Educational Policy Institute

Reframing the Student Loan Costing Debate

The Benefits of Competition

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July 2005

American Higher Education Report Series

Educational Policy Institute

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Suggested Citation:

Galloway, Fred, and Wilson, Hoke (2005). *Reframing the Student Loan Costing Debate: The Benefits of Competition.* Washington, DC: Educational Policy Institute.

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FOREWORD

In 1994, The Clinton Administration pushed and received approval for a new loan program that allowed the government to provide student loans directly to students rather than through a Guaranty Agency. Although initiated by Clinton and the Democratic-led Congress, the creation of the Direct Student Loan (DSL) program, while controversial, has roots in both the Republican and Democratic parties. Only as time went on did the proposal to develop a direct, government-operated student-loan entity become a partisan issue.

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While President Clinton's intention was to move the entire loan portfolio to a Direct Lending format, this has clearly not happened. Ten years later, only one third of student loans are delivered through the DSLP, the remainder through the Federal Family Education Loan (FFEL) Program.

Since 1994, there has been much anecdotal information about which program is better or worse and what the net impact of having the two programs is on the federal loan program and on student lending and debt burden. In my discussions with loan personnel from both Direct programs and FFEL programs, most agree that there is considerable advantage of having both programs. My, how the dialogue has changed over time. In addition, I have spoken with CEOs and other FFEL program leaders who agree that the competition has been good for students.

However, almost all of the discussion to this point has been anecdotal at best, which is why we are pleased to publish this analytical discussion of the DSL and FFEL programs. Authors Galloway and Wilson have put together an interesting analysis of the impact of the two programs on program costs, and, along the way, have constructed an interesting historical account of the development of the federal loan program, from its origination in 1965 to its current and continual battles on Capitol Hill.

It is important to note that the purpose of this piece is not to suggest that one program is better than the other. In fact, the conclusion buttresses the anecdotal evidence over the years, suggesting that the two programs provide a market-like competitive structure, which only helps reduce student burden through increased loan services, better information, and reduced costs. Rather, the purpose is to provide some level of evidence of the two programs and spur continued discussion about how these programs interrelate and what the next generation of loan programs should look like, if we ever get that opportunity.

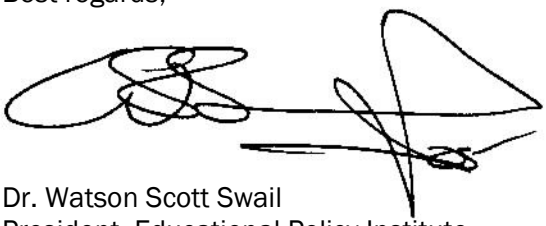
While we are pleased to offer this piece to interested readers across the US and beyond, I must acknowledge that the discussion and findings of this report are completely the account of the two authors and not of the Educational Policy Institute.

I would like to thank the many people that offered suggestions on this politically-sensitive report, including David Breneman, University of Virginia; Sue McMillin, Jacob Fraire, and Matt Short of TG; Mark Lafer of AES/PHEEA; Sam Kipp of the California Student Aid Commission; Bob Shireman of Student Loan Watch; and Stephen Burd, Chronicle of Higher Education.

And, of course, a big thank you to Fred Galloway and Hoke Wilson for the extraordinary amount of time writing, listening, and rewriting this important piece of history and analysis.

In concert with the purpose of this paper, we hope that you and your colleagues find this report both interesting and informative, and we look forward to your feedback. Please email us at *info@educationalpolicy.org* if you have any questions or comments.

Best regards,



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EXECUTIVE SUMMARY

As debate in Washington heats up regarding congressional reauthorization of the Higher Education Act, a central question involves what to do about the continued coexistence of the two student loan programs – the Federal Family Education Loan Program (FFELP) and the Direct Loan Program (DLP). With hundreds of millions of dollars at stake for banks, loan servicers, guaranty agencies, and secondary markets, the debate so far has been long on partisan politics and short on empirical evidence, with both sides claiming that their loan program is the cheapest and most efficient (Student Loan Watch, 2005). However, in this paper we argue that comparing the cost per loan between programs is at best counterproductive, since any benefits that have accrued to taxpayers have occurred as a direct result of the competition between the programs. In other words, the economics of each loan program cannot be viewed in isolation since many, if not all, of the cost-saving innovations advanced by each program have occurred as a way of improving upon the services offered by their competitor.

To demonstrate the importance of competition in reducing student loan program costs, this paper provides a lengthy history of the evolution of the student loan programs, paying particular attention to the way the FFELP community behaved in the absence, and then the presence, of competition from the DLP. Highlighted are the many events that raise serious concerns about the ability of the federal government to manage such a large and logistically-challenging program in the absence of competition. Although this historical information is by itself quite persuasive, in the second part of the paper we move on to the empirical centerpiece of our argument – the estimation of two annual time series models that use detailed federal budgetary data from 1966 to 2003 to investigate the real costs associated with the student loan programs.

The results of this analysis suggest quite strongly that the introduction of the DLP in 1994 has produced significant cost savings. For example, the results from our first time series model show that competition lowered the average annual cost of running the loan programs by almost $685 million per year. To make sure that this $685 million in annual savings was not a result of a significantly cheaper DLP, a similarly specified model that tracked just the costs of the FFELP over the same period was estimated. As was the case with the first model, all of the estimated coefficients were of the expected sign and the model explained almost 96 percent of the inter-temporal variation in programmatic costs. However, the most important finding from this model was the coefficient of the Direct Loan dummy variable (-$620 million), which sug-

gests that introduction of the DLP in 1994 produced slightly more than $620 million dollars in average, per year savings in the FFELP, confirming our competitive market hypothesis. Interestingly, the difference in the estimated coefficients for the Direct Loan variable in the two models ($685 million vs. $620 million) lends some credence to the notion that, at least initially, the DLP was somewhat cheaper than the FFELP. Nonetheless, it is clear that the FFELP responded well to competition.

Taken together, the results of this analysis suggest that the competition between the FFELP and the DLP has generated significant internal efficiencies, which in turn have saved federal taxpayers about $685 million per year. Although evidence has been presented to suggest that, at least initially, the DLP may have been cheaper than the FFELP, the adoption of a system where government becomes the sole supplier and administrator of the student loan program is doomed to at least the same level of inefficiency and upward price-ratcheting as was the case with FFELP before DLP. As such, the authors urge legislators and educational policy makers to come together to preserve the competitive structure that now exists, and to work diligently to make the competition as fair and equitable as possible so that federal taxpayers can continue to reap the benefits of this unusual inter-program competition.

INTRODUCTION

As debate in Washington heats up regarding congressional reauthorization of the Higher Education Act, a central question involves what to do about the continued coexistence of the two student loan programs – the Federal Family Education Loan Program (FFELP) and the Direct Loan Program (DLP). With hundreds of millions of dollars at stake for banks, loan servicers, guaranty agencies, and secondary markets, the debate so far has been long on partisan politics and short on empirical evidence, with both sides claiming that their loan program is the cheapest and most efficient (Student Loan Watch, 2005). However, in an era where the rapidly expanding federal budget deficit has already crowded out many planned increases in discretionary spending, understanding the economics of the student loan programs is essential if Congress is to manage the loan programs in a way that minimizes taxpayer expenditures.

Despite the heated rhetoric and claims put forward by supporters of both sides, the empirical reality is that neither side has a monopoly on the truth; both the General Accounting Office (2001) and U.S. Department of Education Office of the Inspector General (1999) have concluded that either program might be cheaper in a given year, depending on the interest rate environment and how certain shared costs are allocated between the programs. This of course has not stopped supporters from arguing that their program has the lowest cost per loan, and as such, should be granted monopoly status in this potentially winner-take-all game. However, we argue in this paper that focusing on the cost per loan is at best counterproductive, and at worst, technically incorrect.[1] Instead, we argue that any benefits that have accrued to taxpayers have occurred as a direct result of the competition between the programs. In other words, the economics of each loan program cannot be viewed in isolation since many, if not all, of the cost-saving innovations advanced by each program have occurred as a way of improving upon the services offered by their competitor.

