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Student Loans in Bush's Budget:

Government Will Continue to Pay Billions to Banks

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Progressive Ideas for a Strong, Just, and Free America

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President Bush's budget for Fiscal Year 2007 will direct approximately $8 billion in net subsidies to private student lenders next year through the government-guaranteed loan program—even though taxpayers will subsidize that program at a rate nearly 4.5 times higher than that of direct loans in 2007, according to the President's own budget. If 100 percent of loans were disbursed through the direct loan program, the savings could be redirected to the Pell Grant Program to provide up to 1.5 million new grants to students.[1] The figures released today from the White House's Office of Management and Budget (OMB) confirm past findings of both the Congressional Budget Office (CBO) and the Government Accountability Office (GAO) that the guaranteed-government loan program is significantly more costly to taxpayers than the direct loan program.

The government-guaranteed loan program, formally known as the Federal Family Education Loan (FFEL) program, currently accounts for approximately 77 percent of the total volume of student loans. The William D. Ford Direct Loan Program currently comprises the remaining 23 percent of the total volume of student loans. The competing loan programs offer essentially the same products to students. However, under government-guaranteed loans, the government makes significant payments to private lenders to cover or subsidize interest and to shield the lenders from the risks of default.

Although the administration claims to have "worked to improve the way the loan programs perform,"[2] projections in the President's budget for 2006 and 2007 do not indicate that his administration anticipates substantial changes in the relative efficiencies of the two loan programs, nor does it anticipate shifting the loan volume in favor of the more efficient direct loan program.

Key Findings from this Report:

- According to figures from the President's new budget, the government pays a subsidy of 11.0 percent on guaranteed loans, while it pays a subsidy of only 3.65 percent on direct loans – a difference of 7.36 percentage points. For every $100 lent, taxpayers spend more than $7 more on guaranteed loans than they do on direct loans.

- The government could have saved $37 billion between 1992 and 2005, had 100 percent of the student loan volume been disbursed through the direct loan program. Recovered funding could have then been reallocated to the Pell Grant Program to issue additional support for college attendance. For funds lent in 2007 alone, close to $6 billion would be saved if loans were made exclusively through the direct loan program.

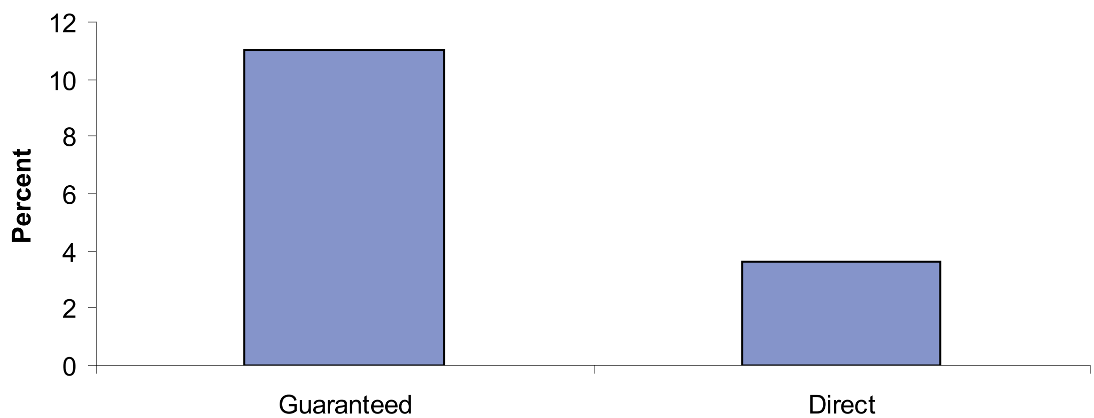
- The student loan industry has benefited from the use of federally subsidized student loans and has become highly profitable as a result. In turn, many of the largest private lenders have made significant financial campaign contributions. The largest private student loan lender disbursed more than $900,000 to campaign funds in this most recent cycle.

