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# COST ESTIMATES FOR FEDERAL STUDENT LOANS

The Market Cost Debate

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EDUCATION POLICY PROGRAM  
*Higher Ed Watch*

NEW AMERICA FOUNDATION

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## Executive Summary

In an ongoing debate about the relative costs of the federal government's direct and guaranteed student loan programs, some budget experts and private lenders have argued for the use of "market cost" estimates. They assert that official government cost estimates for federal student loans differ from what private entities would likely charge taxpayers to deliver the benefits and services the program provides. A market cost estimate would take such information into account.

Although the market cost concept for federal student loans has merit, the student loan industry has abused and distorted it. As part of an effort to discredit government estimates, which suggest that direct lending costs less than guaranteeing loans, the literature published by student loan companies generally calls for adopting market

cost estimates only for direct loans or incorrectly applies the concept to guaranteed loans so that they appear to cost less than government estimates. Government agencies, including the Government Accountability Office, have added weight to these arguments by using flawed methodology.

Market cost research that correctly applies the concept to both types of federal student loans suggests that the programs cost taxpayers much more than is reported in the federal budget. As such, it is important that policymakers, the media, and the public understand the market cost debate as it relates to the cost-effectiveness of guaranteed versus direct federal student loans. This issue brief aims to provide an explanation of the market cost concept and the public policy debate it has spurred.

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For the last 15 years, interest groups, stakeholders, members of Congress, and budget analysts have debated the costs of the federal government’s primary student loan programs—the Federal Family Education Loan (FFEL) program and the Direct Loan program. (See the text box on page 5 for a description of the programs.) The debate has centered on the relative cost-effectiveness of FFEL guaranteed loans and direct loans, and how those costs should be defined, estimated, and reported in the budget. The relative cost of each program is a key factor for policymakers since both loan programs provide nearly identical loan terms to borrowers, making the lower-cost program a superior policy choice.<sup>1</sup>

Many budget experts and stakeholder groups have argued that official cost estimates for federal student loans reported by budget agencies are inaccurate because they do not reflect “market costs,” or what a private entity would charge taxpayers to fund and administer the same benefits and services that the government provides. Government agencies, private consulting organizations, and student loan trade associations have all weighed in. Their conclusions are confusing, often incorrect, and in many cases intentionally misleading.

Private lenders have called for adopting market cost estimates only for direct loans. However, the principle is equally applicable to FFEL guaranteed loans made by private lenders because both loan types expose the federal government to very similar risks and obligations. Lender trade associations have also incorrectly argued that market cost estimates should be applied so that guaranteed loans appear to cost less than official estimates. Separately, the Government Accountability Office (GAO) has published a paper that makes the same erroneous argument.

The debate over federal student loan costs can be confusing for policymakers, the media, and the general public alike. Arguments over complex technical issues and financial concepts are colored by ideological biases and well-funded lobbying efforts. The market cost issue is no exception. Nevertheless, it is important that policymakers understand the concept and apply it correctly. To that end, this issue brief aims to help all concerned to better understand the debate over market cost estimates for federal student loans. An explanation of the market cost concept and

a description of the current cost-estimating approach used by government agencies precedes a discussion of incorrect or misleading arguments in the existing market cost literature. A brief discussion of work that correctly applies the market cost concept follows.

### **Market Cost Estimates in Theory**

The market cost (sometimes termed “market risk” or “economic cost”) of a government program refers to the price private entities would charge taxpayers to offer the same benefits and services currently funded by the government. In the case of government-subsidized student loans, the market cost reflects the price private entities would charge taxpayers to fund low interest rates for borrowers, the government’s administrative costs, and the subsidies it pays to private lenders, among other things. While private entities do not usually offer benefits and services as generous as those provided by the government, information on the prices that private entities would likely charge for such benefits and services can be found by examining prices for similar assets and services in the private market.

Proponents of the market cost approach argue that the costs of government student loan programs should reflect market values for financial activities that involve risk. Private entities and individuals (i.e., taxpayers) ultimately bear all of the risk associated with loans guaranteed or made by the federal government because taxpayer resources are used for the government’s transactions. Moreover, a student loan entails the same risk whether the federal government or the private market makes it, because the federal government cannot reduce risk.<sup>2</sup> The possibility that the borrower

## Federal Student Loan Programs

The federal government offers several types of student loans to help promote access to higher education. The main programs—Stafford, Parent Loans to Undergraduate Students (PLUS loans), Grad PLUS, and Consolidation—generally carry fixed interest rates for borrowers, provide generous deferment and forbearance terms, and offer flexible repayment plans of up to 30 years. All loans are made through one of two different administrative structures: the direct or guaranteed loan programs. Schools choose which administrative structure their students will use.\*

Under the direct loan program, the federal government raises money in the Treasuries market and lends funds directly to students. Borrowers repay loans directly to the federal government. Private contractors are used to administer loan servicing.

