STATEMENT OF

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Student loans are an important component of the overall federal programs to assist postsecondary students. During this fiscal year, 2.3 million loans amounting to nearly $5 billion will go to students through the Guaranteed Student Loan (GSL) and National Direct Student Loan (NDSL) programs. The total federal cost of these loan programs will be approximately $1.3 billion, which is more than 60 percent of all federal student assistance.

If current trends continue, the amount of student lending and the federal cost of student loan programs will increase substantially. Perhaps more importantly, if federal higher education resources are constrained, the growth in loan programs will restrict the funding available for other forms of student assistance, such as the Basic Grants program.

The Congress thus faces two difficult resource allocation questions as it considers reauthorization of student loan programs:

- What are the effects of different student loan policies on federal higher education goals and on the federal budget?
- What is the appropriate allocation of scarce resources between loans and other forms of student aid?

Today, my testimony will deal primarily with the first of these questions.

A BRIEF HISTORY OF FEDERAL STUDENT LOAN ACTIVITIES

Before looking at options for the future of student loan programs, I would like to review their history briefly. Aside from the veterans' programs, the federal role as a provider of student assistance began 21 years ago with passage of the National Defense Education Act. By 1960 this federal program distributed $40 million in loans to 115,000 students, about 5 percent of all full-time students. These loans were intended to expand educated manpower in an increasingly technological society.

By the mid-sixties, it was apparent that young people from minority and lower-income families were attending higher education institutions at much lower rates than other youth. In response to this inequality, the Higher Education Act of 1965 was passed. This act authorized a grant program, a work-study program, and a guaranteed student loan program to provide low-interest loans to students with assessed need. Most of this federal assistance was focused on those students who would otherwise be unable to attend college.

In the early 1970s, the programs authorized by the 1965 act were expanded and the Basic Educational Opportunity Grants (BEOGs)—the "Pell Grants"—were authorized. By 1978 these federal student aid programs provided $4.8 billion to 3 million

students, over 25 percent of all students. Eighty-five percent of this support was given to students from low- and moderate-income families with incomes under $15,000. Fifty percent of all aid was provided in student loans.

In 1979, the passage of the Middle Income Student Assistance (MISA) Act both expanded and shifted the emphasis of the federal role. Funding for student assistance increased 30 percent. The primary emphasis of the federal effort shifted from promoting equality of educational opportunity to a dual focus: both promoting equality of opportunity and reducing the burden of college costs for all students. The Guaranteed Student Loan (GSL) program was substantially altered by MISA; all students became eligible for in-school interest subsidies, increasing the eligible population by one-third. Partly as a result of MISA, participation in the GSL program has increased dramatically. During the first seven months of 1979, the number of borrowers increased 46 percent and the dollar amount borrowed grew by 58 percent above comparable 1978 levels. In 1979 CBO estimates that 1.4 million students borrowed $2.8 billion under the GSL program. This represented approximately 7 percent of all tuition and living expenses for postsecondary students.

## CHOICES IN DESIGNING A STUDENT LOAN POLICY

Historically, three major choices have shaped federal student loan policy: (1) who should be eligible for the loans,

(2) what kind of subsidies should be provided; and (3) who should provide the loan capital. Today the Congress faces these same three issues in designing alternatives to current student loan policies.

The costs and effects of loan programs depend on the interaction among eligibility criteria, subsidies, and sources of capital. Increasing eligibility, for example, will not increase program participation if no more loan capital is provided. In fact, if no more capital is available, previous recipients might actually receive less. On the other hand, expanding eligibility will significantly increase participation if capital is readily available and students have an incentive to borrow. Federal costs, too, will increase in this situation. For example, recently expanded eligibility, greater subsidies for borrowers, and increased payments to lenders have led to large increases in program participation and costs.

## Eligibility Criteria

The most obvious constraint on who benefits from a program is the constraint on who is eligible. Many eligibility standards are possible. Currently, 11 million students, all enrolled half time or more, are eligible for GSL loans. Formerly, subsidized GSL loans were restricted to students from families with incomes below a set amount and NDSL loans were restricted to students with measured need.

Types of Subsidies

Subsidies to borrowers determine who will borrow, the effects of loans on decisions to attend college, the level of future debt burdens, and overall federal budget costs.

Currently, borrowers benefit from two subsidies. First, loans are issued at low interest rates; and second, loans bear no interest during school enrollment and for a short grace period after leaving school. The subsidies associated with providing loans at a rate that is below both the federal cost of money and the market rate of interest has varied appreciably. For example, the 3 percent NDSL rate was less than 1 percent below comparable federal borrowing rates during the first five years of the program. The 7 percent GSL rate was generally above the federal borrowing costs from 1971 to 1978. Currently, however, the 7 percent GSL rate and the 3 percent NDSL rate are below the 8.5 federal rate for bonds of comparable maturity. On average this subsidy amounts to about 6 percent of the original amount borrowed for a GSL loan and 14 percent of the amount for a NDSL loan. Differences between student loan and commercial loan rates are even greater. Student borrowers, however, receive an even greater subsidy--about 26 percent of the original amount borrowed--because their loans bear no interest while the student is in school.

