

CBO TESTIMONY

Statement of
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before the
Committee on Labor and Human Resources
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Mr. Chairman, I am pleased to have this opportunity to discuss the new budgetary treatment of federal credit programs and their implications for S. 1845, the Financial Aid for All Students Act. In particular, I will discuss the budgetary treatment of the Income-Dependent Education Assistance (IDEA) program, a direct federal student loan program contained in S. 1845, and compare its budgetary treatment with that of the current guaranteed student loan (GSL) programs.

HOW CREDIT REFORM WORKS

Credit reform, which was enacted as part of the Omnibus Budget Reconciliation Act of 1990, significantly improves the budgetary accounting, control, and management of federal credit programs. It changes the focus of budgetary accounting from the annual cash flows associated with a direct or guaranteed loan to the government's expected long-term costs of providing credit assistance. It also treats direct loans, guaranteed loans, and noncredit programs on a consistent basis. Before credit reform, when these programs were estimated on a cash basis, the budget tended to exaggerate the costs of direct loan programs and to understate the costs of guarantee programs in their early years--the years that attract the keenest attention of policymakers.

The object of credit reform is to identify the subsidy costs inherent in a direct loan or loan guarantee and separate them from the nonsubsidized cash flows. The law defines subsidy as "the estimated long-term cost to the government of a direct loan or loan guarantee calculated on a net present value basis." Simply stated, the subsidy is the current value of the amount that the government expects to lose on a credit transaction. Under credit reform, the budget reflects only the estimated subsidy costs; these costs are included in the budget at the time that the subsidy is incurred, not many years later as was often the case under cash accounting.

THE TREATMENT OF GUARANTEED STUDENT LOANS_____

Beginning with fiscal year 1992, the principles of credit reform are used to develop the budget estimates for the Stafford loans, Supplemental Loans for Students (SLS), and Parent Loans for Undergraduate Students (PLUS). For each program, an estimate is made of the subsidy rate per dollar of borrowing. In the case of the Stafford loan program, the largest of the GSL programs, the subsidy rate calculation reflects receipts from fees charged to the borrower, interest payments made by the government when the student is in school, a one-time administrative cost allowance paid to guarantee agencies, special allowance payments made by the government to banks

throughout the life of the loan, and guarantee payments made for loans that go into default.

The Congressional Budget Office (CBO) estimates that for every dollar guaranteed through the Stafford loan program, the federal government will incur a subsidy cost of 28 cents. At that rate, the total subsidy cost of the expected \$8.7 billion in loans will be \$2.5 billion in 1992 (see Table 1). For the three student loan programs combined, the average subsidy rate is 25 percent. With a loan volume of over \$11 billion, subsidy costs are estimated to total \$2.8 billion.

TABLE 1. CBO BASELINE ESTIMATES OF LOAN VOLUMES, SUBSIDY RATES, AND TOTAL SUBSIDIES IN FISCAL YEAR 1992

Program	1992 Expected Loan Volumes (Billions of dollars)	Subsidy Rates (Percent)	1992 Subsidy Costs (Billions of dollars)
Stafford	8.7	28	2.5
Supplemental Loans for Students	15	16	0.2
Parent Loans for Undergraduate Students	1.1	<u>8</u>	<u>0.1</u>
Total	11.3	25	2.8

The Income-Dependent Education Assistance program authorized in S. 1845 would provide direct federal loans to students; loan repayments would be tied to students' incomes after leaving school. The IDEA loan program would replace the current Stafford and **SLS** guaranteed loan programs. The PLUS program would remain, although its role might shrink.

The Internal Revenue Service (IRS) would collect repayments on IDEA loans as part of the borrowers' income taxes. The annual repayment for any given year would depend on the amount borrowed and on the borrower's income, or on that of the borrower and the borrower's spouse if the borrower filed a joint tax return. In years in which a borrower's income fell below specified amounts, he or she would not owe any IDEA repayments. A borrower's annual repayments would be capped at 20 percent of modified adjusted gross income, less the standard deduction and personal exemptions. Any unpaid balances on loans would be forgiven after 25 years, or if the borrower died or became disabled.

