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# TIME TO END COSTLY DIRECT STUDENT LOANS

## INTRODUCTION

The Clinton Administration has portrayed its direct lending program for college students as essential to the educational future of young Americans. Nothing could be further from the truth. The direct government lending program is bad for taxpayers, bad for students, and bad for schools. Later this week, the Senate Labor and Human Resources Committee and the House Economic and Educational Opportunities Committee will consider the statutory changes necessary to achieve the spending targets for the 1996 federal education budget. They could expand, cap, or eliminate the Clinton direct lending program. The best choice for taxpayers, students, and schools would be to end it.

## STUDENT LOAN PROGRAMS

The primary source of student financial aid in America is federally guaranteed student loans. Since it was created in 1965, this program, now known as the Federal Family Education Loan Program (FFEL), has funded 74 million student loans worth over $180 billion.[1] More than six million loans totaling nearly $22 billion were disbursed in FY 1994 alone.[2] Private lenders provide the capital for the loans, and private and state guarantor agencies process them. The federal government subsidizes the interest rate, guarantees the loans in cases of default, and exercises regulatory authority over the program. This relationship, while by no means perfect, has worked relatively well in providing loans to millions of American college and university students.[3]

1 For a review of the loan programs and ways to reform them, see Scott A. Hodge, ed., *Rolling Back Government: A Budget Plan to Rebuild America* (Washington, D.C.: The Heritage Foundation, 1995), pp. 199-204.

2 U.S. Department of Education, *FY 1994 Loan Volume Update*.

3 See C. Ronald Kimberling, "Federal Student Aid: A History and Critical Analysis," in *The Academy in Crisis* (New Brunswick, N.J.: Transaction Publishers, 1995), pp. 69-93.

In 1993, the Clinton Administration proposed replacing this program with direct lending by the federal government, extending a limited pilot program approved in the 1992 Higher Education Act. The Administration claimed this would be more efficient. While schools would administer the program, the federal government would borrow the money necessary to provide capital for the loans and would service and collect the loans itself. This plan would radically change the federal government's three-decade involvement in college lending programs by effecting what Senator Nancy Kassebaum (R-KS) called "a total federal takeover of a successful public-private sector partnership."[4]

Congress initially rejected a full direct lending program, but approved a trial phase-in over at least five years: 5 percent of loan volume in 1994-1995, 40 percent in 1995-1996, 50 percent or more in 1996-1998, and 60 percent or more in 1998-1999. The U.S. Department of Education in July 1994 began making direct loans to 104 schools, representing 5 percent of the loan volume. In a sign that schools are hesitating to participate, the 1995-1996 loan volume will end up at around 28.7 percent—far short of the 40 percent target.[5] The Administration hopes to accelerate the program to reach 100 percent participation in 1997-1998, and is willing to require colleges and universities—including those that object to the program—to participate.[6]

## BAD ECONOMICS

Much of the debate over direct loans turns on the question of cost: Replacing guaranteed loans with direct lending is supposed to save taxpayers billions of dollars. The FY 1996 Clinton budget claims $4.1 billion in savings over the 1996-2000 period if the direct loan program is fully implemented.[7] Recent cost estimates tell a very different story.

☞ **Eliminating the direct loan program saves money.** Prior to 1990, the long-term financing and administrative costs of all student loans were ignored in budget scoring, and direct loan capital outlays were considered current year expenditures. This problem was corrected with the Credit Reform Act of 1990, which required calculation of these long-term costs for guaranteed loans but not for direct loans. When the direct loan program was enacted in 1993, the Congressional Budget Office initially estimated the program could save $4.3 billion over five years.[8] This estimate ignored

4 Senator Nancy Kassebaum, press release, March 3, 1995.

5 "Congressional Review Renews Debate About Direct Lending," *The Chronicle of Higher Education*, April 7, 1995.

6 Statement of the Honorable Bart Gordon, Subcommittee on Oversight and Investigations, Committee on Economic and Educational Opportunities, U.S. House of Representatives, May 23, 1995. Representative Gordon released draft legislation being prepared for this purpose by the Department of Education.

