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GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

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April 29, 1993

The Honorable William F. Goodling
Ranking Minority Member, Committee on
Education and Labor
House of Representatives

Dear Mr. Goodling:

Previously,[1] we discussed the potential savings to the federal government from converting the Federal Family Education Loan program into a direct loan program. We estimated that, properly implemented, direct lending could save about $4.7 billion in its first 5 years, in present value terms. A February 22, 1993, report by the Congressional Research Service (CRS) contended that (1) direct lending would neither increase national income nor necessarily achieve greater savings than those attainable from modifying the current guaranteed program and (2) federal administrative costs could absorb whatever interest savings direct lending generated.[2] This letter responds to your request that we evaluate these contentions.

Our methodological approach differed from that of CRS. Consistent with a public welfare analysis, CRS focused on the national income increase associated with student loans. CRS reasoned that since guaranteed and direct lending would provide the same loan volume, both programs lead to equal increases in educational investment and

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[1]Direct Loan Debate (GAO/HRD-93-15R, Feb. 8, 1993); Student Loans: Direct Loans Could Save Billions in First 5 Years With Proper Implementation (GAO/HRD-93-27, Nov. 25, 1992); Direct Student Loans Could Save Money and Simplify Program Administration (GAO/T-HRD-92-8, Oct. 29, 1991); and Student Loans: Direct Loans Could Save Money and Simplify Program Administration (GAO/HRD-91-144BR, Sept. 27, 1991).

[2]Congressional Research Service, "Federal Family Education Loans: Reduced Costs, Direct Lending, and National Income," Number 93-247 E, February 22, 1993.

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national income. Within this meaning of national income, direct lending gains nothing relative to guaranteed lending.

On the other hand, our relative cost analysis focused on federal budgetary costs. In that context, supplying the same loan volume at a lower federal cost would constitute an improvement over the present system, because the federal government can use savings accruing from direct lending for other spending or deficit reduction.

We agree with CRS that reducing interest subsidies in the guaranteed loan program would achieve savings, and recent amendments to the Higher Education Act should realize some of these savings. Neither CRS nor we know how much the subsidy should be reduced or whether, if it were reduced as much as possible, the same savings would accrue as under direct lending.

CRS's report incorrectly stated that we ignored credit risk costs in our direct loan cost estimates. Our most recent calculation of the savings attributable to direct lending included estimates of (1) default costs to the government--credit risk,[3] (2) the costs of servicing loans, and (3) the Department of Education's administrative costs. Because the literature refers to each of these as "administrative costs" and no uniform definition exists, we detail below how we treated each of these costs in our estimates.

Our estimate of the budgeted program cost included default cost estimates. We assumed the same default rate in our cost estimates for the direct and guaranteed loan programs, based on the current program's historical default rate. Under credit reform, loan repayments are estimated for future years, and expected defaults are subtracted from repayments that are due. The program cost fully accounts for defaults (as income that is due in the future but not received).

We also included estimates of loan servicing costs, assuming that the government will contract out loan servicing and collection to private sector agents.

[3]CRS's definition of credit risk costs included costs arising from loan prepayment. However, since students now pay an adjustable interest rate, we do not believe this risk is material.

As CRS noted, direct lending will generate additional administrative expenses. In fact, our November report included estimates of two significant administrative cost increases that the Department of Education would incur as a result of converting to direct lending. First, we estimated new costs associated with infrastructure development for direct lending, such as costs for new computer systems and training materials for college administrators, at about $54 million. Second, we estimated that Education would spend about $117 million more to administer direct loans than it would for guaranteed loans in the first year of the program's operation. In our estimate, these two factors reduce the savings otherwise available from direct loans by about $170 million in the first year--from about $980 million to about $810 million. These reductions would be much smaller in future years.

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Copies of this letter will be provided to the Secretary of Education; the Director, Office of Management and Budget; relevant congressional committees; and other interested parties. If you have any questions or would like to discuss this material further, please call me at (202) 512-6806.

Sincerely yours,

Edward A Densmore

for Lawrence H. Thompson
Assistant Comptroller General

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