Providing loans bearing interest below market rates is unlikely to affect either whether a student goes to college or which institution he attends. There is no evidence that the small differences in future repayment resulting from these subsidies affect present decisions. For example, the difference in payments between 3 percent and 7 percent interest on a $2,000 loan is less than $5 per month. On the other hand, favorable interest rates may affect whether or not students borrow, rather than use other sources of funds, because borrowing at highly subsidized rates is a sound financial decision even if the funds are not needed to pay college costs.

The interest free in-school subsidy may have a more direct effect on behavior. Students with considerable financial need would probably be unable to make interest payments while attending school. Without the subsidy or an accrual of interest costs during schooling, they would have to borrow more, or perhaps, drop out of school or attend a less costly institution. On the other hand, the high in-school subsidy provides a unique opportunity for higher-income students. A zero interest loan provides an attractive source of funds for other purposes, including interest bearing savings accounts. The rapid post-MISA increases in borrowing suggest that many middle- and upper-income families have already recognized this opportunity.

Source of Loan Funds

The source of loan capital affects not only how much capital is available, but also who receives the loans, and how much the program costs. The federal government can provide the loans or it can pay someone else to do it. Presently both methods are used. In the GSL program, private and state lenders, and some institutions that are established lenders, are paid to provide capital for student loans. Lenders receive a return equal to 3.5 percent more than the Bond Equivalency Rate of the 91-day Treasury bill.

Not only has this means of raising loan capital become increasingly costly to the federal government, but it can have unintended effects on both capital availability and loan beneficiaries. Because the actual costs of originating, servicing, and collecting a large loan are not appreciably greater than those for a small loan, lenders have an incentive to provide larger loans to fewer students. Also students with the greatest financial need are probably less able to secure loans from banks, because they are more likely to default and they lack established banking relationships. Although the recent increases in program activity suggest that this supply problem may no longer exist, it is not clear yet whether the additional loan capital is being dispersed to all students, or whether it is being concentrated primarily on more attractive, higher-income borrowers.

Some of the increased lending is occuring because states have greatly increased the amount of capital available through direct state lenders. These lenders generally create greater student accessibility to loans than do private lenders. But in many cases, the federal government incurs a double cost for loans provided by states: besides the regular payments to the state as a lender, there are foregone federal tax revenues because most state lending is supported by the sale of tax-exempt bonds.

The annual volume of tax-exempt student loan bonds has increased dramatically in the last few years and now amounts to about 20 percent of guaranteed student loans.

As an alternative, the federal government could provide student loans directly. Unlike reliance on private lenders, this approach could ensure that sufficient loan capital was available for all eligible applicants, if the loans were provided as entitlements. As the recent history of the NDSL program shows, if subject to annual appropriations, loan availability could be less certain under direct federal lending than under the current system. Whether disbursed directly or through contractors such as colleges and universities, federal lending could more efficiently direct loans toward achieving specific objectives. Finally, by incurring only the costs of originating, servicing, and disbursing loans, the federal government could sustain lower administrative costs.

## COMPARISON OF STUDENT LOAN PROPOSALS

Several proposals for modifying or extending federal student loan programs are currently before the Congress. The proposals include:

- o Continuing current policy programs,
- o Loan program proposed by the House Education and Labor Committee in H.R. 5192,
- o Loan program proposed by Senators Bellmon and Kennedy in S. 1600, and
- o Adaptation of H.R. 5192, proposed in S. 1870.

The attributes of these proposals are outlined in Table 1.

### Current Programs

Currently the GSL and NDSL programs are the major providers of student loans. All students enrolled more than half time, regardless of financial need, are eligible for GSLs. Students pay no interest on GSLs while in school and 7 percent once the loan enters repayment. The loans are provided by private, state, or institutional lenders. NDSLs, on the other hand, are directed at students with financial need. These loans also are interest free while the student is enrolled, and bear only 3 percent during repayment. The loans are provided by institutional revolving loan funds which are supplemented with federal capital contributions.