Under the Federal Family Education Loan program (guaranteed loans), private lenders make the loans with two separate subsidies from the federal government: a guarantee against 97 percent of default losses and a guaranteed interest rate. Lenders receive an interest rate payment equal to short-term interest rates (three-month commercial paper), plus 1.79 percentage points (recent legislation changed the rate from 2.34 percentage points). Borrowers make loan payments to lenders at a fixed interest rate set in law. If the borrower interest payments do not cover the lender's guaranteed interest rate in a given financial quarter, the federal government pays the lender an interest rate subsidy, called a special allowance payment, or SAP, to make up the difference. Conversely, if the borrower interest rate payments exceed the lender's guaranteed interest rate, then the lender remits the excess portion of the borrower payment to the federal government.\*\*

\* Federal Education Budget Project, "Student Loans Overview," New America Foundation, [http://www.newamerica.net/programs/education\\_policy/student\\_loan\\_watch](http://www.newamerica.net/programs/education_policy/student_loan_watch).

\*\* Federal Education Budget Project, "Federal Student Loan Subsidy Structure," New America Foundation, [http://www.newamerica.net/programs/education\\_policy/federal\\_education\\_budget\\_project/subsidies](http://www.newamerica.net/programs/education_policy/federal_education_budget_project/subsidies).

will default on the loan, or that interest rates will fluctuate, or that relative asset values will change over time is the same whether it is the taxpayers or lenders in the private market who shoulder such risks. Therefore, cost estimates for risky financial activities undertaken by the government will accurately reflect the value taxpayers assign to the use of their resources only if they reflect the value that private markets assign to the same activity.

### Credit Reform Rules and the Current Cost Estimate Approach

The Federal Credit Reform Act of 1990 changed the method for determining cost estimates for government loans from cash to accrual accounting. Under cash accounting, costs are reflected only when funds are paid in to or out of the Treasury, so future obligations are not fully visible. Thus, direct loans look like a grant in the year that they are made, and guaranteed loans appear to have no cost in the year that they are made. Accrual accounting, on the other hand, reflects the costs of future obligations in the year that they are made, rather than in the year they are paid. Therefore, the accrual accounting approach adopted in 1990 better

reflects the future costs that may occur when the government makes either a direct loan or a guaranteed loan. Furthermore, the costs of each type of loan are more easily compared under accrual accounting.<sup>3</sup>

Credit reform rules specify how budget agencies are to compute loan costs on an accrual basis.<sup>4</sup> It requires student loan costs to be presented as a subsidy rate reflecting the lifetime cost to the government of making a direct loan or guaranteeing a loan in the year that the loan or guarantee is made. The subsidy rate is a percentage cost of the underlying loan, so that a \$1,000 loan that costs the federal government \$100 to make carries a 10 percent subsidy rate. To determine the subsidy rate, credit reform requires that budget analysts estimate the future cash flows associated with the loan to and from the federal government. These cash flows are then discounted to the present using discount rates equal to the interest rate on a U.S. Treasury bond of equivalent duration. Table 1 illustrates how the Congressional Budget Office (CBO) models cash flows for hypothetical \$3,000 guaranteed and direct loans under credit reform rules.

Table 1. Credit Reform Cash Flow for a \$3,000 Stafford Loan

Year	1	2	3	4	5	6	7	8	9	10	11	12
<b>Guaranteed Loan (\$)</b>	<b>In-School</b>											
In-School Interest Payment to Lender	204	204	204									
3% Borrower Origination Fee	-90											
0.5% Lender Origination Fee	-15											
In-School Lender Interest Rate Subsidy	12	26										
Lender Interest Rate Subsidy			39	38	36	33	29	25	20	15	9	3
Guaranty Agency Processing Fee	12											
<b>Net Cash Flow</b>	<b>123</b>	<b>230</b>	<b>39</b>	<b>38</b>	<b>36</b>	<b>33</b>	<b>29</b>	<b>25</b>	<b>20</b>	<b>15</b>	<b>9</b>	<b>3</b>
<b>Net Present Value: \$537</b>												
<b>Subsidy Rate: 17.9%</b>												
<b>Direct Loan (\$)</b>	<b>In-School</b>											
Principal Disbursed	3,000											
1.5% Borrower Origination Fee (Assumes Discount)	-45											
Principal Repayment			-220	-236	-252	-270	-289	-309	-331	-354	-379	-405
Interest Repayment			-200	-185	-168	-151	-132	-111	-90	-67	-42	-15
<b>Net Cash Flow</b>	<b>2,955</b>	<b>-421</b>										
<b>Net Present Value: -\$103</b>												
<b>Subsidy Rate: -3.4%</b>												