We argue that any benefits that have accrued to taxpayers have occurred as a direct result of the competition between the programs

To demonstrate the importance of competition in reducing student loan program costs, we first describe the evolution of the student loan programs, paying particular attention to the way the FFELP community behaved in the absence, and then the presence, of competition from the DLP. During this discussion, which is not intended to tar and feather the Department of Educa-

[1] In other words, since the cost per loan in each program is a function of both the interest rate environment and overall level of competitiveness in the market for student loans, and since in the past, funds have been spent on one program from the budget of another, it is both technically inaccurate and misleading to think that at this point in time, an exact cost per loan figure can be calculated that will resolve the question of which loan program is ultimately cheaper for federal taxpayers.

tion and its financial partners in the GSLP/FFEL program, we highlight many events that raise serious concerns about the ability of the federal government to manage such a large and logistically challenging program in the absence of competition. After providing this important context, we then move on to the empirical part of the paper where we estimate two autoregressive, moving average time series models that use data from appendices to the U.S. Budgets for the years 1966 to 2003 to show that as a result of the introduction of the DLP, real per-loan costs in the program have fallen significantly. In the final part of the paper, we discuss the policy implications of our analysis. There, and here, we argue for the importance of providing a level playing field for the two loan programs.

EVOLUTION OF THE STUDENT LOAN PROGRAMS

Although this may come as a surprise to many, lending to students to finance their postsecondary educations did not begin with the Federal government. Private lenders supplied funds to students years before the ratification of the Higher Education Act (HEA) of 1965 that, under Title IV, created the Guaranteed Student Loan program (GSLP), the predecessor to today's FFELP. In fact, the first guaranteed loan was made in Massachusetts in 1957 and, by the time the HEA was passed, there were already 21 agencies in existence whose function was to reduce the risk associated with lending to students (National Coalition of Higher Education Loan Programs, 1994). However, private lending was clearly not enough to insure postsecondary access for many low- and middle-income students, since by 1970 the median family income of freshman was almost 22 percent higher than the overall median family income in the United States.[2] If access was to be based on merit and desire, and not financial privilege, then something had to be done to close the gap.

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The GSLP represented a step in the right direction. As with all federal programs, though, questions arose as to how to fund it. Two plans found the strongest advocacy. The first, often called the "Zacharias Plan" in honor of its originator, an MIT physicist and member of the Carnegie Commission on Higher Education that brainstormed federal student lending, called for something remarkably similar to the current DL program. Some of its features in-

[2] Figures for median, freshman, family income are from *The American Freshman: National Norms*, *Annual*, The Higher Education Research Institute, UCLA. Figures for median, U.S. family-income are from the U.S. Bureau of the Census, Income Statistics Branch/HHES Division, March Current Population Surveys.

cluded the use of the Treasury as a source of financial capital, an income-contingent repayment plan, and a 30-year time span for repayment.

For a number of reasons, not the least of which was the potential for drain of Treasury resources during a period in which the federal government was committed to the financing of numerous other programs, including many Great Society programs and the costs associated with the Vietnam War, the Zacharias Plan was not adopted. Instead, the GSLP was born.

The GSLP was not an overnight success. The Department of Health, Education, and Welfare's (HEW) Office of Education anticipated that it would provide 300,000 students with loans in 1966, but served only 48,500. Outcomes improved in 1967 as 330,000 students received GSLs, though the Office of Education missed its target of 775,000[3]. There were a number of reasons for the shortfalls. The most obvious reason was that lenders did not find it particularly profitable to participate. The GSLP initially offered a 6 percent rate of return on student loans, but this was only slightly higher, for example, than average, new home mortgage yields in 1965 (5.81 percent).[4] While the yield is somewhat lower, home mortgages have the advantage that they are reasonably secure. A borrower with a mortgage secures it through the equity in his or her house or, frequently, through the payment of insurance that guarantees the lender's return. This brings us to the second reason for lender reticence. Federal student loans were not initially insured and students, often transient and with little collateral, are notorious risks for default.

These issues were quickly rectified. Within a year the base rate of return was raised to 7 percent. Within four years of HEA enactment, Congress provided "special allowances" that could pay lenders as much as 3 percent above the 90-day Treasury bill rate. In 1969, special allowances resulted in a 2 percent raise in return so, in the course of only four years, lenders could be compensated at a rate 50 percent higher than originally intended.

To address the risk associated with lending to students, Congress authorized the Office of Education to re-insure guaranty agencies – student loan underwriters – for up to 80 percent of their defaults. This step was taken to free more money from Guaranty Agency ledgers for student loans, as well as to make the creation of these agencies fiscally more feasible in states that did not already have one (McNett, 1968). Until agencies were established, the federal government (under the Student Loan Insurance Fund) agreed to 100 percent reimbursement on defaulted loans in states without a guarantor. In

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[3] Unless otherwise indicated, all figures are from appendices to the US Budget.

[4] Rate for new home mortgage yield is from *Facts and Figures on Government Finance* (Washington, D.C.: Tax Foundation, 1998, Table B25). Scott Moody, ed.

such states, *all* of the risk involved in student lending was eliminated while the return was at least two percentage points higher than, arguably, one of the securest of financial vehicles. Eventually, the federal government conditionally raised its re-insurance rate for guaranty agencies to 100 percent.

With a high rate of return for virtually risk-free lending, lender participation skyrocketed. In fact, it increased to the point where available funds for student loans began to dry up. As a partial remedy to this problem, in 1972 the government created the Student Loan Marketing Association, affectionately known as "Sallie Mae." Sallie Mae provided a market for the sale of existing student loans and further increased the supply of loan funds through its student loan warehousing activities. A government sponsored enterprise given, at cost, access to Treasury funds in order to serve the public good by increasing the velocity with which student loan funds are circulated, Sallie Mae has severed almost all formal ties with the federal government. On the eve of the institution of the DL program (1993), it was turning a profit of $394 million, making it one of the 100 largest corporations in the U.S. (Parsons, 1997, p.197).

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Figure 1. GSL/FFEL Program Student Loans, 1966 – 2004