Assessing the Costs of Competing Programs

The President's current budget estimates that in fiscal year 2005, the government paid a subsidy of 16.9 percent on guaranteed loans, while paying a subsidy of 3.1 percent on direct loans.[3] In 2005, taxpayers paid close to $14 more on $100 lent through the government-guaranteed loan program than they did through the direct loan program.

To ensure that costs are measured over time and not solely in one particular year or given time period, the Credit Reform Act of 1990 requires that costs of existing loans be re-estimated in order to reflect actual, as opposed to projected, borrower behavior and interest rates. With this adjusted measure, the average lifetime (1992-2005) subsidy rate for outstanding government-guaranteed loans is 11.0 percent compared to 3.65 percent for direct loans, echoing the yearly results (see figure 1).

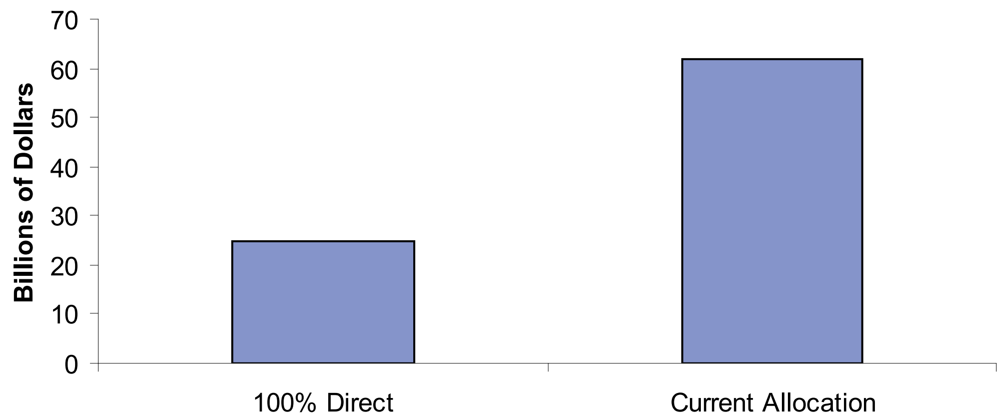
Figure 1: Average Government Lifetime Subsidy Rates, 1992-2005



Source: Budget of the U.S. Government, FY2007, Appendix, p. 367

From 1992 to 2005, $681 billion have been disbursed through both student loan programs ($508 billion through guaranteed, $173 billion through direct), with a total subsidy cost to the government of $62 billion. Had 100 percent of loans during that same time period been disbursed through the direct loan program, the total subsidy cost to the government would have been roughly $25 billion with a savings to taxpayers of $37 billion (see figure 2).

Figure 2: Student Loan Cost Under Alternative Allocations, 1992-2005



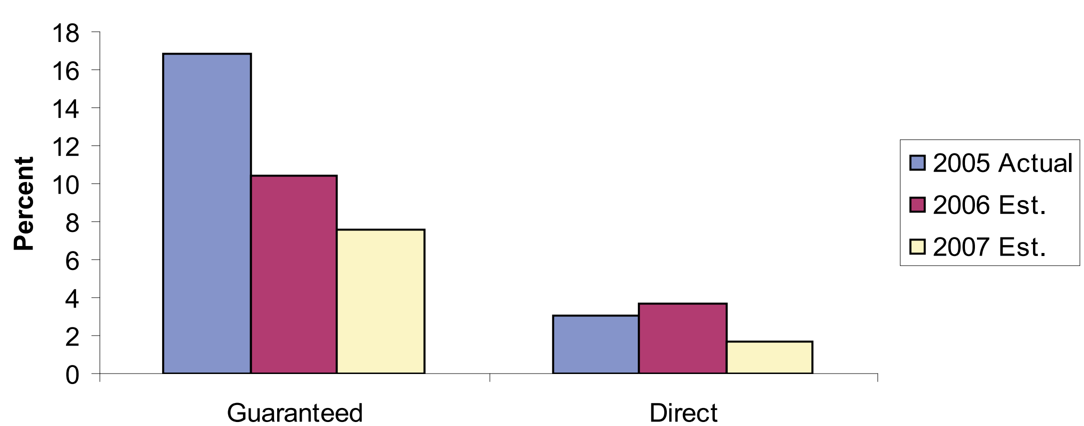
Source: Budget of the U.S. Government, FY2007, Appendix p. 367