Source: U.S. Congressional Budget Office, *Subsidy Estimates for Guaranteed and Direct Student Loans*, November 2005, <http://www.cbo.gov/ftpdocs/68xx/doc6874/11-16-StudentLoans.pdf>, p. 24.

Note: This table presents the credit reform cash flows used to estimate the costs for a hypothetical \$3,000 Stafford student loan with a two-year in-school period and 10-year repayment made under the guaranteed and direct loan programs. The loan carries a fixed 6.8 percent borrower interest rate. Positive numbers reflect a cost to the government. Negative numbers reflect a gain.

To estimate the total up-front costs of the loans, cash flows to and from the federal government are discounted to the present using U.S. Treasury bond rates. The guaranteed loan costs the government \$537 and the direct loan earns \$103. The guaranteed loan cash flow for the federal government is composed almost entirely of annual subsidy payments made to the lender that has made the loan to the student. The federal government also receives origination fees from the student borrower and the lender in the year the loan is disbursed. The direct loan cost estimate, even though the loan is the same for the borrower, is based on a very different cash flow. In year one, the cash flow reflects the disbursement of the \$3,000 loan from government and the \$45 origination fee paid by the borrower to the government. During repayment years, the cash flow reflects repayment of principal and interest from the borrower to the government.

## Market Costs vs. Government Estimates

Under credit reform estimates published by the CBO, certain federal student loans made to undergraduate students in both the guaranteed and direct loan programs, earn a return for the government. According to their figures, the average unsubsidized Stafford direct loan made in 2008 carries a negative subsidy rate of 22.2 percent, meaning that the federal government makes 22.2 cents on a net present value basis for each dollar it lends.<sup>5</sup> According to the same estimates, an unsubsidized Stafford loan made under the FFEL guarantee arrangement carries a negative subsidy of 3.8 percent.<sup>6</sup> This is due to the assumption that fees and interest rebates paid by lenders to the federal government under the guarantee arrangement will be greater than any subsidy paid to lenders and student borrowers.

**Table 2. Federal Student Loan Average Subsidy Estimates (CBO March 2008 Baseline)**

Fiscal Year	2008	2009
Unsubsidized Stafford Direct Loans	-22.2%	-23.19%
Unsubsidized Stafford Guaranteed Loans	-3.8%	-0.09%

Despite credit reform estimates that suggest direct loans earn a return, lenders acting in the private market do not make loans with similar benefits to undergraduate students. They deem such loans too risky and generous to be profitable. Similarly, financial institutions do not sell guarantee arrangements to private student lenders like the one the federal government provides in the FFEL program because the arrangements would be unprofitable. Instead, the private market suggests that in order for a loan to earn a positive return (or for the guarantee arrangement to earn a positive return), the government would have to charge much higher fees and provide less generous benefits to borrowers. Consider the differences between the terms of federal student loans and the loans made in the \$17 billion annual private student loan market.<sup>7</sup>

Private loans made to undergraduate students usually carry variable interest rates between 2 and 10 percent-

age points above a short-term interest rate benchmark. In contrast, federal student loans for undergraduates carry a fixed 6.8 percent interest rate for up to 30 years. Lenders providing private student loans always require a credit check, and may require a co-signer. Private lenders can turn away high-risk borrowers or charge them higher rates and fees. Federal student loans, on the other hand, require no credit check and offer loans to all students on the same terms. Federal loans also include generous deferment and forbearance options that are not provided by private lenders.

In sum, estimates made according to credit reform rules suggest that both federal direct student loans and loan guarantees are likely to earn a positive return for the government. If the loans and guarantees were truly profitable, entities would likely provide them at similar terms in the private market. However, private entities consider the loans and guarantee arrangements to be too risky. Differences between loan costs under credit reform and the costs implied by private markets are the essence of the market cost concept.

## Misleading Market Cost Information

Although budget analysts, academics, and student loan interest groups recognize that the government's cost estimates for the student loan programs differ from the market's estimates, much of the published work on the topic includes serious errors that misrepresent the market cost concept. This misinformation is in part the result of lobbying efforts by the student loan industry, but government agencies are also responsible for incorrect interpretations of the concept.