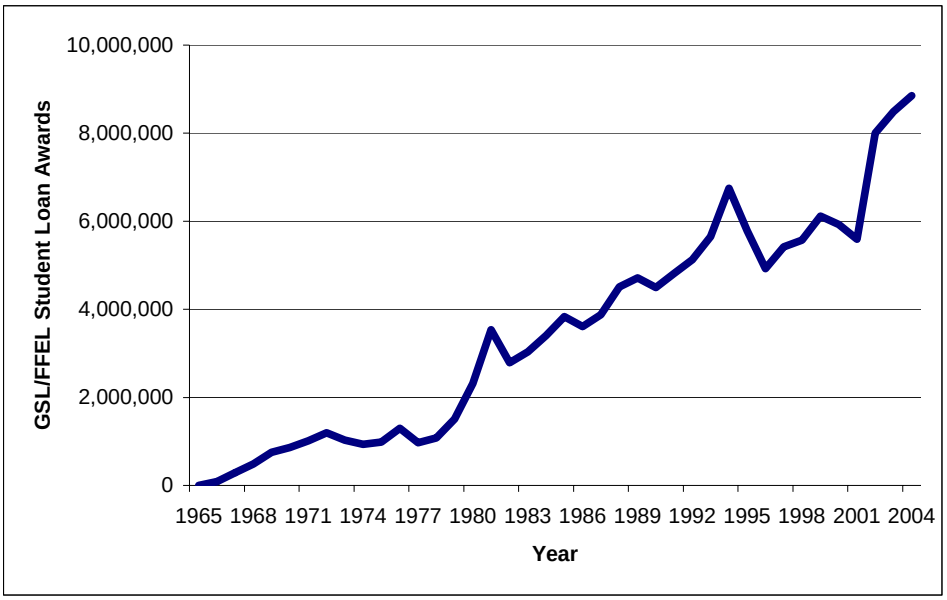
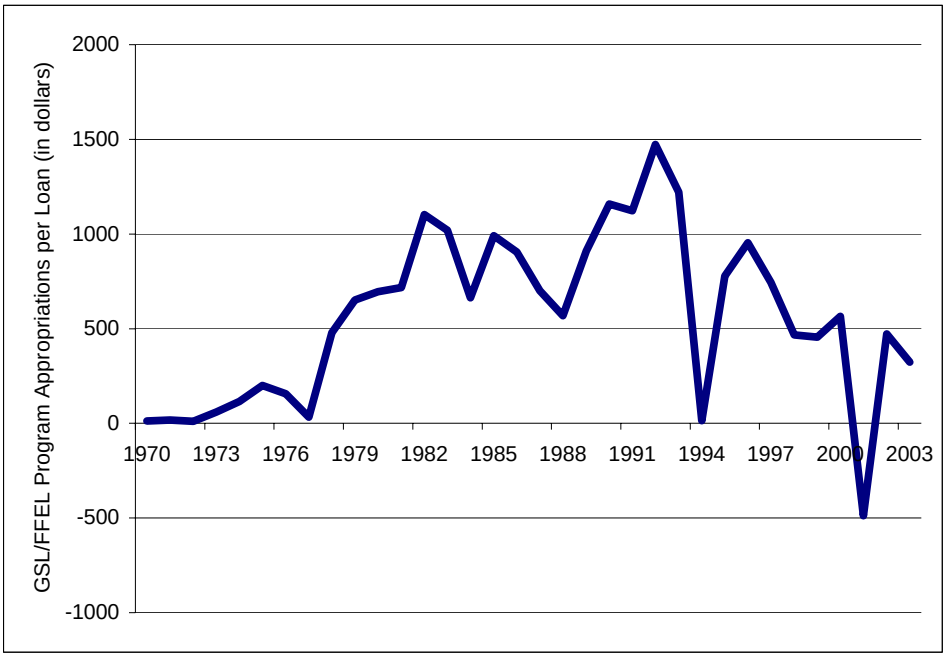


Figure 1 depicts the steady increase in student participation in the GSL/FFEL program, as measured by the number of loans, from its inception until 1994. With the exception of several years in which eligibility changes caused temporary decreases in the number of loans awarded, the steady growth in loans

was uninterrupted until the introduction of the Direct Loan program in 1994.[5] Given increased private participation, an increase in guarantors, and a faster circulation in loan funds, the opportunity for students to access higher education through borrowing existed. It should come as no surprise that they took advantage of it.

Figure 2. GSLP/FFEL Appropriations per Loan, 1970 – 2004



What is something of a surprise is that the cost to the federal government of providing student loans continued to grow through 1993. Figure 2 presents total federal appropriations for the program, divided by the number of awards, for the years 1970 through 2004[6]. While appropriations per loan may not be an ideal depiction of loan cost, it does show a sharp, upward trend until 1993, after which it falls precipitously. Although a number of factors may be responsible for this steady growth including the creation of the Supplemental Loans for Students (SLS) program in 1986, the loosening of eligibility for such loans, particularly at proprietary schools, and the staggering default rates and claims levels that followed this explosive growth in loans, we are also convinced that the federal government's inability to manage the program and the cartel-like grasp that the lending industry came to

[5] For example, in 1981 the passage of the Gramm- Latta bill required students from families with incomes greater than $30,000 to demonstrate financial need before receiving a subsidized loan, essentially repealing part of the Middle Income Student Assistance Act of 1978 that had previously removed needs testing and caused a significant upward spike in the number of loans awarded.

[6] Yes, appropriations per award were negative in 2001. This is largely due to the recall of $950 million in Guaranty Agency reserve funds. See the Appendix to the US Budget for 2001, Department of Education, Office of Student Financial Assistance, p. 370.

enjoy also played significant roles. By now the reader surely knows our explanation for the post 1993 decline, the originally scheduled year for the inauguration of the Direct Loan demonstration project.[7]

From its inception, and through the 1970s, the government demonstrated that administering the GSLP was possibly more of a logistical challenge than it could handle. One of the principal reasons for the slow start at student lending was that the Office of Education could not publish and distribute the necessary forms to lenders in a timely fashion.

From its inception, and through the 1970s, the government demonstrated that administering the GSLP was possibly more of a logistical challenge than it could handle.

If we want to evaluate government performance in terms of financial management, then an examination of the Student Loan Insurance Fund, better known as the Federal Insured Student Loan program (FISL) is in order. As already mentioned, when a lender/Guaranty Agency was not reasonably available to insure a GSLP, the Federal government assumed the responsibility. The FISL represents the separate ledgers associated with these activities. The FISL cost the government $1.3 million in 1968, a figure that increased to almost $2 million in 1969. In 1970, however, it shot up more than three-fold to approximately $6 million. This was a rate of increase significantly greater than that associated with conventional GSLP[8].

As the GSLP expanded, so did problems with loan defaults. By 1977, according to the Government Accounting Office (GAO), one in six GSLP were in default. Worse still, the GAO held a grim outlook for collection. Its estimates for September of that year indicated that the government had paid $436 million in claims to lenders over the life of the program, but had revived only $33.8 million of those debts (Roark, 1977). Shockingly, the US Department of Education (ED) found, in 1982, that about 47,000 federal employees — some working for ED — had defaulted on $68 million in student loans (Chronicle of Higher Education, 1982 (a)). These figures imply that, when left to its own devices, the government was incapable of managing the student loan portfolio. Of course, one could argue that the government should not have had to considering it was paying for professional services it was, arguably, not receiving.

In 1974, the federal government owed $60 million to state guaranty agencies to cover defaults. Compared to the $136 million in defaults the government incurred by insuring loans directly through the FISL, $60 million might not seem excessive. One could conclude from these figures that guaranty agen-

[7] In addition to the introduction of the Direct Loans, the tightening of eligibility for loans from high default schools also contributed to the post-1993 decline.

[8] As shall be demonstrated shortly, a direct comparison between the FISL program and the GSLP is not entirely fair, though.

cies were more effective at managing portfolios, and enforcing lender due diligence requirements, than the federal government. Yet as Kenneth A. Kohl, Associate Commissioner of Education for Guaranteed Student Loans pointed out, one must recall the function of the FISL program in order to explain the difference. The FISL program was created to insure the loans of borrowers at "eligible institutions who do not have reasonable access to State or private programs of student loan insurance." (Appendix to the Budget for Fiscal Year 1972, p.454). Most of these loans — and 58 percent of the FISL defaults — were for students enrolled in proprietary schools. The difference in default volume, then, might be attributable to differences in the risk-level associated with each cache of loans as much as it is to differences in administrative efficiency (Winkler, 1974). Because of the sliding scale used to calculate reinsurance rates, risky loans were not attractive to State guaranty agencies. If they could maintain default rates within their agencies at no more than 5 percent, then the government, at a rate of 100 percent, reinsured them. By "creaming off" the most secure loans, they assumed less risk.

If they could maintain default rates within their agencies at no more than 5 percent, then the government, at a rate of 100 percent, reinsured them. By "creaming off" the most secure loans, they assumed less risk.

