct lending would save billions of dollars a year. Following their lead, President George W. Bush's latest budget tells Congress that the guaranteed student loan program is structurally flawed, with "unnecessary subsidies" and "inefficiencies." The president's budget concludes: "Significantly lower Direct Loan subsidy rates call into question the cost effectiveness of the [guaranteed student loan] program structure, including the appropriate level of lender subsidies."¹

As analysts from across the political spectrum have pointed out, the money that would be saved by reforming the student loan program could be used to help more students.² Over the past few years, the money wasted on guaranteed loans would have been enough to fully fund the No Child Left Behind Act, or to give every low-income college student an extra \$4,000 in grant aid. In fact, each day, more than \$15 million is wasted that could help a deserving student pay for college.

Recommendations

Congress should take action now, before more money is wasted. It should insist that the student loan industry offer up a system that is as cost-effective as direct lending. If the industry can't deliver, Congress should completely replace the guarantee system with direct lending and capture those savings for the benefit of American families who are struggling to afford higher education.



The Politics: Smoke Screens and Ghost Stories

Standing in the way of significant student loan reform have been some conservative House Republicans who lean on a bogus depiction of the guaranteed loan program as a market-based system, which it is not. It is, instead, the worst type of government program in which payments to banks and middlemen are determined by Capitol Hill rather than through a competitive process.

While detractors like to portray direct loans as more of a “government” program, both guaranteed and direct loans use private-sector companies to collect on the loans. (In fact, the direct loan program uses some of the same contractors as the banks.) The difference is that in the guarantee program, we pay the banks a politically determined premium for having provided the capital—the same private-sector capital that the federal government can get at lower rates through highly efficient, market-based Treasury auctions.

Defenders of guaranteed loans claim that direct loans only *appear* cheaper because of “accounting procedures.” But the procedures that they object to are the same ones that, as GAO says, “more accurately measure the government’s cost of federal loan programs” and “permit better cost comparisons among and between credit programs.”³ Critics of direct loans offer no alternative accounting methods, but instead tell stories of “hidden costs ... that exist but don’t show up on the federal government’s balance sheet.”⁴ These are ghost stories. But they have nonetheless succeeded in sowing confusion, leading to inaction that allows continuation of the wasteful *status quo*.

Not all Republicans are fans of the guarantee program. One of the longest-serving Republicans on the education panel in the House is Tom Petri (R-Wisc.). After studying the guaranteed loan program, he found that despite the initial impression that it represents a private-sector approach, it is in fact so flawed that “no fiscal conservative or free-market supporter could justify embracing it.”⁵ He says his colleagues who support guaranteed loans have been sold a bill of goods by the student loan industry.

Why Direct Student Loans Are a Better Deal for Taxpayers

Whether the loans are direct or guaranteed, the amount students can borrow and the fees and interest rates they are charged are essentially the same. The rate at which students default on their loan payments is also similar: 5.4 percent in the guarantee program versus 5.2 percent in the direct program. The major differences are in how the loans reach students, and how the providers and collectors are paid.

In the guaranteed loan program, the government gives the student-paid interest income to the lenders, but puts all of the risks on the shoulders of taxpayers (such as the costs of defaults and the costs associated with rising interest rates). In the direct program, the government still bears the risks but it is able to cover some of the expenses with the interest paid by borrowers. This is the biggest reason that direct student loans are cheaper.

The other major factor is the numerous middlemen who take mark-ups in the guarantee program. First among them are the banks. When we as taxpayers pay a student’s interest while they are in school, we pay the bank its borrowing costs plus a bonus on top of that. When a loan is made directly by taxpayers through the government, the cost of the in-

school subsidy to students is limited to the Treasury’s borrowing costs on the open market, with no bonus required.

There are other middlemen, too. When a loan is fully backed by the government, the bank has little financial incentive to put resources into aggressively collecting the payments because the government will pay off any defaults. So, to ensure that lenders do their collection job, the federal government subsidizes 36 agencies across the country to police the lenders—employing thousands of people at the expense of students and taxpayers. These agencies are not needed in a direct loan program, because the collection is done through a performance-based competitive contract.

After all of these costs are considered, a direct loan costs the government far less than the *same* loan made through the guarantee program. Using figures from the most recent federal budget , here is what the cost comparison looks like for one type of federal student loan:

Taxpayer Cost for \$10,000 in Subsidized Stafford Loans
(net present value, same cost to students whether direct or guaranteed)

Type of Loan		Subsidies		Admin costs		Total
Guaranteed	=	Subsidy costs of 16.37% (in-school interest subsidies + bank interest subsidies + defaults + guaranty agency subsidies – fees paid by borrowers & lenders)	+	Federal administrative costs of 0.69%	=	\$1,706 total cost
Direct	=	Subsidy costs of 3.05% (in-school interest subsidies + interest paid to Treasury + defaults – fees & interest paid by borrowers)	+	Federal administrative costs of 1.45% (includes loan collection & servicing)	=	\$ 450 total cost

Source: Subsidy rates from the Budget of the United States Government, 2005
(Credit Supplement: http://www.whitehouse.gov/omb/budget/fy2005/pdf/cr_supp.pdf).
Administrative costs from U.S. Department of Education.