7 "Direct Loan/FFEL Program Cost Update," Office of the Under Secretary, February 1995, p. 7. The Administration claims that its budget saves $12 billion over the 1996-2000 period due to changes in the student loan program. This is misleading: $6.8 billion is a result of the 1993 Student Loan Reform Act, and $1.1 billion is based on the elimination of "more-than-competitive returns" to lenders. Neither is the result of the shift to direct lending.

the long-term costs of direct loans in accordance with the Credit Reform Act. The 1996 Budget Resolution, however, amended the Credit Reform Act to account for the complicated long-term administrative costs of the direct loan program. The revised report of the Congressional Budget Office, released in July and based on these changes in official budget scoring, projects that a fully implemented direct loan program would save just $115 million over the next seven years. Indeed, according to the CBO, eliminating the direct loan program and maintaining the guaranteed program would save $1.5 billion in budget outlays over the next seven years.[9]

☞ **The direct loan program adds considerably to the national debt.** The vast bulk of capital for student loans today is provided by private sources. But under the Clinton plan, the federal government would borrow the money necessary to provide capital for the loans. This would require the federal government to borrow an additional $20 billion-$25 billion each year to provide enough capital for the program. According the Representative Ernest Istook (R-OK) in congressional testimony last spring, a complete shift to direct loans could add $348 billion to the national debt by the year 2014.[10] Two independent analyses in 1993, conducted by leading accounting firms, argued that such amounts of government borrowing could increase interest rates on the public debt. One noted that this would "wipe out the saving claimed for direct lending" and warned lawmakers that they "may be on the verge of making a serious public policy mistake" if they shifted to direct lending.[11]

☞ **Furthermore, the direct loan program is fiscally irresponsible.** A key feature of the Clinton direct loan program is the "income contingent repayment plan" for students. The goal of this plan is to reduce the debt repayment burden on graduates struggling with repayment, thereby also reducing the rate of loan defaults. Instead of a regular monthly installment, repayment is contingent on future income. Students choosing this option, however, could well end up increasing their personal debt by stretching out their repayment period and actually increasing the principal on the loan. Nor will this help the default problem. According to the Congressional Research Service, "direct lending is largely irrelevant as a means of reducing [default] costs" and "may well increase default costs."[12] If borrowers

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8 Letter from Robert D. Reischauer, Director, Congressional Budget Office, to the Honorable Claiborne Pell, May 26, 1993.

9 Letter from June E. O'Neill, Director, Congressional Budget Office, to the Honorable William F. Goodling, July 26, 1995, with enclosed budget estimates based on updated scoring.

10 Statement of the Honorable Ernest J. Istook, Subcommittee on Oversight and Investigations, Committee on Economic and Educational Opportunities, U.S. House of Representatives, May 23, 1995.

11 Dr. Rudolph G. Penner, "Direct Government Lending vs. Guarantees for Student Loans: A Comparative Analysis," KMPG Peat Marwick, May 1993, and Dr. Perry D. Quick, "Direct Government Lending: The Bottom Line," Ernst & Young, Spring 1993.

12 Congressional Research Service, "Critique of the Administration's estimated savings from direct lending for student loans," April 20, 1995.

stretch out their repayments to 25 years, as encouraged by the income contingent repayment plan, the accumulated debt will simply be forgiven. Loan defaults would be permitted and assumed by the government.

## Bad Education Policy

Direct lending centralizes control of student loans within the U.S. Department of Education. The Department is hiring 600 new employees to administer the program and anticipates 20,000 contract employees by the time the program is fully operational. The government already is funding this expansion with an unencumbered $2.5 billion authorization. This not only builds a new government bureaucracy, but also creates the potential for vast inefficiencies and unconstrained program costs.

The Department of Education is notoriously disorganized and mismanaged. It has proven that it cannot manage the existing student aid program,[13] and already is having problems dealing with the current small-scale direct lending program. Among other things, students are experiencing delays and complicated paperwork.[14] In 1994 the Department of Education gave out $700 million in direct loans but was unable to account for some $100 million.[15] The Advisory Committee on Student Financial Assistance, created by Congress as an independent advisory body on student aid, concludes in a recent study that the direct loan program is "potentially exposed to multiple loans, overawards, loans to ineligible students, and excessive cash drawdowns" and, in general, cannot "ensure program integrity."[16]

The Administration has proposed turning to another bureaucracy to solve the problem of loan collection: the Internal Revenue Service. A joint study by the Education and Treasury Departments, however, concludes that "it is not feasible to expand the participation of the IRS in the collection of student loans." IRS involvement in loan collection would "strain IRS resources, interfere with its primary mission, and decrease higher dollar tax collections, without improving student loan program administration or customer service."[17] Without the IRS, however, the burden falls back on the Department of Education.