By the beginning of the 1980s, the student loan market began to undergo structural changes that enhanced the competition between lenders, between guarantors, and between lenders and guarantors. Ironically, the increased competition led to intra-industry finger pointing that revealed the self-interested practices of some of ED's partners in the GSLP. As electronic funds transfers became increasingly common, and as the financial market became progressively concentrated with larger firms absorbing smaller ones, lenders and guarantors began to expand across the state boundaries that had heretofore provided them with a sort of regional autonomy. As long as each enjoyed a secure fiefdom, they could share a unity of interest that allowed them to echo one another's voices when they warned the federal government that, without increasingly higher rates of return and lower risk, they would have to leave the student loan market. When lenders and guarantors began to make incursions upon the territories of one another, though, it soon became clear that participation in the GSLP was not as unprofitable as they had previously and repeatedly proclaimed. Their "zealous pursuit" of student borrowers sent signals to Congress and the Republican administrations of the 1980s that "lenders are making too much money"[9] (Wilson, 1985 (a)). This information was not of much use to the government, though, as with no alternative to their participation, the government had little recourse but to acquiesce to almost any demand.

[9] Quote attributed to Sherry A. Ward, Director of the Virginia State Education Assistance Authority.

As a consequence of inter-state banking and heightened competition between banks and the insurance companies that were beginning to push their way into the market, the topography for guaranty agencies also changed. In 1976 there were a total of 25 guaranty agencies in the United States, almost all of them directly associated with the government of the State in which they operated. By 1987 this number swelled to 58 with an ever-increasing proportion having no formal ties to any government — State or Federal (Wilson, 1987a). By 1990, almost half of all guaranty agencies were privately controlled (DeLoughry, 1990a).[10] Initially, the two largest private guaranty agencies, the Higher Education Assistance Foundation (HEAF) and the United Student Aid Fund (USAF), were the principal guarantors for the large insurance companies entering the market (Peebles, 1985). Following their primary customers across State lines, they tread upon the turf of more traditional State agencies and helped to catalyze disunity among all guaranty agencies. Hostility openly erupted in 1983 when HEAF announced that it would guarantee nationwide, $300 million in GSLs for law school students. This upset other guaranty agencies because law students took out large loans for at least three years[11]. "They're taking the cream of the crop of loans out of the state agencies," said Paul P. Borden, head of Kentucky's state Guaranty Agency (Chronicle of Higher Education, 1983).

This genesis of large, national guaranty agencies provided traditional guarantors with more to worry about than the loss of a particularly secure cache of loans. They were losing control over their default rates. Guaranty agencies had to keep default rates at or below 5 percent in order to remain 100 percent re-insured by the federal government. This could be accomplished by shying away from risky loans. However, with new, private, inter-state guaranty agencies on the scene, a lender who refused guarantees by a state agency could simply take its entire portfolio — risky and risk-less loans — elsewhere. Regional agencies faced a choice. They could actually perform the function for which they were created — assume risk — or see their portfolios diminished. These options were not palatable and so the state agencies lobbied Congress for an amendment to the HEA. The "Goodling Amendment"[12] allowed state agencies to police lenders and private guarantors operating in their jurisdiction. By providing state agencies with the power to proscribe a lender (regardless of who guaranteed their loans) from operating within their state, Congress returned to them a measure of their past abilities to operate as regional hegemonists (Wilson, 1985 (b)). In the process, though, the state

Regional agencies faced a choice. They could actually perform the function for which they were created — assume risk — or see their portfolios diminished. These options were not palatable.

[10] By 1990, though, the number of guarantee agencies decreased to 45.

[11] Medical students might also appear to be lucrative targets. However, medical students were eligible for very low-interest and federally administered HEAL loans.

[12] Named in honor of the bill's main sponsor, Representative William F. Goodling (Rep., Pa.).

agencies inadvertently revealed to Congress, the Reagan and Bush administrations, and the public that participation in the student loan program was not as financially debilitating as some public statements might lead one to believe.

One practice that became popular in the early 1980s was that of using agency reserves and loan portfolios to back the issuance of bonds. Because these bonds were tax-exempt, guaranty agencies could offer them at lower interest rates than the returns garnered from student loans.[13] A 1980 CBO report estimated that the federal government was losing hundreds of millions of dollars a year in tax revenues as a result. The next reauthorization of HEA tightened this loophole, but did not close it. Profits to guaranty agencies on the issuance of these bonds were limited to 2.5 to 3 percent (depending on the ratio of students to state population) (Chronicle of Higher Education, 1980). By 1984, though, guaranty agencies learned that they could use Sallie Mae as an intermediary to get around these limits (Chronicle of Higher Education, 1984).

Guaranty agencies received funds from other sources as well, including the 5 percent insurance fee they were authorized to charge students for their loans. In fiscal 1981, state loan guaranty agencies reaped $426 million in revenues — 42 percent more than their expenses of $300 million (Hook, 1981 (a)). In 1982, at least $260 million of their revenues emanated from the insurance fees charged to students. These funds were used to build up agency reserves, allowing them to hedge against future defaults. In the same year, though, only two agencies, New York and Maryland, incurred default rates higher than 5 percent. Therefore, only these two states encountered any default expenses whatsoever. The fight among guaranty agencies for higher reserves and revenues raised the question of precisely what they were doing with all this money. As chief of ED's student loan branch, David C. Boyer, wrote to state guaranty agencies in 1982, "It was never the intent of Congress that guaranty agencies should get rich (as a result of the GSLP)" (Quoted in Hook, 1982 (a)).

As chief of ED's student loan branch, David C. Boyer, wrote to state guaranty agencies in 1982, "It was never the intent of Congress that guaranty agencies should get rich (as a result of the GSLP)."

Some of the money was used to enhance the salaries,[14] perquisites, and the work environment of Guaranty Agency officers and staff. It also went to cover

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[13] To understand how profits could be made, consider it this way: Suppose you buy a bond with a 10 percent interest rate. At the end of the year, though, you have to pay, say, a 10 percent capital gains tax. That would mean that the effective yield on the bond is only 9 percent. By purchasing a tax-free bond returning 9 percent (or better), then you would be at least as well off. If the bond issuer does not have to pay taxes on the instruments backing the bonds then, in this instance, the issuer can realize as much as a 1 percent profit. The figures used in this example were chosen for ease of math.

[14] The executive director of the Vermont Student Assistance Corporation — the state's Guaranty Agency — received a salary $72,000 higher than the governor's in 1989 (Wilson, 1989)

administrative expenses such as office supplies, loan servicing, and collection efforts purchased from private, for-profit suppliers[15]. Curiously, at least one of these suppliers was owned, in whole or in part, by Guaranty Agency officers, occasionally with their revenues improperly coming from Guaranty Agency reserve funds and default reimbursements (Wilson, 1986 (a)). In reply to GAO accusations that state-agency reserves totaled $1 billion in 1985 and were used chiefly to gather dust and interest, the executive director of one of the largest such agencies argued that "Nobody can take (that) money and buy an airplane with it. … It is there to run the loan program" (quoted in Wilson, 1986 (a)). Perhaps the executive never did buy an airplane, but several years later federal and state investigators suspected the agency of receiving "rather lucrative" kickbacks from an educational management corporation. Although the individual in question was ultimately acquitted, the corporation was under contract for $1.7 million to the agency to help collect student loans (see Janchik, 1988 and Wilson, 1989).