President's Budget Continues Inefficient Allocation of Student Loan Funds

Figures from the President's budget indicate that the administration anticipates that direct loans will remain far less expensive. Similarly, it anticipates little change in the allocation of loan funds to the two programs.

In 2006, the President's current budget estimates a subsidy rate on government-guaranteed loans of 10.7 percent and on direct loans of 3.67 percent. For 2007, the budget estimates subsidy rates of 7.59 percent on government-guaranteed loans and 1.70 percent on direct loans (see figure 3).

Figure 3: Subsidy Rates, 2005-2007



Source: Budget of the U.S. Government, FY 2007, Appendix p. 367

Who Stands to Benefit from the Government-Guaranteed Loan Program?

As discussed in the report, both the government-guaranteed loan program and the direct loan program offer essentially the same loan products to students. As far as the student borrower is concerned, neither loan offers a greater benefit or a better product. Further, since taxpayers incur a substantially greater cost on loans disbursed through the government-guaranteed loan program, increases in loan volume through that program will increase costs to taxpayers as well relative to the direct loan program.

The private student loan industry, however, has benefited greatly from the great volume of loans disbursed through the government-guaranteed loan program. Private companies receive payments from the government in the form of interest rate subsidies, and are also protected from the risks of default and loss. Guaranteed student loans have served as a risk-free investment for these lenders with regularly high returns and profit margins.

The Student Loan Marketing Association (SLM), commonly referred to as Sallie Mae, was originally established in 1972 as a government-sponsored organization with the original intent to create a secondary market for student loans. Having since privatized, it is now the largest private holder of student loans and a highly profitable Fortune 500 company with over $1.9 billion in profits in 2004.[A]

The private student loan industry has also actively engaged in the political process both in and out of the campaign cycle. In this most recent election cycle, the Sallie Mae Political Action Committee donated a total of $954,704.[B]

Many of its contributions have targeted powerful members of both the House and Senate Education Committees. For example, in the 2003-2004 election cycle, Rep. John A. Boehner (R-OH), Chairman of the House Committee on Education and the Workforce, received over $100,000 from officials of Sallie Mae. [C] Representative Boehner's political action committee, the Freedom Project, received $292,570 from both employees and lobbyists of the private student lending industry and for-profit academic institutions – these donations constitute more than half of the $572,719 that the PAC received in this last cycle.

While it is always difficult to measure whether financial contributions have an impact on legislative priorities and judgment, Rep. Boehner has denied the consensus of the OMB, CBO, and GAO regarding the costs of the two programs, asserting during floor debate that "the idea that the federal government can provide [student loans] cheaper than the private sector is, on its face, not possible."

[A] "Fortune 500, 2005: SLM," CNNMoney.com, available at http://money.cnn.com/magazines/fortune/fortune500/snapshots/1227.html

[B] Federal Election Commission, Committee Summary Reports.

[C] "Representative Boehner's links to student-loan giant could complicate his climb up Capitol Hill," Chronicle of Higher Education, January 27, 2006.

[D] Thomas B. Edsall, "Controversial Industries Have Backed Boehner," The Washington Post, January 29, 2006, A05.

[E] Stephen Burd and Kelly Field, "House Panel Approves $15-Billion Cut in Student-Loan Programs," Chronicle of Higher Education, November 4, 2005.

Funding levels from the President's budget also indicate that the administration does not intend to encourage schools to shift loan volume in favor of the more efficient direct loan program – estimated allocations remain flat at 77 percent for government-guaranteed loans and 23 percent for direct loans.

