Dr. Dave: The President's budget adds money to the Pell grant program, but cuts money for student loans. On balance, do students win? Do the states have a role in this?

A. The President proposed adding money to the Pell Grant program, which was running a deficit, by eliminating Perkins Loans.

The Perkins Loan is a fixed, low-interest loan. The federal government contributed $7 billion toward Perkins Loans in 2004. About $1.2 billion of this was new money; the rest comes from repayment of outstanding loans. The program is helpful, but modestly used. About 3 percent of students take out Perkins Loans, about 673,000 students nationwide. The number of schools participating in the program has declined over the last 20 years. And recently, standard student loan interest rates have been lower than the 5 percent fixed rate for Perkins Loans.

The President does propose to expand funding for Pell grants, the major federal student grant program. But only slightly, from $13 billion in 2004 to $13.5 billion in 2006. This will add $100 to the current maximum award of $4,050.[1]

The key here is not what the President is proposing, but what he isn't proposing. He isn't planning to change the way the major existing federal student loan programs operate. And that is where the real money is, and where the potential for generating major new student aid money lies.

Eliminating another loan program, the government-guaranteed loan program, could increase Pell Grants by three times as much as the White House budget proposes.

Here's the story.[2] Overall, college students borrowed $56.7 billion from the federal government in 2003-2004, up from $22.6 billion ten years ago. The increase has come from more students borrowing, not from individuals borrowing larger amounts, because annual loan limits have not changed since 1986. Yet over this period, average public college tuition has doubled, reducing the coverage of the average student loan to only a quarter of the cost of attendance.[3]

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[1] Budget of the United States Government, Fiscal Year 2006, Office of Management and Budget. Perkins Loans are eliminated entirely in the proposed 2006 budget. Pell Grants are increased by less than the amount of federal capital contributions to Perkins Loans. Since the overall student aid budget is reduced, it is not clear where money from student repayments on outstanding loans will be directed.

[2] For a fuller discussion and to track recent developments, the best single source is Robert Shireman, director of The Institute for College Access and Success, founder of Student Loan Watch, and congressional appointee to the Federal Advisory Committee on Student Financial Assistance. Mr. Shireman is also an advisor to the Aspen Institute, and was a senior policy advisor to President Clinton.

[3] *Wall Street Journal*, February 2, 2005. First year undergraduate students can borrow $2625. The loan amount increases to $5500 for students in their third through fifth years of undergraduate. Independent students (who are not claimed as dependents by parents) can borrow more: $6625 in the first year and $10,500 in later years. U.S. Department of Education, Federal Student Aid.

Most student loans are Stafford or PLUS (for parents). Stafford loans can be either subsidized, meaning no interest is charged while the student is in school full-time, or unsubsidized.

Two parallel government systems provide these loans. In one, Federal Direct Student Loans (FDSL), the federal government loans money to students through their colleges. The money comes from Treasury bonds.

In the other program, Federal Family Education Loans (FFEL, formerly called Guaranteed Student Loans[4]), private lenders loan money to students, through their colleges and a state or nonprofit guarantee agency.

From the student's perspective, the two systems seem almost identical. But from the taxpayer's perspective they are quite different.

In the direct loan program, the Department of Education lends the money, manages the program, collects the interest on the loan, contracts with collection agencies when necessary, and assumes the risk of default. In the guaranteed loan program, the state or nonprofit intermediary (called a "guaranty agency") contracts with private lenders, which provide loans and keep the interest on repayment. If a loan goes into default, the intermediary pays the bank. The federal government pays fees to the intermediaries for administering the loans, fees for avoiding default, and a percentage of recovered payments on defaulted loans. For loans that remain in default, however, the federal government reimburses the agency for 98 percent of the cost.

It's complicated, but the gist is that in the FFEL program, banks collect interest from students, and intermediaries collect fees from the federal government, but the federal government assumes all the risk.

In the beginning, federal student loans were direct loans, following a recommendation of conservative economist Milton Friedman. Then in 1965 the system foundered on the shoals of Congressional budget rules. Direct loans showed up as a debit against the current year's budget, even though the loan would be paid back with interest. Government guarantees for loans did not add to the current year's deficit.[5]

To reduce a federal deficit that was growing as the Vietnam War expanded, Congress replaced direct loans with the Guaranteed Student Loan program.

The 1965 federal program tried sharing the risk of default with state and nonprofit "guaranty agencies" that managed the loans. That didn't work. So Congress changed the program to one in which the federal government assumed virtually all the risk.

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[4] "Guaranteed" refers not to the fact that students are guaranteed a loan, although most are, but to the role the government plays as a guarantor, promising to pay the lender if the borrower defaults.
[5] Although defaults would be debited against future budgets.

