Losing on a Sure Thing

Leave it to government to lose money on a sure thing. Back in 1995, as a Federal Reserve Governor, I argued that the cost to the taxpayer of having the government lend directly to students would be less than the cost of guaranteeing loans issued by the private sector. After all, as the world's highest rated borrower, the government can borrow more cheaply than the private sector can. Too bad things haven't worked out as planned.

When the Clinton Administration set up the Direct Student Loan program under the Department of Education, they never bothered to set up an appropriate accounting system to see how the loans they issued were performing. They didn't have to. The law setting up the program provided for a permanent indefinite appropriation, the equivalent of an entitlement, to cover any shortfall. So, if the system lost money or didn't perform as the budget projected, there was no problem, the government just wrote a check.

The shortfalls turned out to be huge. The Department's own estimate of how much interest it expected to collect from borrowers turned out to be a whopping 67 percent higher than what they actually collected from 1995-2003. Even more troubling was the performance of the Direct Lending program in collecting the money borrowed. Estimated default collections from borrowers were 44 percent higher than the amount actually collected. This is underperformance on a grand scale.

In theory, the Direct Lending program should be a profitable one. After all, the government is borrowing from the market and lending to students at a rate about 2 percent higher than its cost of funds. This should be the government equivalent of the old joke about bankers' having a "3-6-9" program. Borrow at 3, Lend at 6, Time left for 9 holes.

But, the Direct Lending program has been losing more money with each passing year. Last year, in its ninth full year of operation, the program had interest costs that exceeded its interest and fee income by $2.9 billion. Some of this loss is understandable. Students do not have to pay interest while in school. So, interest payments do not start coming in until year five for a four year student. Then, the interest payments from graduates should be covering a larger portion of the interest cost of lending to new students, and total student interest payments should start to rise relative to the interest paid by the government. But, the program lost $1.9 billion in interest in its seventh year, $2.4 billion in its eighth, and $2.9 billion in its ninth year. It is going ever deeper in the hole, with no end in sight.

The General Accounting Office, Congress's watchdog on government programs, has issued two highly critical reports. The first, in 2001, was scathing regarding the inept, nearly non-existent, accounting process set up by the Clinton Administration for comparing forecasted and actual performance. The paucity of good data made detailed analysis of the program's performance impossible. A second GAO report, issued this Spring, noted some improvements, but remained critical of the accounting lapses that still exist.

In spite of this, the Center for American Progress, run by advisors to the Kerry campaign, are claiming a budget windfall of $4.5 billion per year by moving all student loans to the Direct Lending program. This sounds like the businessman who was losing money on each product he sold but thought he could make up the difference by increasing his volume. Not surprisingly, Kerry's advisers are the same people who set up the flawed accounting for the program during the 1990s. With the higher education bill up for reauthorization this year, it's critical to take a careful look at the actual performance of the Direct Student Loan program.

At the very least, we need more experience and real data on loan performance before any expansion of the Direct Lending system is even considered. In particular, Congress must demand improvements in default collection performance and a modern financial accounting system. This is not a small program. This year the total amount of direct loans outstanding will approach the $100 billion mark. Even by the standards of Washington, this is real money.

Lawrence B. Lindsey is President and CEO of The Lindsey Group, a global economic consulting firm. He previously served as President George W. Bush's chief economic advisor.