Some reports incorrectly conclude that market cost estimates are relevant only for direct loans and not for guaranteed loans. Others fail to recognize that a market cost estimate for guaranteed loans should make adjustments to credit reform cash flow models to reflect the risky cash flow between the private lender and the borrower. Similarly, the literature argues for estimates that incorrectly reduce the cost of guaranteed loans. On the other hand, some facets of the market cost concept are correctly identified in the existing literature. For example, the literature correctly says that estimates must more accurately account for administrative costs, and that estimates should be based on discount rates that reflect the private market's assessment of risk.

## Why Market Costs Matter for Both Student Loan Programs

Some student loan trade associations argue that market cost estimates should only be applied to direct loans, or that guaranteed loans are unaffected by such estimating techniques. In fact, market cost estimates are equally relevant for estimating the costs of both programs because both types of loans expose the federal government to very similar risks and obligations.

Loans under both federal programs are made to the same populations at nearly identical borrower terms, including interest rates and repayment length. Moreover, the federal government bears similar default and interest rate risk whether it guarantees a loan or makes it directly. In the FFEL guaranteed loan program, the 97 percent default guarantee exposes the government to nearly all of the default costs it would assume in making a direct loan.<sup>8</sup> Additionally, the interest rate subsidy arrangement for lenders in the guaranteed program exposes the government to interest rate risks similar to those it faces when making loans directly.

Despite the similar risks in both loan programs, the mar-

ket cost literature often excludes any discussion of market cost estimates for guaranteed loans. A paper published in 2006 by America's Student Loan Providers, a trade association, focuses entirely on market cost estimates regarding direct loans and dismisses the concept with respect to guaranteed loans.<sup>9</sup> (For other examples of this approach, see the text box on page 10). Douglas Holtz-Eakin, a former director of the Congressional Budget Office, argues in a paper commissioned by student loan companies and trade associations that direct loan cost estimates should include market costs because "in making direct student loans, the Government assumes market risks and uses its powers to pass these risks along to taxpayers."<sup>10</sup> Although Holtz-Eakin's reasoning applies equally to government-guaranteed student loans, he makes no mention of them in this regard.

## The Problem with "Risk-free" Discount Rates

Discount rates are used to estimate the value of a future cash flow from a loan (repayment of principal and interest) in today's dollars by accounting for the time value of money and the effects of risk and uncertainty on the value of a loan. The riskier the loan is, the lower its present value will be which is reflected in cost estimates by using higher discount

### Does the Government Have a Financing Advantage in Treasury Bonds?

Some sources claim that the federal government has a financing advantage over private loan companies that makes student loans profitable when they otherwise would not be. They argue that the government can finance the loans at a lower cost than the private market can by issuing Treasury bonds with below-market interest rates.\* This so-called financing advantage is an accounting illusion.

The federal government is able to borrow at a lower cost because it has the power to tax to cover its obligations. However, the loans it makes with the borrowed funds are not less risky. The lower cost stems from the fact that the risks inherent in the loan have been spread among current and future taxpayers, and are no longer borne by the bondholders, as would be the case in the private market.

Put another way, individuals purchasing Treasury bonds accept lower interest rates on the bonds than they would for corporate bonds, not because the student loan that the bond has financed is less risky than if private entities had made the loan, but because the federal government can compel taxpayers to pay the bondholder regardless of what happens to the student loan. If the loan goes into default, or interest rate changes diminish its value, the federal government will still pay bondholders by raising the necessary revenue. The private market offers bondholders no such guarantee. In essence, Treasury bondholders are insulated from risk—but the risk associated with the loan as valued in the private market is the same whether it is financed by means of corporate bonds or Treasury bonds.

\* Kim Clark, "Student Loans Make Money for Taxpayers," U.S. News and World Report, May 21, 2008.

rates. A higher discount rate makes a future cash flow worth less in today's dollars; a lower discount rate makes it worth more.

However, credit reform rules do not allow for the use of such risk-based discount rates in making federal loan cost estimates. Instead, the rules require the use of U.S. Treasury bond interest rates to discount loan cash flows.<sup>11</sup> Interest rates on Treasury bonds represent a "risk-free" rate that is lower than other securities in the market because the government is not likely to default on its debt given its taxing authority. In short, credit reform and private market techniques for estimating the value of a loan differ because private entities would use a discount rate that reflects an appropriate level of risk, while the government allows only "risk-free" discount rates.