TABLE 1. MAJOR COMPONENTS OF FOUR STUDENT LOAN PROGRAMS

| Program | Eligibility | Borrower Subsidies | Source of Capital and Associated Costs | CBO Assumptions |
|---|---|---|---|---|
| Current Programs | For GSLs, all students enrolled half time or more. For NDSLs, financially needy students enrolled half time or more. (Institution assesses need.) | Interest foregiven on both GSLs and NDSLs while students in school or in one-year grace. GSLs in repayment bear 7 percent interest; NDSLs bear 3 percent interest. | For GSLs, capital provided by private and state lenders. Costs include special allowance payments to lenders, and revenue losses from sale of tax exempt state bonds to support state lending. For NDSLs, capital provided from revolving loan funds, supplemented with federal capital contributions. | 1.9 million students borrow $4.3 billion in guaranteed loans and 0.9 million students borrow $0.6 billion in direct loans. Overall 2.8 million loans would provide $4.9 billion in fiscal year 1981. |
| H.R. 5192 | Same as current programs for student loan eligibility. Parents eligible to borrow up to the difference between educational costs and available gift aid. | Same as current programs for student loans. Parent loans would bear 7 percent interest from the date of disbursement. | Same as current programs for student loans. Parent loans treated like guaranteed student loans. | Same as current programs for participation in NDSLs, and slight increase in participation in GSLs. 81,000 parents borrow $237 million in the first year. Overall, 2.9 million loans would provide $5.3 billion in fiscal year 1981. |
| S. 1870 | For GSLs, all students enrolled in degree credit courses. NDSLs remain available only to students enrolled half time or more with assessed need. Parent eligibility the same as under H.R. 5192. | GSLs and parent loans the same as in H.R. 5192. Collectors could offer delinquent students an income contingent loan plan rather than the straight 10 year repayment schedule. NDSL interest would increase from 3 to 7 percent. | Same as under H.R. 5192. | Borrowing for GSLs increases by 250,000 loans and $200 million to acccommodate less than half time students. No change in borrowing level for NDSLs, but increased collections in outyears from increased interest charges. Overall, 3.2 million loans would provide $5.5 billion in fiscal year 1981. |
| S. 1600 | In Tier I, students enrolled half time or more with assessed need could borrow up to the level of their unmet need. (Assessed need determined from the needs analysis formula for BEOGs.) In Tier II, students and parents could borrow up to expected family contribution. | In Tier I, for undergraduate students, in-school interest free loans bearing 7 percent interest in repayment. No in-school subsidies for graduate students. Students could opt for graduated repayments rather than straight 15-year schedule. In Tier II, borrowers pay 1 percent less than the Treasury bill rate from the date of disbursement. Loans to be repaid within 10 years. | Capital for loans in Tier I provided directly by federal government through federal borrowing. Administrative costs include fees for loan origination and servicing. Capital for Tier II still provided through private lenders, requiring special allowance payments to lenders. | In Tier I, 1.7 million undergraduates borrow $3.1 billion; 160,000 graduate students (a decline of 50,000) borrow $0.5 billion. In Tier II, 565,000 loans in Tier II, amounting to $1.78 billion. Overall, 2.5 million loans would provide $5.36 billion in fiscal year 1981. |

These two programs would provide 2.8 million loans amounting to $4.9 billion in fiscal year 1981. The first-year federal cost would be approximately $0.6 billion (see Table 2). Before being fully retired, these loans would cost the federal government $2.4 billion in 1981 dollars, or 48 percent of the original amount provided.

TABLE 2. COMPARATIVE COST ESTIMATES FOR FOUR STUDENT LOAN PROGRAMS

| | Current Programs | H.R. 5192 | S. 1870 | S. 1600 |
|---|---|---|---|---|
| Full-term cost of a $2,000 loan[a] (in dollars) | 1,240 | 1,240 | 1,240 | 987 |
| First-year cost of the new loans provided in fiscal year 1981 (in millions of dollars) | 619 | 640 | 653 | 440 |
| Full-term cost of the new loans provided in fiscal year 1981 (in 1981 dollars, in millions of dollars) | 2,258 | 2,448 | 2,422 | 1,860 |

[a]Assumes a loan that is interest free while in school and for a three-year grace period after leaving school with 7 percent repayment for seven years.

H.R. 5192 as Reported by House Education and Labor Committee

This proposal would alter the existing GSL program by expanding eligibility to parents at a lower subsidized rate than that for students, by increasing the overall loan limits, and by changing the administrative process to reduce defaults. H.R. 5192 would expand funding for the NDSL program but would not change the operations of the program significantly.

CBO estimates that this package of loans (GSLs, parent loans, and NDSLs) would provide 2.9 million borrowers with $5.3 billion in fiscal year 1981. The costs of these loans would be approximately equal to those under current policies. The long-term costs of the loans provided in 1981 would be $2.5 billion, or 46 percent of the original amount borrowed.

