

Budget Cost of Student Loans

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What is COFFI?

- Center On Federal Financial Institutions (COFFI) is a non-partisan think tank
- We focus on federal lending and insurance
 - Pension Benefit Guaranty Corporation
 - Terrorism Risk Insurance
 - National Flood Insurance Program
- Our activities are educational, we generally do not take policy positions.
- Our reports are available at www.coffi.org

Most of Budget Is on Cash Basis

- General rule is that annual budget cost equals net cash inflow or outflow for the relevant year
- Federal credit programs used to be on this same basis
- This created many problems, spurring passage of Federal Credit Reform Act of 1990 (“Credit Reform”)

Problems Under Old Approach

- **Disincentives to expand lending.** Growth in loan volume always hurt the budget deficit. Shrinkage always helped.
- **Incentives to garner near-term cash,** regardless of economics. For example, a fire sale of loans would help budget.
- **Bias towards guarantees.** Loans have immediate large outflows. Guarantees may start with net inflows.

Multi-Year Approach Is Needed

- Lending is different from spending. It matters that we expect to be repaid
- Economists and financial markets long ago developed models to value long-term cash flows
- Keys are to estimate **all** significant cash flows and to discount them back to today's dollars using an appropriate interest rate

Credit Reform Budgeting Rules

- Future cash inflows and outflows related to this year's authorized lending are projected
- "Present value" of each cash flow is calculated by seeing how many dollars would need to be set aside today, if they grew at an interest rate referred to as "discount rate"
- Budget cost ("subsidy") is based on sum of these present values: "net present value" or NPV

Credit Reform Rules (cont.)

- Discount rate for a given future cash flow is based on government's cost for a zero-coupon borrowing of that maturity
- This does not incorporate a risk premium
- Administrative costs are not included in the subsidy, but are included elsewhere in budget on an annual cash basis

Effects of Credit Reform

- Net effect is to level playing field between loans, guarantees, and grants
- Many policy distortions are eliminated
- However, budgeting now requires estimates going years into future
- Best estimates of future can change year to year, giving rise to budget reestimates

Fights About Subsidy Calculations

- Direct Loan and FFELP advocates have fought about subsidy calculations from beginning of Direct Loan program
- OMB and CBO figures generally show lower budget costs for Direct Loans
- FFELP advocates believe there are “hidden costs” and other misleading factors

COFFI's Student Loan Model

- We recently published a study using our own model of budget costs
- Although simple enough to be comprehensible, it incorporates main variables influencing relative costs of Direct versus Guaranteed loans
- Considerable complexity was avoided by taking forward-looking view, not attempting to explain past budget variations

Comparative Cost of Direct vs. Guaranteed Loans

- Model projects cash flows from a set of loans to incoming Freshmen
- We then calculate federal budget costs depending on whether loans are made as Direct loans or Guaranteed loans
- Cash flows from a student's point of view are little different, but federal budget costs can vary considerably between programs
- Budget cost is only *one* policy consideration

Key Findings

- Direct loans almost always have lower budget costs under today's current and projected interest rates, by about 10 points
- But, high spreads between long-term and short-term rates would make Guaranteed loans relatively cheaper
- Spreads were above crossover point for Stafford loans about 30% of months in last 50 years. Figure is 8% for PLUS loans.

Key Findings (continued)

- Loan default rates have little effect on relative cost of two programs, since government absorbs very high proportion of default costs even in FFELP loans
- PLUS loans have lowest budget costs, Subsidized Stafford loans cost most, and Unsubsidized Stafford loans are in middle

Effects of Alternative Discount Rates

- Some propose using a short-term discount rate to better match floating rate loans
- Short-term discount rate would raise Direct loan cost advantage and sharply reduce volatility of budget costs
- There are also proposals to add a factor to charge for risks taken on by government
- We cannot currently estimate impact, but it would clearly make all loans more expensive, with greatest effect on Direct loans

COFFI Model Will Be Refined

- We welcome comments and suggestions
- Our hope is that COFFI's model will stimulate further discussion and analysis
- We view the model as a work in progress and will refine it based on input from others