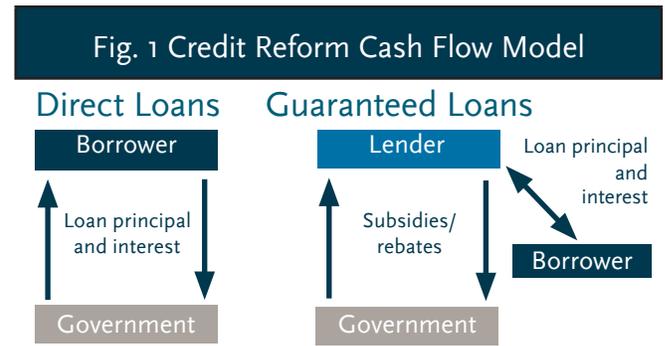
The market cost literature correctly identifies this discrepancy. For example, the paper by America's Student Loan Providers states that "in the case of direct loans, not accounting for risk through the discount rates assures that the budget subsidy amounts overvalue the future cash flows...."<sup>12</sup> And a report by PricewaterhouseCoopers concludes that "a market-based rate should be used to discount the cash flows associated with direct loans and loan guarantees made by the government."<sup>13</sup>

### The Problem with Cash Flow Models for Market Cost Estimates

Appropriate discount rates are not the only major component of a market cost estimate. Estimates should be based on loan cash flow models that reflect risk in a manner similar to those used by the private market. Cash flow models for direct loans under credit reform reflect risk in much the same way that the private market would. But cash flows for guaranteed loans do not. Almost none of the market cost literature identifies this key point. It is perhaps the most significant error in the methodology and reasoning in existing market cost literature.

Direct loan cash flows modeled under credit reform rules reflect the disbursement of the loan to the student and the repayment of the loan with interest over time (see table 1 and figure 1). Because this cash flow treatment accounts for risk in much the same way that the private market would, discounting the cash flow at higher, market-based rates produces cost estimates consistent with the market cost concept. The use of a higher, market-based discount rate reduces the present

value of the future repayment of interest and principal to the government, increasing the cost of the loan. The market cost literature includes a correct interpretation of this concept for direct loans. As the PricewaterhouseCoopers study notes, "[Direct loan] future cash inflows will be worth less (i.e., government costs will increase) because they will be discounted at a higher rate."<sup>14</sup>



On the other hand, guaranteed loan cash flows under credit reform rules are treated very differently. Specifically, guaranteed loan cash flow models do not reflect the loan that has been made to the student borrower because they do not show the disbursement of principal and repayment of interest and principal. Instead, cash flow represents the subsidy payments from the federal government to a lender (see table 1 and figure 1). In one sense, this presentation is accurate because the lender, not the federal government, has made the loan to the student, and credit reform rules are concerned only with cash flow to and from the government. To be consistent with private market cost estimates, however, the cash flow model used in the estimate should reflect the cash flow of the loan that the lender has made to the student. It is this cash flow that exposes the government to default and interest rate risk.

Most of the market cost literature fails to mention this important point, and instead accepts the credit reform cash flow model as an accurate reflection of the risk that the government assumes in each loan program.<sup>15</sup> The literature fails to recognize that although the government's role in each program differs, the risks and obligations the government bears in each program are very similar and that this should be reflected in the cash flow model. This leads to a related error in most of the market cost literature.

The literature argues that higher, market-based discount rates should be applied to the credit reform cash flow for guaranteed loans to produce market cost estimates, which

## Examples of Misleading Market Cost Reports

### PricewaterhouseCoopers, *The Limitations of Budget Score-keeping in Comparing the Federal Student Loan Programs* (March 2005)

This paper, commissioned by companies that make federal student loans, points out that direct loans and guaranteed loans display very different cash flows under credit reform rules and recognizes that “discount rate changes have asymmetric impacts on the estimated subsidy costs of the two programs due to differences in the timing of their cash flows.” There is no discussion, however, of the fact that the two cash flows are not comparable and that applying a higher discount rate to guaranteed loans produces incorrect results. Instead, the paper concludes, “discounting with the market-based rate would result in higher costs for FDLP [direct loans] relative to FFELP [guaranteed loans].” The paper leads readers to believe that such an outcome is an accurate reflection of market values when, in fact, it is inherently flawed. Logically, market cost estimates should in fact have symmetric impacts on subsidy cost estimates given the similar risks for the government in both types of loans.

