FOLLOWING THE STUDENT'S DOLLAR THROUGH THE FEDERAL AID SYSTEM

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INTRODUCTION

Over the past 15 years, tuition and fee increases have outpaced both inflation and growth in the median family income [1-6]. This trend continues to negatively impact the current 16.5 million students [7] who attend approximately 4,000 colleges and universities [8] where tuition and fees continue to escalate [2, 4] across all institutional types [9-13]. Simultaneously, professional organizations, regional accreditation bodies, and state licensing requirements are perpetuating *credentialism* [14] by increasing credit hours to complete a degree. As a result, decreases in private, institutional, state, and federal grants [10, 15, 16], coupled with the sharp upsurge in student loans [11, 15-17], have driven many students into severe debt [10, 18-21]. All of this is occurring while loan scandals persist and governmental subsidies for lenders are reaching record highs [17, 22-31]. In short, America is experiencing a tuition crisis.

This is the first of three papers demonstrating the urgency of this situation, focusing particularly on the delivery of federal financial aid. The second will analyze policies, accreditation agencies, and local political actors through the perspective of state laws [11, 32-43]. The third will illustrate how local campuses – influenced by students, faculty, administrators, and staff – are inextricably responsible for the increasing cost of postsecondary education [3, 6, 16, 28, 41, 44-57]. Together, these papers will provide a comprehensive diagnosis of the waste of financial resources in the educational system, starting with the federal arena.

The waste in the federal system can be found by first analyzing the technical and political feasibility of fixed bond rates and tax-exempt bonds and the efficiency of their delivery. In this context, the paper will reveal additional waste by asking whether it is efficient for the U.S. Treasury to make money from student loan interest, from loan consolidation, and from interdepartmental taxes. The third sector of waste will be revealed by analyzing legislation that affirms guaranteed default subsidies to for-profit lenders and the costs for policing these lenders. The paper will close with proposal of a seven-pillar formula to create a *National Tuition Endowment* [58, 59] that will transform the waste in the federal aid system into revenue for more student aid.

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The findings in this paper came from a series of discussions held by student leaders at Columbia University who began by asking a simple question: what happens to the interest generated from student loans? When they discovered that it returns to the Treasury and subsidizes the private lending industry, they asked more urgent questions: how is aid delivered and why are so many companies calling to consolidate loans? What happens to the income from these consolidations? Who benefits from these deals and, perhaps most important, who can students trust?

In this context, Columbia students invited student governments throughout the country to participate in a debate on the subject.[3] As a result, students from dozens of colleges and universities have begun to recognize and challenge a federal aid system that produces an extraordinary amount of waste. Put simply, these students ask why the income generated by student debt does not return to students and how can this waste in the federal aid system generate revenue for additional aid? To answer these questions, these students began to track the dollar as it is cycled through the federal aid system.

FOLLOWING THE AID DOLLAR

BOND RATES

To annually deliver $50 billion in student and parent loans [20, 49], the Department of Education (Education) depends on the U.S. Treasury to be awarded a series of bonds. Traditionally, bonds issued to governments are delivered at the market rate, if not lower; however, in the case of federal financial aid, a handful of private corporations prosper on fixed 9.5 percent bonds [30, 60, 61]. This is three times the going bond rate of 3.37% [30]. In November 2004, Congress sought to close this loophole [60, 61] by passing H.R. 5186. This bill has two problems, however. First, it only temporarily addresses the 9.5 percent loan windfall through FY 2005. Second, it permits "recycling," whereby lenders issue new loans to receive the 9.5 percent subsidy. It is important to note that recycling accounts for 49% of the current loan volume of 9.5 percent loans. Arguably, without these fixed rates, banks would not issue loan bonds, but this is not true. By securing a competitive market, multiple companies can participate, thus insuring lower interest rates. Furthermore, by eliminating these loopholes, the U.S. Treasury would save over $10 billion over the next ten years, which could give millions of students access to postsecondary education [62].

TAX FREE BONDS

The 9.5% scandal is a result of Congress permitting nonprofit lenders in the 1980s to "finance their loans by using tax-exempt bonds – coupled with a guaranteed return of 9.5 percent on loans, to help protect them at a time when the economy was sour and the cost of making loans was soaring" [63]. Yet, federal legislation failed to change when companies like Sallie Mae privatized[4] [17, 29], which resulted in a series of student-aid scandals disclosed by the 1990 Nunn Hearings [34, 64, 65]. Currently, these companies reap a two-part benefit when issuing bonds – fixed 9.5 percent bonds that are tax-free. Removal of tax-free bonds would save the federal government over 2 billion dollars over the next five years [30, 66].