Student loans are unique. This same analysis would *not* apply to, say, home loans. With houses, private lenders play a critical role in determining who is a credit-worthy borrower, and what the appropriate loan amount is for the asset that is being purchased with the loan proceeds. The financial risk of being wrong causes lenders to take seriously the job of allocating loan capital efficiently. But in the federal student loan program, there is a single process for determining eligibility for college aid from the Department of Education and other federal agencies. When private lenders are involved in the student loan program, they get paid but add no economic value to the process beyond the provision of capital—a role the federal government plays quite efficiently.

A Brief History of Student Loans

When Congress started guaranteeing student loans in 1965, it was an economist's nightmare and a politician's dream come true. For Congress, placing the full faith and credit of the United States behind a bank loan appeared to have no cost at all, because the defaults and interest subsidies would occur in later years and thus would be someone else's problem. Economists cried foul, concerned that financial commitments were being made without accounting for the ultimate costs.

In 1990, the economists' concerns were addressed. With President George H.W. Bush's signature on the Credit Reform Act, all government loan programs—whether guarantees of commercial loans, or loans made directly from a federal agency—had to account for their full long-term expenses and income. Every loan program now has an estimated “subsidy cost”—put simply, the amount of money that needs to be set aside when the loan is made in order to cover the loan's costs to the government over the life of the loan. The GAO explains that the old approach “distorted costs and did not recognize the economic reality of the transactions,” while the new approach “provides transparency regarding the government's total estimated subsidy costs rather than recognizing these costs sporadically on a cash basis over several years as payments are made and receipts are collected.” This more rational approach changed the nature of policy discussions on Capitol Hill. Student loans were among the first programs to be affected.

Federal student loans had originally been direct loans, following a recommendation of the economist Milton Friedman in the 1950s. But when Congress in 1965 wanted to expand on that start, the irrational budget rules of the time got in the way: A guaranteed loan appeared to cost nothing, and a direct loan showed up in the budget as a total loss in the year it was made, even though most of it would be paid back with interest. But now, after the 1990 budget reforms, the equation changed.

Congress, prompted by a memo leaked from the Bush administration that indicated direct loans would be less costly and simpler to administer than guaranteed loans, responded by creating a pilot program of direct student loans. The next year, as newly elected President Clinton focused on erasing the budget deficit, estimates showed that the direct loan program would deliver the same loans to students at a much lower cost to taxpayers than guaranteed loans. So Clinton proposed replacing the guarantee program with the new direct approach.

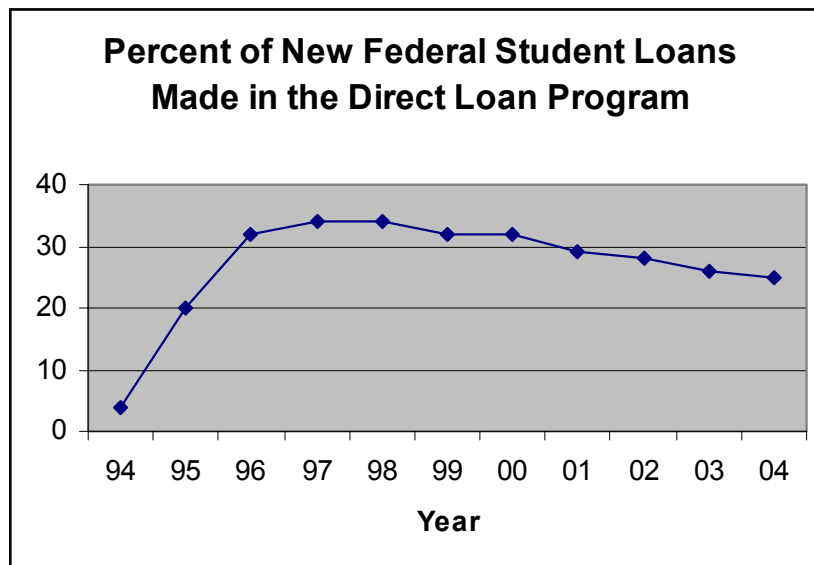
Student Loan Reform Efforts: 1993 to Present

Responding to President Clinton's proposal in 1993, Congress went part way toward replacing the guarantee program, phasing in direct lending first with colleges that volunteered to participate, and giving the Secretary of Education the power, if necessary, to require colleges to switch until at least 60 percent of the loans nationwide were direct. While the law called for direct lending to replace guaranteed loans, it was silent about what would happen beyond the 60-percent mark, since that was outside of the five-year window covered by the budget.