### Government Accountability Office, *Federal Student Loans: Challenges in Estimating Federal Subsidy Costs* (September 2005)

In this report, the GAO concludes that “using a risk-adjusted [market] discount rate would have a greater impact on the subsidy cost estimates of FDLP [direct loans] relative to FFELP [guaranteed loans]” and that “this difference would result, in part, because of differences in the amount and timing of cash flows.” While this conclusion is mathematically correct, it is an incorrect interpretation of the market cost concept. Market discount rates should produce similar effects for direct and guaranteed loans because loans under both programs represent similar risks for the federal government. Instead, the GAO’s conclusion is based on the effect of applying a higher discount rate to both the direct and guaranteed loan credit reform cash flows. Discount rates lower than risk-free Treasury rates, however, best reflect the market cost of a guaranteed student loan when the credit reform cash flow model is used.

### America’s Student Loan Providers, *Guaranteed Student Loans Cost Taxpayers Less* (May 2006)

America’s Student Loan Providers, which represents private lenders making federal student loans, argues in this paper that market-based discount rates should be used to reflect market values for the direct loan program, but not the guaranteed program. The ALSF concludes that market discount rates increase the government’s cost of making a direct loan compared to credit reform rules, reflecting the value that the private market places on the activity. However, the paper incorrectly states in a footnote that the government’s costs for guaranteed loans are unaffected when market discount rates are used. “Because most of the [guaranteed loan] program costs are early in the loans lives (in-school interest payments and defaults), [guaranteed loan] program subsidy estimates are far less sensitive to discount rates and are not affected by the higher rate.” The ALSF erroneously draws this conclusion because it applies the discount rates to the guaranteed loan cash flow as calculated under credit reform rules. It makes no mention of the problems inherent in using this cash flow model and higher discount rates to produce market cost estimates.

would appear to lower the government’s cost for guaranteed loans. This occurs because the guaranteed loan cash flow is composed of deferred payments (interest subsidy payments and in the case of default, a one-time payment) that decrease in value as discount rates increase. However, this methodology is incorrect. A market cost estimate for guaranteed loans that employs the credit reform cash flow model rather than the cash flow between borrower and lender should use discount rates that are *lower* than Treasury rates.<sup>16</sup>

By definition, the market value of the guarantee arrangement is equal to the value of the protection from uncertainty and potential financial loss that the government provides to the lender. Discounting future payments to lenders at risk-free rates implies that the protection provided by the guarantee arrangement is worth only the face value of its payments, minus the risk-free value of money over time. But the private market places a value on the uncertainty of the events that trigger payments under the guarantee (default and interest rate fluctuations) that is in addition

to the face value of the payments themselves. To account for the market value of this uncertainty, the guarantee payments must be worth *more* than the sum of their credit reform cash flow discounted at risk-free rates. This additional value is reflected by discounting the credit reform cash flow at rates *lower* than risk-free rates, which increases the value (cost) of the guarantee.

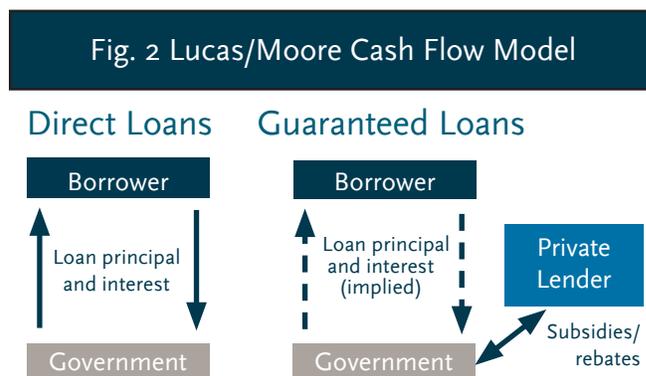
Thus, under credit reform cash flow models, a market cost estimate would account for the increased risk of a 20-year loan versus a 10-year loan by using a lower discount rate, increasing the present value of the guarantee. The error in arguing that higher discount rates reflect greater risk should be clear in this example. An increase in the discount rate reduces the value of the guarantee even though it is worth more because the 20-year loan is riskier. However, most market cost literature incorrectly argues the opposite. According to the GAO, for example, “The student loans would reflect the market’s valuation of the loans, because the expected cash flows would have been discounted using a *higher discount rate* that incorporates risks—such as interest rate risk—that are not included in [the Department of] Education’s subsidy cost model [emphasis added].”<sup>17</sup> (See the text box on page 10 for other examples of this incorrect approach.)