The 1976 Tax Reform Act encouraged states to issue tax-exempt student loan bonds to make money available for all eligible students. High interest rates at the time meant that states were issuing bonds at 6 percent interest and earning 16 percent interest on student loans, far more profit than Congress intended to build into the program. In 1980 Congress attempted to fix this, but states complained that if interest rates dropped too low, interest income from student loans would not cover the cost of the bonds. That was the year that interest rates on bonds soared into the double digits. The final legislation capped the maximum return lenders could earn, but guaranteed them a minimum return of 9.5 percent.[6]

As interest rates plunged, the government found itself making subsidy payments to ensure lenders the minimum return of 9.5 percent. By 2004, interest rates on student loans had dropped to 3.5 percent. Lenders were receiving subsidies of around 6 percent.[7]

The 1990 Credit Reform Act sought to correct the flaw in the budgeting process that had led Congress to switch from direct loans to guaranteed loans in 1965 by requiring government loan programs to show a "subsidy cost"; that is, how much the loan will cost the government over the life of the loan.[8]

In 1993, Congress created a direct loan program. It was run initially by colleges that volunteered to participate, but was expected to eventually replace the guaranteed loan program.[9] But in 1995, the newly Republican House of Representatives demanded that the Department of Education stop the phase-in of direct loans. The compromise reached was "choice"; colleges could choose the program they wanted to participate in.

But colleges and states had an incentive to choose the guaranteed loan program since they would gain a portion of the bank's profits from the loans. The amount isn't great – California expects to earn up to $30 million next year – but for the 23 state agencies that benefit from the program, it is found money.[10]

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[6] James Kvaal and Robert Shireman, *Money for Nothing*, The Institute for College Access and Success, August 2004.
[7] *Ibid.*
[8] This calculation includes fees paid to guaranty agencies, including payments to close the gap between prevailing interest rates and the 9.5 percent guaranteed return, and projections for default risks.
[9] As part of the 1993 legislation reintroducing direct loans, Congress eliminated the 9.5 percent guarantee for all student loans financed with new bonds. But it kept the 1980 formula for loans financed with existing bonds. It was discovered in 2004 that lenders used accounting tricks to prolong the lives of their pre-1993 bonds, so the government continues to pay many private lenders the difference between their 9.5 percent guaranteed rate of return and the prevailing interest rates in the neighborhood of 4 percent. The Department of Education looked the other way, even when one lender sent a letter (with a flow chart, for clarification) asking for confirmation that its actions were legal *See* James Kvaal and Robert Shireman, *Money for Nothing*, The Institute for College Access and Success, August
[10] Robert Shireman, "Corporate Welfare in Disguise," *National Crosstalk*, Winter 2005.

Private lenders, too, love the guaranteed loan program. They earn interest on loans that are, for them, risk free. And for some of these lenders, student loan profits have been much higher than prevailing interest rates.

Every audit and investigation of the two loan programs has found direct loans to be more cost-effective, a conclusion that agrees with common sense. This includes the White House Office of Management and Budget, the Government Accountability Office, the Congressional Budget Office, and U.S. News and World Report.[11]

In 1998 the direct loan program hit its peak, accounting for about one third of all federal student college loans. By 2004 this had fallen to about one-quarter.

The President's recent budget shows that from 1992 to 2004, the subsidy cost of FDSL was $3 billion on $146 billion in loans. The subsidy costs for FFEL was $39 billion on $413 billion in loans.[12]

In other words, the federal direct loan program loaned $48 to students for every $1 cost to the federal government. The government-guaranteed loan program, on the other hand, loaned just $10 for every $1 in subsidies. From 2004 through 2006, the President's budget plans for a taxpayer subsidy on a $1000 guaranteed loan ten times higher than for a direct loan.

The White House estimates that $7.54 billion will go to subsidize lenders for their risk-free role, rather than to student aid, in 2005 alone.[13]

Given the desperate need for more student aid, this enormous subsidy to lenders has come under increasingly bipartisan attack. Republican Congressman Tom Petri of Wisconsin, for example, has declared that despite the perception that the guaranteed loan program is a private sector solution, it is so flawed that "no fiscal conservative or free-market supporter could justify embracing it."

A bi-partisan bill in the House would allow schools that use the direct loan program to keep any savings to the government, and use this money to supplement Pell Grants for its

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[11] *See* Student Loan Watch; U.S. Government Accountability Office, *Student Loan Programs: Lower Interest Rates and Higher Loan Volume Have Increased Federal Consolidation Loan Costs*, GAO-04-568T, March 17, 2004; Megan Barnett, Julian Barnes, and Danielle Knight, "Big Money on Campus," *U.S. News and World Report*, October 27, 2003.
The Association of Student Loan Providers cites in its defense a 2004 GAO study that says the direct loan program has spent $10.7 billion more on interest than it has taken in since it was created in 2003. This is true, but it omits GAO's explanation: "This is primarily because Education is required to make interest payments to Treasury, even if borrowers are not making interest payments to Education, which could occur when borrowers are in school or in a grace or deferment period." GAO-04-567R, *Op. Cit*.
[12] Budget of the United States Government, Fiscal Year 2006, Office of Management and Budget. Page 371.
[13] Student Loan Watch, February 9, 2005.

students. A Congressional Budget Office Analysis finds the bill would add at least $12 billion, and as much as $60 billion, to Pell Grants over the next decade at no expense to taxpayers.[14] This is between 3 times and 10 times the expansion of the grant program proposed by the President.

[14] The low number assumes just 40 percent of loans are direct loans. The higher number assumes all government guaranteed loans are eliminated. U.S. House of Representatives News Release, January 12, 2005.