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[3]For more about this debate, see www.TuitionEndowment.org.

[4]"Nelnet was formed in 1998 when the non-profit loan company NebHelp [privatized]" (Kvaal & Shireman, 2004).

TREASURY INTEREST

After the non-taxed dollar is given to the Treasury through the 9.5 percent bonds, it further depreciates as it moves through the system. This occurs when the U.S. Treasury charges interest to the Department of Education (Education) for an interdepartmental transfer. Similar to the World Bank, the Treasury currently provides no-interest loans to foreign governments, but it does charge interest to Education for transferring the student-aid bonds [23]. These interest charges generate millions of dollars annually for the Treasury, partially compensating for the loss of money from the fixed and tax-free bonds.

Upon receiving the funds, Education delivers the aid to students through institutions of higher education in several ways: work-study funds, Pell grants, and guaranteed and/or direct loans. Alternate student aid is delivered through various programs such as veteran benefits (Defense), educational tax-credits[5] (Taxation), and loan forgiveness programs (NIH, NSF), to name a few [43, 67, 68]. Specific to loan delivery there are two competing programs.

GUARANTEED V. DIRECT

The first is the Federal Family Education Loan Program (FFEL)[6] that "permits the federal government to pay interest subsidies to... private lenders and guarantees loans against defaults…" [43]. Put simply, the Treasury will pay a private bank if a student cannot repay the loan . The second is the William D. Ford Direct Loan program,[7] which provides loans directly from the government to the student. "Under the [Direct] program, loan capital is provided directly by the federal government, using Treasury borrowing,[8] rather than through federal subsidization of private lenders and state level guaranty agencies" [43]. It is widely known that the Direct loan program costs the Treasury far less than guaranteed loans, "even after deducting administrative costs" [28] (Table 2).

Democrats are traditionally opposed to private subsidies; however, Republicans also continue to criticize the FFEL program. Representative Thomas Petri (R-WI) describes guaranteed lending as "corporate welfare" and "a government-assistance program for private lenders." Petri clarifies that "taxpayers end up subsidizing private agencies to recover [default] loans" [26]. Although President Bush consistently supports the privatization of student aid, his most recent budget declares that direct loans are more efficient than guaranteed loans [17, 23]. The report says: "Significantly lower Direct Loan subsidy rates call into question the cost effectiveness of the Federal Family Education Loan Program structure, including the appropriate level of lender subsidies" [27].

The press has also revealed the inefficiencies of guaranteed subsidies [28, 31]. The *New York Times* recently reported that if "all loans granted from 1995 to 2003 had been direct, more than $20 billion would have been saved, according to Bush administration budget figures" [23]. The *Washington Post* reported that "the budget shows the cost of the direct loan program as a negative $492 million. In other words, by the administration's calculations, the direct loan program produces net income for the government" [17].

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[5]It is important to note that tax credits have been replacing grants as a form of student aid; however, studies show they have severe unintended consequences (McPherson & Schapiro, 1998; Roth, 2001), especially for low-income students and families (Gladieux, 1997, 1999) .

[6]Originally the "Guaranteed Student Loan Program" through the 1964 Higher Education Act.

[7]Established by the Student Loan Reform Act (SLRA) of 1993.

[8]Note example of Treasury taxation on Education.

The *Post* adds that specific companies like Sallie Mae have seen increases in their profits "from $384 million in 2001 to $792 million in 2002, and to $1.3 billion last year" [17]. These numbers show that Sallie Mae's profits in 2003 could have sent over 46,000 students to UCLA on a full four-year tuition scholarship, while CEO Albert Lord's profit of $33.6 million in 2002 [28] alone could have sent 1,200 students to college. This further highlights the fact that if Congress eliminates guaranteed default subsidies to FFEL lenders, at least $4 billion would be saved in the next ten years [30, 66].

POLICING AGENCIES

Since the federal government subsidizes student defaults, guaranteed lenders have little incentive to follow up on students who fail to pay. This is a blatant irony about the federal-aid system: the federal government also subsidizes policing agencies to ensure that students do not default on FFEL loans. Annually, this costs millions of dollars to fund "36 state and private non-profit guaranty agencies that serve as insurance intermediaries between the government and FFEL lenders for loan defaults" [43]. This inefficiency will continue to negatively impact a federal aid system in desperate need for reform. No wonder the Government Accountability Office (GAO)[9] "has repeatedly labeled student aid as creating a high risk of waste, fraud, abuse, and mismanagement" [30, 69].