When Ronald Reagan took office, in 1981, the potential for abuses on the part of lenders and guaranty agencies had not yet become apparent. Reagan, his administrators, and the Republican Congress saved their wrath for students, proprietary schools and, of course, the Department of Education that they intended to dismantle. In fact, they were quite receptive to agency and lender demands. When, in his first year, Reagan moved to end interest subsidies for students, it was only intervention by NCHELP and lenders that kept him from being successful. They testified that doing so would cause the GSLP to come to an "abrupt halt" (NCHELP President, Douglas R. Seipelt, quoted in Hook, 1981 (b)). By ending subsidies,[16] student loans would have become much more expensive to the borrower and — if the simplest laws of supply and demand came into play — would have reduced loan volume. This was ironically unattractive to an industry that frequently decried the GSLP as an unprofitable drain on their resources. Also in 1981, Reagan approved the collection from students of 5 percent origination fees by banks (Hook, 1981 (c)) with the proceeds from these fees reverting to the Federal government.[17] In the autumn of 1982, bowing to pressure from lenders, Congress approved a bill that made federally-insured loans to students exempt from the Truth in Lending Act. Bankers had contended that the Act's disclosure and reporting

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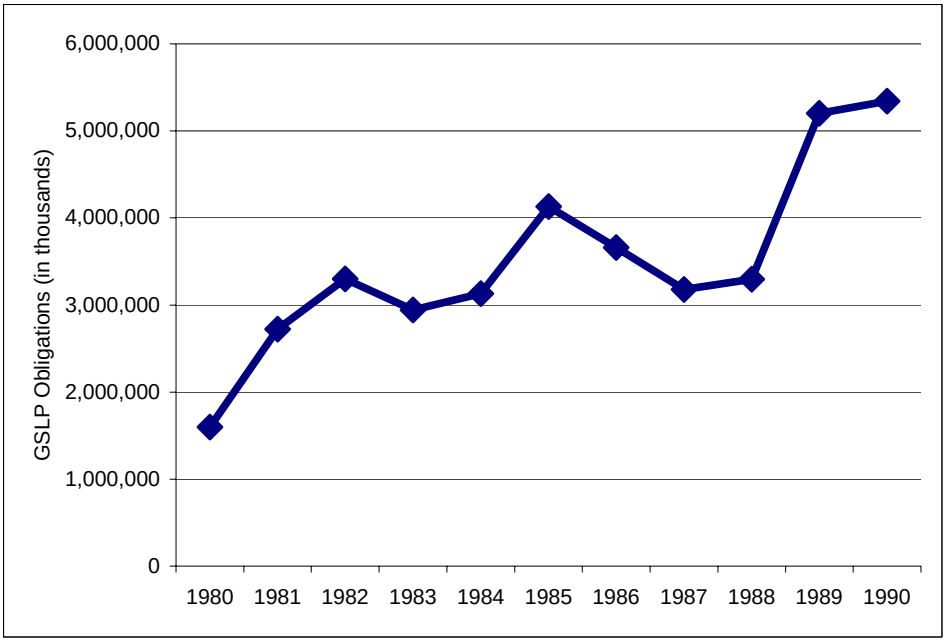
15 Guarantee agencies were paid an "administrative allowance" by the federal government that amounted to almost $35 million in 1982.

16 The plan was for the government to stop paying the subsidies. Instead, interest would accrue on the principal and as a result, when the student began repayment after graduation he, or she, would have a larger debt to pay off.

17 Recall that guarantee agencies were charging students as much as 5 percent in insurance fees. Additionally, many colleges and universities deducted a percentage of loan principal in return for processing the loan. A student could easily sign for a loan of $1,000 and receive a check for less than $900.

requirements were more detailed than need be and placed an unnecessary administrative burden on them (Chronicle of Higher Education, 1982 (b)).

Figure 3. Total GSLP Obligations, 1980 – 1990 (in thousands)



As Reagan began his second term, however, the focus of his administration's efforts to control costs began to shift away from students and proprietary schools, and toward lenders and guarantors. Even though the number of GSLs issued remained reasonably constant over his first term, rising from 3.5 million in 1981 to 3.8 million in 1985, the cost of the program did not. As shown in Figure 3, the total cost of the program swelled from $2.7 billion in 1981 to $4.1 billion in 1985, an increase of almost 52 percent. Although in real terms (constant 1992 dollars) this increase was only 26 percent and on a per loan basis 16 percent, considering the short time period, this was considerable. Reagan paid more for each student loan and students, at least, got less in return, in part as a result of the origination fees now charged by the Federal government. These fees were meant to assist the government in meeting the costs of responsibly administering GSLP. The default situation only got worse, however, with defaults costing the government $256 million in 1981 and $1.08 billion by 1985. On a per loan basis, net default costs grew six-fold, from $49.90 per loan issued in 1981 to $300.86 in 1985. And the administrative costs associated with the program, including administrative allowances paid to guaranty agencies, also rose 87 percent — from $60 million in 1981 to $112 million in 1985. Interest benefits — the subsidies paid by the government on behalf of students, but not including special allowances — similarly mushroomed. The government doled out $73.6 million

to cover interest payments while students were in school in 1981 and more than $1.8 billion in 1985. To even the most casual observer, it was obvious that the situation had gotten out of hand. The federal government was spending billions of dollars and, for this expense, it was saddled with the unenviable duty of having to keep a watchful eye, not only on the program's beneficiaries, but also to a lesser extent on its vendors.

At this point in time, the public perception was that the GSLP had become a "500-pound gorilla" that pandered to the interests of a "vast number of lenders and guaranty agencies" (Wilson, 1988 (a)). As it began to appear that the threats of lenders and guaranty agencies to leave the program might be hollow, Reagan moved to reduce federal expenses by cutting their revenues. Over their vociferous protests that such actions would "shut the whole program down"[18] (Engelgau, 1985), Reagan attempted to reduce the special allowances paid to lenders from 3.5 percent to 3 percent. More drastically, he wanted to slash them to 1.5 percent while students were in school and lenders had little to do but collect the proceeds. Further, he wanted to require lenders to disburse funds twice a year, instead of just once. Special allowances and other interest charges would then be paid on a semi-annual basis and not on the entire, annual amount, as was previously the case. As popular as Reagan was, he was only able to reduce special allowances to 3.25 percent. He was successful in obtaining multiple disbursements from lenders, but not in an attempt to reduce the maximum re-insurance rate paid to guaranty agencies to 90 percent from 100 percent. He also wanted to end the payment of administrative allowances to guaranty agencies, but here, again, he was unsuccessful (Engelgau, 1985). Against the politically less powerful, Reagan was able to secure a few more significant reforms. With the passage of the 1986 HEA reauthorization, a needs analysis was reinstated for students whose families earned more than $30,000 a year and, after the fourth year of repayment, the interest rate students were responsible for was raised to 10 percent from 8 percent (Wilson, 1986 (b)).

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Also in 1985, the Reagan administration initiated efforts to reclaim excess Guaranty Agency reserves. William J. Gainer, a GAO associate director, testified before the House Subcommittee on Postsecondary Education that guaranty agencies should not be permitted to "generate unnecessary income or reserves at the expense of either the student-borrower or the federal government." Allowing them to accumulate $841.9 million in surplus reserves accomplished precisely that end, Gainer explained. NCHELP responded that they had no "surplus" reserves, with every nickel necessary to guard against

[18] Muriel Johnson, executive director of the Virginia State Educational Assistance Authority, quoted in Engelgau (1985).

future defaults (Wilson, 1985 (c)). Nevertheless, by 1988, the government did attempt to rein in what it perceived as excess reserves, collecting almost $25.6 million that year. As further evidence that Reagan no longer believed Guaranty Agency beseechments, ED flatly withheld $55 million in administrative allowances in 1985. The Department's rationalization was that, due to an unexpected upturn in default claims, ED could not afford to distribute the administrative allowances.[19]

Generally, though, Reagan could not rein in GSLP costs. While it was now suspected that lenders and guarantors were as much to blame for expenses and abuses associated with the program as any other participant, they proved themselves to be much too powerful to control. On the one hand, the GSLP served over 3 million students in 1987 and secured employment for literally thousands of people at banks and guaranty agencies. Legislators could not simply shut the program down. On the other hand, few legislators knew enough about the program to feel comfortable making radical changes (Wilson, 1988 (a))[20].