Loan Products are the Same, but Costs Differ Drastically

As far as the borrower is concerned, the government-guaranteed loan program and the direct loan program offer virtually the same loan products – subsidized and unsubsidized Stafford Loans to students and Parent Loans for Undergraduate Students (PLUS). While there are slight differences in origination fees and repayment options between the two loan programs, both offer the same interest rates, interest rate subsidy periods, and deferral options to borrowers.[4]

As far as the government is concerned, the two loan programs incur substantially different costs. Under the government-guaranteed loan program, borrowers obtain loans through private lenders. The government pays a varying portion of the interest received by the private lender and also shields the lender from the risks of loss due to default. Under the direct loan program, borrowers obtain loans directly from the government. The government raises capital in the bond markets, makes the initial disbursement of the loan through a performance-based contract, and is then the recipient of all payments of interest and principal.

The net result is that loans administered under the government-guaranteed loan program are far more costly than loans administered under the direct loan program.

CBO Accounts for Differences in Costs and Offers Estimates for Subsidy Rates

As the President's 2006 budget explained, "the Federal Government assumes almost all of the risk for the [guaranteed student] loans, while Federal subsidies to intermediaries—lenders and guaranty agencies—are set high enough to allow the less efficient ones to generate a profit. These problems lead to unnecessary costs for taxpayers and prevent the program from achieving the efficiencies the market is designed to provide."[5]

A 2005 report released by the non-partisan Congressional Budget Office (CBO) attributed close to half of this substantial difference in subsidy rates to the fact that under the government-guaranteed loan program, the government makes various payments to private lenders over the life of a loan – providing either the entire interest payment to the lender or making up the difference between the subsidized interest rate paid by the borrower and the guaranteed interest rate received by the lender. The source of the other half of the differential comes largely from the difference between the borrower's interest rate and the rate the government must pay on the capital – in the direct loan program, the government receives the interest payments, thus there is a net gain to the government for outstanding capital for non-defaulted loans.[6]

According to the CBO estimates, the subsidy rate for government-guaranteed loans was 15 percent, while the subsidy rate for direct loans was estimated at -2 percent.[7]

Impact of FY2006 Budget Reconciliation

The FY2006 Budget Reconciliation, passed in the House on February 2, 2006, provided for a number of changes to the Federal Student Loan programs – including adjustments to formulas on lender yields, borrower interests rates, insurance rates, and various fees. These provisions will produce a reported net $12.7 billion in savings from 2006 to 2010.[8] However, these savings were not reinvested in other programs to provide access to higher education, and any budgetary savings would be more than offset with higher revenue costs elsewhere in the budget if a pending companion tax reconciliation package were to pass.

Budget is Not Effectively Meeting Stated Presidential Goals

The President's 2006 budget stated a goal of providing greater benefits to students. For the student loan program, meeting presidential goals required "reforming the student loan programs by reducing unnecessary subsidies to lenders and other financial intermediaries, and redirecting these funds to the Pell Grant program to help low income students pay for college."[9]

The Pell Grant Program offers financial aid to students based on documented need. Unlike loans disbursed via the student loan program, the grant of aid does not need to be repaid – thereby freeing the student of additional financial burdens upon graduation.

As figures in the President's budget show, if all loans in 2007 were provided through the direct loan program, the government would achieve a savings of approximately $5.6 billion.[10] These savings could then be passed on to produce up to 1.5 million more grants under the Pell Grant Program, providing greater long-term relief to low-income students and families.

As the President states in his FY2007 budget, "Federal dollars must be spent wisely or not at all."[11] The government could provide a far greater benefit to students if lending were shifted to direct loans. By not doing so, the President's budget fails to deliver potential efficiency gains.