When the Republicans took over Congress the next year, the new leadership targeted direct lending for elimination. But they did not anticipate the enormous support that the new approach would have from colleges and universities. The reality was that many college officials couldn't stand the guaranteed loan system, because it forced financial aid administrators to deal with what the GAO labeled a “complicated, cumbersome process,” disconnected from other federal aid and involving thousands of middlemen. College and

university officials were cautiously optimistic about a direct loan program that would operate in tandem with the other federal aid programs. So even with the election in 1994 of a Republican Congress that was hostile to it, the direct loan program took off with the enthusiastic participation of hundreds of colleges and universities.

Instead of eliminating the new program, the Republicans demanded that the Department of Education stop encouraging or requiring colleges to switch. The new mantra was college choice: Universities would choose to participate in one program or the other. But the trick was that the banks and middlemen could use all of their money and people to coax and cajole, while the Secretary of Education had both hands tied behind his back by the Republican Congress. Not surprisingly, campus participation in the Direct Loan Program has dropped. (See *chart*.)



Multiple ways of delivering a government benefit may be a good idea in some circumstances. But in this case duplication is costly, and not only in terms of money. From a management standpoint, GAO says it is ineffective for the government to run two loan programs. In a series of reports on “high-risk” government programs, the auditors said the existence of two competing loan programs leads to “a fragmented operating environment in which two different groups of students, schools, lenders, Department administrators, and other entities participate in two mostly similar programs.”⁶

College financial aid administrators like the idea of two loan programs, because they have seen how the more streamlined direct loan program has forced the industry to improve the operation of the complicated guarantee system. For example, lenders and middlemen used to have separate forms, data formats, and processes, imposing huge burdens on college staff members to keep it all straight. Because of direct lending, the industry was forced to standardize and improve their systems for approving loans. But this competitive dynamic comes at an extremely high price. Would financial aid administrators opt for keeping the guarantee program if they saw it as standing in the way of a \$10 billion increase in financial aid for low-income students? That is the real choice that Congress faces, and it should be an easy choice to make. Students should come first.

Federal Reserve Chairman Alan Greenspan recently warned that the strength of the American economy depends on the education level of our people:

[O]ur system of higher education bears an important responsibility for ensuring that our workforce is prepared for the demands of economic change. America's reputation as the world's leader in higher education is grounded in the ability of these versatile institutions to serve the practical needs of the economy by teaching and training and, more significantly, by unleashing the creative thinking that moves our economy forward.⁷

As a nation, we cannot afford to waste the potential of deserving young people. Congress should move all campuses to direct lending—or to an equally efficient guarantee approach if one can be designed—and turn the savings over to colleges and states for programs that ensure that all American families, regardless of background, have access to higher education.

¹ President Bush's FY 2005 budget submission to Congress is unequivocal. It says that there are "unnecessary subsidies" and that, "Significantly lower Direct Loan subsidy rates call into question the cost effectiveness of the FFEL program structure, including the appropriate level of lender subsidies." (<http://www.whitehouse.gov/omb/budget/fy2005/pma/education.pdf>, page 34). The actual subsidy rates for the two programs can be found in the Credit Supplement of the budget (http://www.whitehouse.gov/omb/budget/fy2005/pdf/cr_supp.pdf, pages 2 and 4). GAO, the accounting arm of Congress, was the first to suggest direct lending as a big money-saver with two reports in the early 1990s. More recent reports confirm those predictions. For example, in a March 2004 report, GAO found that consolidation loans in the direct loan program brought a "net gain to the government" of more than \$1 billion in 2002-3. In contrast, with the guarantee program, taxpayers suffered a net loss of more than \$2.7 billion ("Student Loan Programs: Lower Interest Rates and Higher Loan Volume Have Increased Federal Consolidation Loan Costs," March 17, 2004, GAO-04-568T at www.gao.gov, pages 7 and 9). Meanwhile, in a 2003 presentation to congressional staff, CBO concluded, "Under any apples-to-apples comparison the federal government will place a higher value on these assets [student loans] than would private sector investors." Congressional staffers indicate that CBO's current cost estimates continue to show direct lending as a significant money-saver. *U.S. News & World Report* investigative reporters reviewed federal data and concluded that "the FFEL plan costs the treasury far more than direct loans, even after deducting administrative costs" ("Big Money on Campus: How Taxpayers are Getting Scammed by Student Loans," by Megan Barnett, Julian E. Barnes, and Danielle Knight, *U.S. News & World Report*, October 27, 2003).

² The Heritage Foundation, *A Budget for America*, 2001.

³ GAO-04-101, "Student Loan Programs: As Federal Costs of Loan Consolidation Rise, Other Options Should Be Considered," October 2003.

⁴ "Dear Colleague" letter from John Boehner, Chairman, Education and the Workforce Committee, and Howard P. "Buck" McKeon, Chairman, 21st Century Competitiveness Subcommittee, May 20, 2004.

⁵ "Putting Students First," by Thomas E. Petri, *New York Times*, June 14, 2004.

⁶ GAO/HR-97-11, *Student Financial Aid*, High-Risk Series, February 1997.

⁷ Remarks at the Boston College Finance Conference, Boston, Massachusetts, March 12, 2004.