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That being the case, the program proceeded through the rest of Reagan's final term, and George Bush's as well, pretty much as it had before 1985. The only real difference was that the government was in open contest with the private sector agents it had once hoped it could count on to run the program efficiently. Numerous, sensational investigations and court battles in the latter half of the 1980s brought the program into the public spotlight.

Highlights for 1987 included OIG accusations that Pennsylvania's state Guaranty Agency, PHEAA, had defrauded the federal government of $17.8 million by billing ED for default reimbursements before lenders had even attempted to collect on the loans, and for inappropriate administrative costs (Wilson, 1987 (b)). In the same year, a GAO study determined that ED had reimbursed lenders for at least $83 million in defaulted loans for which they had not exercised sufficient due diligence in attempting to collect. The GAO revealed that half of all reimbursement claims it examined should have been re-

[19] See Chronicle of Higher Education, 1985 (a) and (b). ED resumed the payment of administrative cost allowances in July of 1986.

[20] And the banking industry, at least, found it difficult to provide estimates that were consistent from lender to lender. CBA studies of the student loan industry consistently predicted dire consequences should cost-saving measures be enacted. When asked about the profits accruing to lenders from student loans, the most common CBA response was that, because different banks calculate profits in different ways, there was no way to tell. When pushed to provide a figure in 1986, the CBA suggested that lenders earn an average of about 0.75 percent on each loan as compared to 1.0 percent on traditional consumer loans. The CBA would not, however, reveal how it derived the figure, stating, "Most lenders are reluctant to reveal their profits on student loans" (Wilson, 1986 (c). Also see Wilson, 1986 (d)).

jected.[21] (Wilson, 1987 (c)). In another study, conducted in 1987, the GAO perused the records of 16 of the largest lenders in the program and found that 18 percent of the bills submitted for interest subsidy payments contained errors. These errors led to the overpayment of at least $1.8 million. That such errors could slip past ED, charged as they were with auditing the records of roughly 14,000 lenders in the program, is not surprising (Wilson, 1988 (b)).

Even when ordered by ED to comply with its mandates, guaranty agencies were reticent to comply. A series of court cases in 1989 pitted ED against 22 state guaranty agencies that refused to turn over control of $200 million in reserves[22]. Some agencies argued that the interest from the reserves was needed to meet operating expenses. Moreover, they were being unfairly singled out because, unlike other agencies that had chosen to put their reserves into real estate and other less liquid assets, they had opted to hold theirs in cash (DeLoughry, 1989). Another court case brought forth allegations by two former managers at Sallie Mae's Lawrence, Kansas, processing center that the government-sponsored enterprise routinely defrauded the government. They alleged that Sallie Mae was in the habit of accepting canceled loans from banks (loans that had never been dispersed) and then failing to report them as canceled to ED. By doing so, Sallie Mae could collect interest benefit payments from the government for loans that, in effect, had never been made. They alleged, as well, that Sallie Mae regularly misled borrowers by informing them that their accounts were delinquent when, in fact, they were up to date. If true, such a tactic could cause borrowers to pay more than they should on their loans[23] (DeLoughry, 1990 (b)).

With reauthorization again looming on the horizon, in 1990, the Senate Permanent Subcommittee on Investigations conducted well-publicized hearings. "The Nunn Commission," as it was called, charged that lenders, processors, and guaranty agencies had wasted millions of taxpayer dollars through "abuse and outright fraud." Said the commission's chairman, Sam Nunn (D-GA), "(I)n our investigation we have yet to hear of even a single part of the student-loan program that is working efficiently or effectively" (Myers, 1990). Something had to be done. But, what?

Said the commission's chairman, Sam Nunn (Dem., Ga.), "(I)n our investigation we have yet to hear of even a single part of the student-loan program that is working efficiently or effectively."

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[21] Note that this implies negligence on the parts of both lenders and guarantee agencies: The lenders for submitting the reimbursement claims to the guarantee agencies, and the guarantee agencies for approving them and submitting them to ED for re-insurance claims.

[22] Guaranty Agency reserves totaled roughly $1 billion in 1989.

[23] The plaintiffs claimed that they were wrongfully terminated when they brought these matters to the attention of their superiors.

The point was made, at the beginning of this history, that when the Gardner Commission suggested to President Johnson a broader use of student loans to help make higher education more accessible, they offered two methods for funding and administering the GSLP. LBJ could "out-source" the program, in essence hiring private firms to provide loan funds and services, or, as the commission preferred, he could have selected the "in-house" option by which the government would provide the loan capital and administrative functions itself. Hoping that the former would be cheaper, Johnson chose to out-source. Almost every year thereafter one advisory panel or another recommended scrapping the GSLP in favor of a national student-loan bank, or some other permutation of in-house, direct lending. By the early 1990s, President Bush began to take such recommendations seriously. In January of 1991, a spokesperson for the Bush administration floated the idea of cutting banks and guaranty agencies out of the picture. Instead, perhaps it might be better to allow colleges to originate and administer the loan program with funds borrowed from the U.S. treasury. The lenders and guaranty agencies that only a decade earlier had bemoaned how unprofitable the GSLP was rabidly opposed the plan (DeLoughry, 1991). Shortly thereafter, Bush's Education Secretary, Lamar Alexander, announced the administration's adamant opposition to the plan and threatened the upcoming HEA reauthorization with a presidential veto should it include provisions for direct lending.

The Democratically-controlled Congress seized on the idea, however. With the conviction — and votes — to override a presidential veto, Democrats pushed through a Direct Loan pilot program. As originally conceived, the pilot program would offer direct lending to 500 postsecondary schools whose loan volume did not exceed $500 million in the most recent year (Student Aid News, 1992). This was not enough for Bush's successor, Bill Clinton, though. Just a few months later, Clinton seized on the Direct Loan initiative, labeling it a focal point for his "reinventing government" project headed by Vice President Gore (Pitsch, 1994). Bolstered by Congressional Budget Office estimates that Direct Lending could save the government between $3 billion and $6 billion over the next five years (Student Aid News, 1993 (a)), Clinton proposed to scrap the pilot and immediately begin direct lending. The President hoped to phase in the DLP gradually until it could replace the GSLP/FFEL[24] by the 1997/98 academic year. In advancing the DLP, Clinton set off what was arguably to become the most partisan firestorm in the last decade.

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[24] The Guaranteed Student Loan program was renamed the "Federal Family Education Loan Program" with the 1992 reauthorization. What was formerly referred to as the "GSLP" will, from here on, be designated the "FFELP".

In conjunction with other techniques, the student loan industry attempted to derail the DLP by seeding a grassroots opposition movement. Plastering campuses all over the state with unprofessionally scrawled posters, the "Ohio Students for Loan Reform" declared the new DLP to be "kind of like pass-fail with your future on the line." The posters included tear-off cards addressed to Ohio's senators, urging them to vote "no" on the DLP proposal, and a toll-free telephone number by which students might "register (their) concerns by phone." What the posters did not make clear was that the Ohio Students for Loan Reform was actually associated with the Student Loan Funding Corporation, a secondary marketer that feared it would be swept away by the DLP. This deception[25], said Senator Paul Simon (Dem., Ill), was only "the latest outrage in an all-out lobbying campaign orchestrated by Sallie Mae and its allies." Simon related that Sallie Mae was backing a similar endeavor in Wisconsin and was further engaging some of the most expensive and well-positioned lobbying firms in Washington to defeat Direct Lending (All quotes in Weisskopf, 1993).