Endnotes

[1] Calculations based on the maximum grant of $4,050.
[2] Budget of the U.S. Government, FY2007, p. 83.
[3] "Federal budgeting for student loans and other credit programs reflects the net effect of all future cash payments to and from the government related to a year's lending…there is a strong consensus on the general principle of discounting all cash flows relating to a year's lending." (Center on Federal Financial Institutions, "Student Loans: A Budget Primer," November 8, 2005, p. 7).
[4] "Student Loans: A Budget Primer," Center on Federal Financial Institutions, 2005, p. 5.
[5] Budget of the U.S. Government, FY2006, Appendix, p. 103.
[6] The government must also cover administrative expenses for additional loans. While loan default can also reduce the gain to the government, the federal government must also bear the cost of defaults through the guaranteed loan program as well. On net, the direct loan program is significantly less costly, as described above.
[7] A negative subsidy rate indicated that taxpayers recoup more than the cost of the loans.
[8] "Student Loans and FY2006 Budget Reconciliation," Congressional Research Service, January 27, 2006.
[9] Budget of the Government of the U.S., FY2006, p. 97.
[10] Author's calculations are based on past average lifetime subsidy rates and current loan commitments and represent the difference between total subsidies in 2007 under current allocations and the estimated subsidy in 2007 under a 100 percent direct loan allocation.
[11] Budget of the Government of the U.S., FY2007, p. 83

About the Authors

Kate Sabatini is the Special Assistant for Economic Policy at the Center for American Progress. Before joining the Center, Kate worked in the Washington office of U.S. Congressman Jim Langevin (D-RI). In addition to serving as the first point of contact for constituents, she tracked legislation and initiatives for the legislative staff and assisted the Rhode Island-based Director of Communications with press releases and events. Prior to her work on the Hill, Kate was an Account Manager for nearly two years at Jager Di Paola Kemp Design in Burlington, VT – a full-service creative firm. She provided account service and brand strategy development for the following clients – Segway, Merrell Performance Footwear, Magic Hat Brewing Company, Robert Hull Fleming Museum, Phish, and Burton Snowboards. Kate is a native of Woodbury, CT and graduated cum laude from Middlebury College with a B.A. in International Studies.

John S. Irons, Ph.D., is the Director of Tax and Budget Policy at The Center for American Progress, where he specializes in federal tax policy, federal budget issues, and the U.S. economy. Prior to joining the Center, he was a Senior Economic Research and Policy Analyst and Staff Economist at OMB Watch, a nonprofit organization dedicated to promoting government accountability and citizen participation. Prior to coming to Washington D.C., Dr. Irons was a tenure-track Assistant Professor of Economics at Amherst College. He came to Washington, D.C. in 2003 to play a more active role in economic policy analysis and advocacy. He has also worked at the Federal Reserve Board of Governors and briefly at the Brookings Institution and the National Bureau of Economic Research. Dr. Irons' academic publications have appeared in several Journals including the Journal of Monetary Economics, Journal of Applied Econometrics, and the Eastern Economic Journal. He is co-editor (with N. Ericsson) of Testing Exogeneity, published by Oxford University Press. He has authored numerous reports and articles on tax and budget policy, as well as on the economy. He has been quoted in numerous national and local print publications and has appeared on TV and radio programs commenting on various economic policy issues. He has been a guest lecturer and has presented research at many colleges and universities including American University, Harvard University, Middlebury College, MIT, University of Missouri, University of Nebraska, and others. Dr. Irons was awarded a National Science Foundation Graduate Fellowship, as well as a Graduate Fellowship from the Harvard/MIT Research Training Group in Positive Political Economy. In addition, he has won several awards for his economics websites, including top-5 awards from The Economist magazine and Forbes. He has been an occasional "econo-blogger" at the Wall Street Journal. He has also served on the board of nonprofit institutions, including the Coalition on Human Needs. Dr. Irons holds a B.A. with High Honors in economics from Swarthmore College, and a Ph.D. in economics from the Massachusetts Institute of Technology.

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