### Guaranteed Loan Cash Flow Adjustments

Northwestern University’s Deborah Lucas and the CBO’s Damien Moore recognize the problems that the credit reform guaranteed loan cash flow model poses for determining a market cost estimate. Their 2007 paper for the National Bureau of Economic Research represents the most complete and robust market cost estimate of the federal student loan programs to date.<sup>18</sup> And their conclusions are quite different than those reached by student loan providers, interest groups, and other government agencies.

In their estimates, Lucas and Moore use a market-based discount rate derived from the private student loan market. To correct for the treatment of guaranteed loan cash flows under credit reform, they model the cash flow as an “implied” loan. The guaranteed loan cash flow is presented as if the government is making a *direct loan* to a student, but with funds it borrows from private banks. Interest rate subsidy payments the government pays to the lender through the guarantee arrangement are treated as financing costs. In other words, the subsidy payments are treated as interest on the funds the government hypothetically borrowed

from the bank to make the direct loan. When compared to credit reform rules, Lucas and Moore’s implied loan technique allows for the risky cash flow from the loan—the principal and interest payments—to be more fully revealed and correctly discounted at a higher, market-based rate. Moreover, it models the risky cash flows for guaranteed loans in a method comparable to that used for direct loans (see figure 2).



Using these techniques for loans issued in the 2006–07 academic year, Lucas and Moore find that both direct and guaranteed loans are more costly than reported by the CBO under credit reform rules.<sup>19</sup> Their work suggests that the average direct loan costs the federal government about \$20 for every \$100 lent (20 percent subsidy) over the life of the loan, instead of earning \$4 (negative 4 percent subsidy) as stated by the CBO in its 2006 baseline projections.<sup>20</sup> Likewise, they suggest that the government’s guarantee arrangement with lenders costs \$31 for every \$100 lent (31 percent subsidy), compared to \$12 (12 percent subsidy) under credit reform rules as reported by the CBO.<sup>21</sup>

### The Question of Administrative Costs

Under credit reform rules, loan program administrative expenses incurred by the federal government are excluded from cost estimates. Both direct and guaranteed student loan program estimates exclude salary and information technology expenses incurred by the Department of Education. Payments made by the federal government to private contractors that service the direct loan program are also excluded. The Office of Management and Budget estimates that the administrative costs of a direct loan amount to \$1.50 for every \$100 lent (or 1.5 percent) over the life of the loan, in present-value terms. A guaranteed loan costs \$0.37 for every \$100 lent.<sup>22</sup>

While these expenses do not pose risks to the federal gov-

ernment per se, private market estimates for loan program costs would certainly include such administrative costs in valuing both the direct and guaranteed student loan programs. Generally, the market cost literature correctly identifies the different treatment of administrative costs under credit reform and private market estimates. Most reports, however, incorrectly suggest that incorporating administrative costs accounts for a significant share of any cost difference between direct and guaranteed loans. Lucas and Moore demonstrate that administrative costs are in fact only a small fraction of total market costs and do not have much influence on the relative costs of each loan type. The authors find that administrative costs make up \$2.10 of the \$20 it costs to make a \$100 direct loan.<sup>23</sup> In comparison, they show that administrative costs make up \$0.80 of the \$31 it costs to guarantee a \$100 loan.

### More Costly Than We Think

The debate over the cost-effectiveness of guaranteed versus direct federal student loans can be confusing, especially with respect to the market cost concept. Government agencies and stakeholder interest groups have correctly interpreted some aspects of the concept, but they have incorrectly interpreted others. The most problematic of these misinterpretations is the failure to identify the importance of the market cost concept for both direct *and* guaranteed loans. Another problem occurs with the unique treatment of guaranteed loan cash flows under credit reform rules when compared to a private market cost estimate. Despite the misinterpretations in much of the existing literature, some research has been published, such as work by Northwestern University's Deborah Lucas and the CBO's Damien Moore, that correctly applies the market cost concept to both student loan programs, and this research concludes that both direct and guaranteed student loans cost taxpayers much more than is reported in the federal budget. Lucas and Moore's work also demonstrates that guaranteed loans have a higher market cost than direct loans. As the debate continues it is clear that policymakers, the media, and the public are better served by a more critical examination of the existing literature on market cost estimates for these programs.

## Notes

1 While both the direct and guaranteed loan programs provide standard borrower benefits (such as fixed interest rates) as defined by law, private lenders making guaranteed loans have in the past offered additional benefits at their discretion. Supporters of the guaranteed loan program have argued that the program provides better customer service to borrowers than the private contractors who administer the direct loan program.