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13 "Billions for Schools are Lost in Fraud, Waste and Abuse," "Trying to Manage Federal Aid, Education Department Can't Keep Up," and "Overhauling School Grants: Much Debate but Little Gain," *The New York Times*, February 2-4, 1994. See also U.S. General Accounting Office, "Stafford Student Loans: Millions of Dollars in Loans Awarded to Ineligible Borrowers," December 1990, and "Abuses in Federal Student Aid Programs," Report of the Permanent Subcommittee on Investigations, Committee on Governmental Affairs, U.S. Senate, May 21, 1991.

14 See Shannon Malone, "Financial Aid Process Disillusioning," and Ragina Cheeke, "Student says new loan program causing more headaches than before" (letter to the editor), Ball State University *Daily News*, September 8, 1995.

15 Rite Koselka and Suzanne Oliver, "Hairdressers, anyone?" *Forbes*, May 22, 1995, p. 122.

16 "Integrity and Accountability: Recommendations for Improving the Management, Delivery, and Operations of the Federal Student Aid Programs," Advisory Committee on Student Financial Aid, August 1995, p. 13.

17 "A Study of the Feasibility of the IRS Collecting Repayments of Federal Student Loans," U.S. Department of Treasury and U.S. Department of Education, June 1995, p. iii.

There are precedents for failure with direct loans. In the early 1970s, Congress experimented with direct loans through the Federally Insured Student Loan (FISL) program. It was poorly managed, and because the government was ineffective at collecting the loans, default rates soared above previous levels. It was phased out in 1976. Largely because of this failure, there emerged the current decentralized system that relies on private lenders and guarantors.

The direct loan program also is bad for academic freedom. Three quarters of all available college financial aid comes from the federal government.[18] If the government takes over the loan program, colleges and universities will become dependent on a single lender to support their students. Its power to control loan revenue, together with its regulatory authority and enforcement power, will give the government vast influence over post-secondary education. The very possibility that the federal government might use this new authority to force curriculum changes or mandate racial preferences should breed caution. This is no farfetched theory; it is the very question settled in favor of the government in the 1984 Supreme Court case of *Grove City College v. Bell.*[19] There currently are efforts to centralize further the college accreditation process (which allows a college's students to be eligible for financial aid in the first place) as a way of enforcing nationwide multicultural education standards.[20] One can only imagine the temptations presented to some education reformers if the power of accreditation is combined with government control over student loan money. If recent history is any guide, further government intrusion can only harm college and university education.[21]

## CONCLUSION

The existing guaranteed loan program is not perfect. Taxpayers bear all the risk, and schools, students, and lenders should bear greater responsibility. The system must be based on genuine risk sharing that minimizes government costs without destabilizing the current loan program. At the same time, recent improvements in the program should not be overlooked. The loan application process has become simpler in recent years, and the default rate has declined significantly. All of these improvements would be even greater if some of the streamlining ideas in the direct lending program were applied to the guaranteed loan program.

The solution is not to nationalize the multi-billion-dollar student loan program. That would mean new costs and bureaucracy. Moreover, Americans believe strongly that student loans should continue to be provided through private financial institutions, not the federal government.[22]

18 "Financial Support for College Students Climbs to a Record $30.8 Billion," *The Chronicle of Higher Education*, September 16, 1992, p. A37.

19 See George Roche, *The Fall of the Ivory Tower: Government Funding, Corruption, and the Bankrupting of American Higher Education* (Washington, D.C.: Regnery Publishing, 1994) pp. 111-116.

20 See Thomas E. Dillon, "Coming After U.: Why Colleges Should Fear the Accrediting Cartel," *Policy Review* No. 72, Spring 1995. Mr. Dillon is President of Thomas Aquinas College.

21 See Jon Westling, "Getting Government Out of Higher Education," *Heritage Lecture* No. 533, May 3, 1995. Mr. Westling is the Provost of Boston University.

Nor is the solution to maintain the program at some arbitrary level. This only postpones the final program decision, validates the creation of a new education bureaucracy, and delays the reforms needed to strengthen and improve funding prospects for America's educational future.[23]

The only prudent and fiscally responsible answer is to eliminate the program.

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22 "Strong Public Support for Privately-Funded Student Loans," Luntz Research Companies, July 18, 1995. A nationwide poll of 1,000 respondents found that 72 percent of Americans believe student loans should continue to be offered through private institutions.

23 The Department of Education's single-minded emphasis on direct loans prevents it from focusing on guaranteed lending reforms and improvements, according to Advisory Committee on Student Financial Aid, "Integrity and Accountability," pp. 3-5.