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Their efforts to derail the DLP were unsuccessful, obviously. While the student loan industry continued to publicly denounce the DLP as a disaster waiting to happen, some participants conceded that "The best way to handle the situation is to come out with a strong (FFEL) program and not wait for a fumble in the direct loan program "(Director of student financial services at UC, San Diego, William Hansen, quoted in Student Aid News, 1994). What this really meant was that, if the student loan industry hoped to survive, it had to match the DLP, innovation for innovation.

Indeed, the credit for student loan innovations should go to the Department of Education. The Clinton administration and ED invested a lot of political capital in the DLP and, therefore, were determined to make the program as attractive to borrowers and college financial aid administrators as possible. Customer service, something not normally associated with the provision by government of collectively consumed goods, was driven by ED and mimicked by private industry. The DLP was to provide "one-stop shopping" for students, said ED Secretary Richard Riley. Previously, students seeking a loan had to gain approval from their school and then take the resulting paperwork to a lender and begin the process again. Loan terms were inflexible. If they did take the loan, they were lucky to receive the proceeds (less 8 percent in origination and insurance fees[26]) within several weeks. Once the student entered repayment, given the speculative nature of the student-loan industry, finding

[25] Student Loan Funding Corp. chief financial officer, Mark Weadick, called it an "oversight." He claimed that it was never the companies "intent to mislead anyone in anyway."

[26] But, legally, as much as 10 percent.

out to whom they should send payments often presented a problem. In contrast, under the DLP, students could fill out a paperless application, on-line or at their student aid office. Once approved by their postsecondary institution, the student's financial aid office had merely to electronically draw down an account established for the school by ED and cut a check for proceeds in excess of tuition and fees. The turn-around time? Seventy-two hours, start to finish (Goodman, 1993). Once in repayment, there could be little confusion over to whom they owed money. In addition, students could choose from a variety of repayment plans. In addition to the aforementioned income-contingent plan, students could stick with the standard (10-year) plan, opt for an extended (20-year) repayment plan, or choose a graduated repayment plan in which payments increase over the course of the repayment period (Quinn, 1994). ED also offered to cut the fees students paid under the FFEL in half — from 8 percent to 4 percent.

Backed by the CBA, NCHELP, and Sallie Mae, Republican congressional leaders attempted to muster support for a reformed FFELP as an alternative to direct lending by offering the same services that ED was including in its DLP. Lenders, guarantors, servicers, and secondary marketers, under the auspices of the Coalition for Student Loan Reform (CSLR), brought to their supporters on Capitol Hill proposals that they hoped would circumnavigate their "total obliteration."[27] Even the threat of competition, it seemed, was enough to inspire the student loan industry to make proposals that, only a few years previously, would have motivated declarations of hardship. "Darned concerned" about losing their jobs,[28] the impossible suddenly became feasible. The CSLR offered to reduce defaults by allowing income-sensitive repayment[29] and doubling the repayment period from ten to twenty years. Additionally, the CSLR proposed that lenders hold loans for nine months, instead of six, before declaring them in default. They also offered to decrease re-insurance rates, and reduce federal administrative payments. Most striking of all was the CSLR suggestion that $1.3 billion could be saved by reducing lender special allowances (interest subsidies) from 3.1 percent to 2.45 percent while students were in school (Student Aid News, 1993 (d)). In other words, lenders actually engaged in price and service competition with the federal government.

"Darned concerned" about losing their jobs, the impossible suddenly became feasible.

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27 Quote attributed to NCHELP president Jean Frohlicher in Student Aid News, 1993 (b).

28 Sam Kipp, executive director of the California Student Aid Commission (Guaranty Agency), quoted in Student Aid News, 1993 (c).

29 Income-sensitive repayment differs subtly from income-contingent with both providing advantages and disadvantages for borrowers. Under the DLP's income contingent plan, payments are strictly calculated as a percentage of the borrower's income. With income sensitive repayment, payments are also calculated as a percentage of income, however, the minimum payment must equal the interest accrued over the repayment period. Interest never compounds principle. Under the income contingent plan payments can be lower, but because interest can be added to principle, the length of the loan can be extended.

While the CSLR could not defeat the DLP[30], it did win some important rear-guard actions. Arguing that a level-playing field was necessary to effectively compete, it was able to see to it that the FFELP was amended in such a fashion that the industry could adopt the same practices that ED had instituted for the DLP. Most importantly, they were able to secure a cap on the growth of the DLP, guaranteeing themselves significant market share through 1998. This not only short-circuited Clinton's plan to do away with the FFELP by 1998, but gave them the time to prove that the FFELP could be a viable alternative to the DSLP. Specifically, some of the highlights of the direct lending compromise provided for the following:

Arguing that a level-playing field was necessary to effectively compete, it was able to see to it that the FFELP was amended in such a fashion that the industry could adopt the same practices that ED had instituted for the DLP.

- For both programs, during in school, grace, and deferment periods, the interest rate charged borrowers was reduced from that of the 91-day T-bill plus 3.1 percent to the 91-day T-bill plus 2.5 percent. This meant that special allowances paid to lenders under the FFELP were reduced 60 basis points;
- Fees paid by students in the FFELP were cut in half to 4 percent, matching those charged under the DLP. Federal Origination fees declined from 4 percent to 3 percent, while the insurance fees that guaranty agencies could charge also dropped a percentage point;
- Regardless of the T-bill rate, borrower interest rates were not to exceed a ceiling of 8.25 percent;
- Guaranty Agency retention allowances for collections on loans in default reduced from 30 percent to 27 percent;
- The maximum reinsurance rate paid by the federal government decreased from 100 percent to 98 percent. All other reinsurance tiers were also reduced by 2 percent;
- Sallie Mae charged 0.3 percent on its outstanding loan volume annually, rising to 1 percent if it fails to act as a “lender of last resort” when called upon by ED to do so; and
- Limit DLP volume to 5 percent of industry total in the program's first year (1994), rising to 60 percent by 1998/99. (Student Aid News, 1993 (e)).

Because of these changes to the FFELP, the student-loan industry won time to reconstitute itself into a form reminiscent of a competitive market. How-

[30] Created as part of a 1993, five-year, deficit reduction plan.

ever, the entities the industry served — students, schools, and taxpayers — were the biggest winners.

Although it is presently agreed that both programs will co-exist, side-by-side, competition, both political and economic, is still keen. As any economist can tell you, this means that the collective and individual consumers of student loans have benefited, and will continue to do so as long as real competition is maintained. For example, in 1994, Maine Educational Services announced that it would fund "Super Loans" to Maine residents and out-of-state students attending institutions in the state, at a full percentage point lower than the FFELP/DLP rate (Ornstein, 1994). As well, in 1995, Sallie Mae successfully lured the University of Maryland at College Park out of the DSLP and back to the FFELP exclusively. The University of Maryland, one of the largest of the first year direct loan program participants, left the program, according to the school's financial aid director, William Leith, because it was concerned that the 104th Congress might eviscerate the DLP. Given that Sallie Mae agreed to institute a loan delivery system similar to that used in the DLP, it seemed rational to abandon the program before it sank (Student Aid News, 1995). Direct lending did not founder, of course. It has withstood various political volleys and, for good or ill, continues to sail along.

THE COST BENEFITS OF INTER-PROGRAM COMPETITION

As mentioned earlier, the purpose of the preceding history was not to tar and feather the Department of Education and its financial partners in the GSLP/FFEL program. Instead, it was designed to accomplish two important tasks.

The first task was to point out the federal government's inability, due to its dependent position, to steer the behavior of its financial partners in a socially, and not individually, optimal direction. Given the obvious importance of student loans to the economic health of our nation, it comes as no surprise that those controlling access to the loan capital – typically lenders and guarantors – could some times assert their own self-interest over that of federal taxpayers. Although many examples of this behavior were discussed in the proceeding section, the mere fact that on the eve of the creation of the DLP, numerous financial concessions, which at one time would have provoked a threat by lenders to withdraw from the program entirely, were offered by the FFELP community strongly suggests that the taxpayer savings associated with these concessions were directly a result of the threat of competition.