2 U.S. Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Guarantees*, August 2004, <http://www.cbo.gov/ftpdocs/57xx/doc5751/08-19-Credit-Subsidies.pdf>, pp. 4–5.

3 When the credit reform Act of 1990 was debated and adopted, student loans were provided only through the guaranteed program. Thus, the act originally made costs for guaranteed loans and other student aid programs more comparable. In 1992, credit reform helped to make adoption of the direct loan program possible by establishing similar budget treatment for both guaranteed and direct loans.

4 U.S. Congress, *Omnibus Budget Reconciliation Act of 1990*, Public Law 101-508, November 5, 1990, <http://thomas.loc.gov/cgi-bin/bdquery/z?d101:HR05835:@@D&summ2=m&>.

5 The term “unsubsidized” refers to Stafford loans available to all undergraduate students. Students from lower-income families may qualify for more generous “subsidized” Stafford loans, which do not accrue interest while the borrower is in school and may carry lower interest rates; U.S. Congressional Budget Office, *CBO March 2008 Baseline Projections for the Student Loan and Grant Programs*, <http://www.cbo.gov/budget/factsheets/2008b/education.pdf>, pp. 4–5.

6 *Ibid.*, 4.

7 The College Board, *Trends in Student Aid, Trends in Higher Education Series*, 2007.

8 The default guarantee was recently as high as 99 percent for lenders deemed to be “exceptional performers,” or those with good performance records, such as low default rates. Before the exceptional performer status

was discontinued, 18 lenders with exceptional performer status accounted for 90 percent of federal student loan volume.

9 America's Student Loan Providers, *Guaranteed Student Loans Cost Taxpayers Less*, May 2006, <http://www.usa-funds.org/NR/rdonlyres/48014947-4D17-4021-911A-DE90C5D6986E/4863/WhitePaper2006vFINALfinal.pdf>.

10 Douglas Holtz-Eakin, *Budget-Scoring Barriers to Efficient Student Loan Policy* (prepared for the Consumer Bankers Association, the Education Finance Council, the National Council of Higher Education Loan Programs, Nelnet, and Sallie Mae), December 2006, <http://www.studentloanfacts.org/NR/rdonlyres/65DDECf9-3020-4C6A-8C8F-B568556FEA64/7398/BudgetScoringBarrierstoEfficientStudentLoanPolicy.pdf>, p. 9.

11 Thomas Stanton, *Primer on Credit Reform*, Center on Federal Financial Institutions, 1998, <http://www.coffi.org/pubs/Primer%20on%20Credit%20Reform%20by%20Stanton.pdf>, p. 8.

12 America's Student Loan Providers, *Guaranteed Student Loans Cost Taxpayers Less*, 13.

13 PricewaterhouseCoopers, *The Limitations of Budget Score-keeping in Comparing the Federal Student Loan Programs* (prepared for the Consumer Bankers Association, the Education Finance Council, and the National Council of Higher Education Loan Programs), March 2005, 15.

14 *Ibid.*, 14.

15 U.S. Government Accountability Office, *Federal Student Loans: Challenges in Estimating Subsidy Costs*, GAO 05-874, September 2005, <http://www.gao.gov/new.items/d05874.pdf>, p.10.

16 Deborah Lucas and Marvin Phaup, *The Cost of Risk to the Federal Government and Its Implications for Federal Budgeting* (National Bureau of Economic Research, August 2007), <http://www.nber.org/chapters/c3039.pdf>, p. 27.

17 *Ibid.*, 32.

18 Deborah Lucas and Damien Moore, *Guaranteed vs. Direct Lending: The Case of Student Loans* (National Bureau of Economic Research, November 2007), <http://www.nber.org/chapters/c3038.pdf>.

19 Lucas and Moore make other changes to the credit reform approach that also partially account for the higher costs of both programs. These include changes to the collection costs and rates for defaulted loans and the treatment of consolidation loan default rates, and the inclusion of all administrative costs incurred by the government.

20 Lucas and Moore, *Guaranteed vs. Direct Lending*, 30; and Congressional Budget Office, *CBO March 2006 Baseline Projections of Mandatory Outlays, supplemental data, education, student loans*, March 2006, p. 4.

21 Lucas and Moore, *Guaranteed vs. Direct Lending*, 30; and Congressional Budget Office, *CBO March 2006 Baseline Projections of Mandatory Outlays*, 3.

22 Budget of the United States Government, Fiscal Year 2009 Appendix, 364.

23 Lucas and Moore, *Guaranteed vs. Direct Lending*, 30.

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