Under the rules of credit reform, the budget records the cost of new direct loans on a subsidy basis. The subsidy cost of IDEA loans will equal the

amount the government pays out in IDEA loans in any year, less the net present value of repayments of interest and principal made in subsequent years. Thus, the cost or savings to the federal government of supplying IDEA loans will depend on how many borrowers take out loans, how long they stay in school, and their earnings and marital status after leaving school.

The cost of an IDEA loan to the government will vary enormously from borrower to borrower. For a loan provided to a borrower whose later income never exceeds the tax threshold, the subsidy will be 100 percent. A loan to a borrower whose later income is high, however, can entail a negative subsidy; in such a case, the present value of loan repayments will exceed the amount the government loaned. Generally, IDEA loans made to borrowers with high future incomes will have negative or small positive subsidy rates, and loans made to borrowers with low future incomes will have positive subsidy rates.

At the moment, we have only limited information on which students might borrow through the IDEA program, the size of their loans, and their future income streams. CBO is working with the Department of Education's National Longitudinal Study of the class of 1972 to project the future income streams of student borrowers. We hope to use these data to estimate the subsidy rates and budget costs or savings associated with the IDEA loan program.

A COMPARISON OF THE IDEA AND GSL PROGRAMS_____

Nevertheless, it is possible to draw some comparisons between the IDEA program and the current GSL programs. Subsidy rates under the IDEA program are almost sure to be lower than current rates. Under the current Stafford loan **program**, the government pays all interest while students are either in school or in deferment status. In addition, the government makes special allowance payments to banks throughout the life of the loan. IDEA would eliminate both of these payments. The Stafford program, however, expects all borrowers to repay their loans, whereas the IDEA program would exempt low earners.

Using the IRS to collect loan repayments will also affect subsidy costs. If repayments are more consistently collected through the tax system than under **today's** procedures, subsidy rates will be reduced. But collecting loan repayments will be a new activity for the IRS, with attendant administrative costs. Moreover, staff at the IRS have indicated that using the tax system to collect loan repayments could increase tax evasion and result in revenue losses. Under credit reform, changes in administrative costs and in tax compliance would not be counted in estimating subsidy costs, but these factors would still have to be considered in evaluating the proposed program.

Also, while it seems likely that subsidy rates will be lower under the IDEA program, the amount of borrowing will almost surely be greater. First, many potential borrowers may find the new income-dependent repayments more attractive than the fixed repayment required under the current GSL programs. Second, loan limits will be significantly higher. Freshman and sophomore borrowers will be able to borrow up to \$6,500 a year, instead of the current lending limit of \$2,625. Borrowing limits for juniors and seniors will increase from \$4,000 to \$8,000 per year, with similar increases for graduate students. Finally, IDEA loans will be available to all families with eligible students, without regard to family income. Of course, the loan limits and income restrictions in the Stafford loan program could be liberalized without converting it into a direct loan program.

Thus, even though the subsidy per dollar will be lower for IDEA loans than for guaranteed student loans, total subsidy costs could prove to be higher if borrowing increases substantially. Even if total subsidy costs are lower, the government will face large additional borrowing requirements to take over the loans now made by private institutions. Finally, because repayments of IDEA loans depend on future incomes, the costs of IDEA are more uncertain than those of the current programs. Proposals that involve substantial increases in the level and uncertainty of government borrowing must be carefully

scrutinized at a time when the federal government is already absorbing a large portion of the nation's limited supply of saving.

CONCLUSION

Credit reform has placed guaranteed loan programs and direct loan programs on a level playing field. For the first time, budgetary accounting does not impede making rational comparisons between guaranteed students loans, such as the Stafford loan program, and direct loan programs, such as IDEA. The lack of reliable data, however, keeps us from estimating whether total subsidy costs would rise or fall if the IDEA program was put in place, or how much total federal borrowing would rise. In the absence of such information, changes in education loan programs should be made with extreme caution.