These estimates are based on the assumption that most families would act as a unit and use the least costly loan program available. Families, therefore, would be more likely to have students borrow money that bears no interest while the student is in school than to have parents borrow money that bears 7 percent interest immediately. As a result, CBO projects relatively low demand for parental loans. Most parental borrowing would be by those with children attending higher-cost institutions.

S. 1870, Introduced by Senator Williams

This proposal adapts H.R. 5192 by extending eligibility to students enrolled less than half time and by increasing the interest on NDSLs from 3 percent to 7 percent. This loan package would provide 3.2 million students with $5.4 *billion* in loans in fiscal year 1981. The first-year federal cost would be $0.7 billion. The long-term costs of this proposal are nearly the same as the Ford proposal because the increased costs for providing benefits to less than half-time students are offset by increased NDSL collections resulting from the higher interest charges.

Increasing eligibility to students enrolled less than half time would not appreciably increase overall lending or program costs. If these students participate at the same rate as other students, the total guaranteed student loan volume is projected to increase by only 3 percent. But, because the costs of administering these relatively small loans would lower lenders'profits, less than half-time students might find it difficult to secure loans.

S. 1600, Introduced by Senators Bellmon and Kennedy

S. 1600 considerably alters the structure of student loan programs. This bill would (1) target highly subsidized loans on needy students, (2) provide less highly subsidized loans to students and families without assessed financial need, and (3)

shift student loans from relying on private lenders to financing directly through a federal lender. In fiscal year 1981, this program, if fully operational, would provide 2.5 million loans amounting to $5.4 billion. The federal cost for these loans in fiscal year 1981 would be $0.5 billion. The residual costs from prior programs would be appreciably less than under any of the other options because repayments from the old NDSL program would be available to reduce budget costs. Over the life of the loans provided in fiscal year 1981 under S. 1600, federal costs would amount to $2.0 billion, or 36 percent of the original amount borrowed.

S. 1600 would provide slightly fewer loans than any of the other options, but it would provide slightly more dollars. Compared to current policy, savings in federal costs would be appreciable in the early years of this option. In the first year, this proposal would reduce federal outlays by $600 million below current policy, with savings increasing to more than $1 billion a year by 1985 (see Table 3). In later years, while still less expensive than current policy, the savings would not be as great because S. 1600 allows more time for repayment, thus continuing the interest subsidy that much longer.

TABLE 3. FIVE-YEAR COST PROJECTIONS OF FOUR STUDENT LOAN PROGRAMS: IN BILLIONS OF DOLLARS[a]

| Fiscal Year | Current Programs | H.R. 5192 | S. 1870 | S. 1600 |
|---|---|---|---|---|
| 1981 | 1.7 | 1.7 | 1.7 | 1.2 |
| 1982 | 2.0 | 2.0 | 2.0 | 1.1 |
| 1983 | 2.1 | 2.1 | 2.1 | 0.8 |
| 1984 | 2.3 | 2.3 | 2.4 | 0.9 |
| 1985 | 2.4 | 2.4 | 2.4 | 1.2 |
| Five-Year Total | 10.5 | 10.5 | 10.6 | 5.2 |

[a]Includes direct expenditures for new loans and prior year commitments for GSL and NDSL loans; does not include tax expenditures from sale of tax-exempt bonds to finance state lending.

This proposal also would shift the distribution of loans, compared to the other options. Our analysis predicts that one-third of the amount borrowed would be in the less highly subsidized parental borrowing component of the plan, a much higher level of presumed parental borrowing than under any of the other plans. Even though these loans would be less highly subsidized, the federal costs of providing them would remain relatively high (20 percent of total loan volume), principally because these loans would be financed through private lenders.

## SUMMARY

The principal problem facing the Congress in designing federal student loan programs is the allocation of subsidies. Subsidies are costly. And they are a great deal more costly when provided to all students rather than only to students with financial need. In part this is because middle-income students are more likely to attend college, with or without financial aid, and they also are much more likely to understand the benefits to be gained from subsidized borrowing. But there are tradeoffs. Although subsidies could be reduced without significantly affecting whether or where middle-income students attend college, any reduction would increase the net burden on students and their families.

The source of loan funds also greatly affects costs. Providing the loan capital and managing the program directly would cost the federal government less than the current practice of paying private lenders to provide loans. But federal lending intrudes into private capital markets, and the Congress must weigh the costs and benefits of this intrusion.

The subsidies--or costs--of federal student loan programs are also important because they affect the funding of other student aid programs. There is reason for concern; it may be that we cannot afford to continue the current mix of programs. In an

austere budget, increases in student loans would result in decreases in other forms of assistance. As entitlements, guaranteed student loans are an uncontrollable item in the federal budget process. If their costs continue to rise rapidly, as it appears they will, the funding for other student assistance programs, which are not entitlements, may be jeopardized.

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