INTEREST AND CONSOLIDATION

To this point we have followed the dollar through five avenues of the federal aid system, returning us to the students' original question: What happens to the interest generated from direct loans? Put simply, this interest goes to pay for fixed 9.5 percent tax-exempt bonds; interdepartmental charges between the Treasury and Education; guaranteed subsidies, and policing agencies. Table 1 illustrates the significant amount of savings that could occur by eliminating the waste in the system. The federal government would then be permitted to channel its income from interest and consolidation toward additional student funding. The interest from direct loans would generate over 3.7 billion dollars[10] over the next ten years [58]. The GAO found that consolidating direct loans brought a "net gain to the government" of more than $1 billion in 2002-3 [70]. Moreover, for FFEL consolidation loans, "subsidy costs grew from $0.651 billion for loans made in the fiscal year 2002 to $2.135 billion for loans made in fiscal year 2003" [71].

CONCLUDING RECOMMENDATIONS

In order to return the waste in the federal aid system to students, the following seven pillars are recommended. First, refinance 9.5 percent bond rates to reflect market value. Second, remove all loop-holes that legalize tax-exempt loan bonds. Third, remove Treasury interest charges to the Department of Education. Fourth, eliminate default subsidies. Fifth, reduce subsidies to agencies that police lenders. Sixth, return the interest from student loans to students. Seventh, return to students the income from student loan consolidation. Together, this proposed seven-pillared system (Table 1) could generate at least $30 billion in federal student aid over the next ten years [58, 59]. These funds can be used to establish a *National Tuition Endowment* that will use the waste in the federal aid system to generate more aid for students.

[9] Formerly the General Accounting Office.
[10] Author's calculations from the FY 2005 President's Budget Loan Volumes.

In closing, the establishment of a *National Tuition Endowment* would achieve three promising goals. First, it would ensure an open market for multiple lenders to participate in a competitive loan industry; this would ensure low rates and administrative efficiency in the system. Second, the income generated by the U.S. government would no longer subsidize a handful of private lenders; instead this revenue would be used to generate more aid for students. Third, tax-payers would no longer have to support a federal aid system that generates waste; rather, an efficient and ethical use of tax-payers dollars would make certain that millions of students would have access to postsecondary education.

Interconnected Systems

This analysis does not assume that federal student aid operates in isolation [72]. On the contrary, it is inherently interconnected to the systems of state financial aid [11, 32-43], institutional policies, and campus practices [3, 6, 16, 28, 41, 44-57]. Future articles will diagnose these systems in relation to an issue affecting all of us: America's tuition crisis.

Table 1. Seven-pillar formula generating over $30 billion* in additional student aid [58].

Pillar 1	Refinance 9.5% bond rates	$10 billion[1]*
Pillar 2	Remove tax-exempt bonds	$10 billion[2]*
Pillar 3	Remove U.S. Treasury interest charges to Dept of Education	X
Pillar 4	Eliminate default subsidies	$3 billion[3]*
Pillar 5	Reduce subsidies to 36 agencies who police lenders	Y
Pillar 6	Return income from student loan interest	$3.7 billion[4]*
Pillar 7	Return income from loan consolidation	$1 billion[3]

*Over the next 10 years. (1) Congressional Research Service, Memorandum: "9.5 Percent Floor Loans," October 8, 2003; (2) The Joint Committee on Taxation estimates tax exemption on loan bonds will cost the Treasury $4 billion from 2004-8 [66]; US Department of Education, unpublished data 2004; (3) GAO-04-568T; (4) author's calculations from the FY 2005 President's Budget Loan Volumes [58].

Table 2. Federal Cost for $65 Billion in Federally Guaranteed Student Loans

Guaranteed (FFEL) Loans Projected in FY 2005	$64,637,000,000
Estimated Federal Cost	$6,793,000,000
Estimated Federal Cost for Same Amount of Direct Loans	$446,000,000
Potential Savings	$6,347,000,000

Sources: Volume estimates from the FY 2005 Budget Appendix, p. 366; Incorporating Federal Administrative Costs into FFEL and Direct Loan Program Cost Estimates, Department of Education, 1999. Table used by permission from bill summary, Direct Loan Rewards Act of 2004 (H.R. 4270), June 29, 2004.

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