The second purpose was to show that ED, or its HEW predecessor, did nothing to suggest that they were capable of efficiently managing a student loan program on their own. While it is true that ED currently manages about 30 percent of all student loans through the DLP, their management of the program has been plagued with problems, especially in the areas of loan origination, reconciliation, and consolidation, and we argue that much of its success can be attributed to shortcomings in the FFELP. Moreover, the federal record of success with other educational loan programs is not entirely encouraging – consider the history of the HEAL program for medical professionals and the Perkins Loan program for low income students – one of which no longer exists and the other, due to its continued inefficiency and inequity, has been targeted for termination by every president since Nixon.

Taken together, these problems suggest that in the absence of competition, ED would be hard-pressed to manage either loan program in a socially-efficient manner. As a result, we argue that neither the DL nor FFEL programs, by themselves, can be anything more than stagnant and wasteful in the long-term; however, by operating in competition with each other, the two student loan programs continue to push one another towards supplying the best possible product at the cheapest possible price. Although the results of the national Direct Loan evaluation suggest that the quality of the product

Taken together, these problems suggest that in the absence of competition, ED would be hard-pressed to manage either loan program in a socially-efficient manner.

itself has been improving since the competition started in 1994, we now turn to an estimation of the taxpayer savings that have resulted from the competition itself.

RESEARCH METHODOLOGY

To estimate the cost savings associated with the introduction of the DLP in 1994, we used detailed federal budgetary data from 1966 through 2001 to specify two autoregressive, moving average time series models that examined the real net cost (in 1996 dollars) of running the two student loan programs, as well as the real net cost of running just the FFELP program.

However, before discussing our data sources and the variables used in our models, a natural question to ask is why we used annual expenses as our cost measure instead of the more familiar budgetary measure, annual obligations. Our answer is threefold and begins with the simplest reason – the absence of data describing total federal obligations from 1966 until 1979 -- which from a modeling perspective would significantly reduce the statistical power of our analysis. Furthermore, total obligations are a measure of expenses incurred – present and future – in a given year and therefore may not accurately represent expenditures in a specific year. Finally, by deducting fees received by the federal government, we can come to a figure reflective of the net costs associated with the program. However, we would not expect our results to differ significantly had we used total obligations instead of total expenses, since the simple correlation between total obligations and our net cost variable from 1979 to 2001, was 0.95.

To estimate these two models, we first gathered data for our two dependent variables from the appendices to the U.S. Budget from 1966 – 2001 and then converted these nominal values into real (1996) dollars using the Federal Reserve GDP Deflator. As described and shown in Figure 4, we added together interest benefits, special allowance payments (FFELP only), net default costs, and death, disability and bankruptcy benefits, then subtracted out fees received and interest payments (DLP only) to arrive at the net cost of running each loan program. These line items are described in more detail below:

- INTEREST BENEFITS: For the FFELP, these benefits comprise interest on student loans paid by the government, to lenders, while students attend school, during the grace period immediately following school attendance, and during other specified deferment periods. For the DLP, they include

interest on loans that the government does not collect while students attend school, during the grace period immediately following school attendance, and during other specified deferment periods.

- SPECIAL ALLOWANCES: The interest on principal in the FFEL program paid by the Federal government to encourage participation by private lenders. Historically, special allowances have ranged from 2.45 to 3.5 percent. Special allowances paid by State governments are not included. Special allowances do not apply to the DLP.

- NET DEFAULT COSTS: For the FFELP, net default costs equal loan defaults plus costs associated with the collection of defaulted loans, less defaulted loans collected. The cost of collecting on defaulted loans includes "Contract Collection Costs" and "Guaranty Agency Retentions." The former includes payments to private collection firms while the latter consists of funds retained by guaranty agencies as an incentive for following up on loans declared in default and, for which, they have already been reimbursed. For the DLP, net default costs equal loan defaults plus costs associated with the collection of defaulted loans, less defaulted loans collected. The cost of collecting on defaulted loans includes administrative costs and private, collection agency fees.

- DEATH, DISABILITY, AND BANKRUPTCY BENEFITS: For both programs, these are the operational losses due to the death, disability, or bankruptcy of the borrower.

- ADMINISTRATIVE COSTS: For the FFELP, these costs include Federal administrative costs and administrative payments to guaranty agencies. Payments to guaranty agencies include Account Maintenance Fees, Loan Insurance and Processing Fees, and Supplemental Preclaims Assistance. Student Aid Management fees, which may go to administering either the FFELP or the DLP, are not included.

- FEES RECEIVED: For the FFELP, these fees include borrower origination fees, lender origination fees, Sallie Mae offset fees, consolidation loan holder fees, reinsurance and insurance fees. These fees are deducted from the sum of all other cost components to arrive at a net cost figure. For the DLP, only borrower origination fees are deducted.

- INTEREST: For the FFELP, this entry does not apply. For the DLP, it represents interest payments for funds borrowed from the Treasury. Interest payments received from DLP borrowers are deducted as an offset.

Figure 4. Comparison of Calculated Expenses for the GSL/FFEL and DSL Programs

Federal Family Education Loan Program	Federal Direct Student Loan Program
Interest Benefits	
Interest on student loans *paid* by the government to lenders while students attend school, during the grace period immediately following school attendance, and during other specified deferment periods.	Interest on student loans that the government *does not collect* while students attend school, during the grace period immediately following school attendance, and during other specified deferment periods.
Special Allowances	
Additional interest on principal paid by the government to lenders to encourage their participation in the GSL/FFEL program.	Special allowances do not apply to the DSL program.
Net Default Costs	
(+) Total value of loans defaulting	(+) Total value of loans defaulting
(-) Total value of defaulted loans collected	(-) Total value of defaulted loans collected
(+) Contract collection costs	(+) Administrative costs of default collection
(+) Guaranty Agency retentions	(+) Private collection agency fees
Death, Disability and Bankruptcy Benefits	
Operational losses due to the death, disability, or bankruptcy of the borrower.	Operational losses due to the death, disability, or bankruptcy of the borrower.
Administrative Costs	
(+) Federal administrative costs	(+) Federal administrative costs
(+) Administrative payments to guarantors, *including* …	
- Account maintenance fees	
- Loan insurance and processing fees	
- Supplemental preclaims assistance	
Fees Received (deducted from total program cost)	
(-) Borrower origination fees	(-) Borrower origination fees
(-) Lender origination fees	
(-) Sallie Mae offset fees	
(-) Consolidation loan holder fees	
(-) Reinsurance and insurance fees	
Interest Paid on Financial Capital	
Does not apply to the GSL/FFEL program. Lenders supply capital for which they are compensated by the borrower, subsidized by federal government.	This item represents interest payments on funds borrowed from the federal Treasury. *Interest payments received from DL borrowers are deducted as an offset.*

To parsimoniously estimate the net cost of the combined DL and FFEL programs, as well as the cost of the FFELP alone, we then used the following independent variables in our analysis: total loans issued (originated), a one-year lag of the annual average of the 90-day Treasury Bill interest rate, and a "direct loan constant." The direct loan constant takes a value of zero in all years prior to 1994 (the year in which the DLP officially became operational), and a value of one in 1994 and all subsequent years. That is, the direct loan constant is a dummy variable designed to capture the effect of competition on net cost.

Total loans issued are of obvious use in predicting net cost. As the number of loans issued in a given year increases so, too, should associated expenses that have nothing to do with inter-program competition[31]. Similarly, an ac-

[31] Actually, as will be pointed out very shortly, the "cost" of a loan in its initial year is frequently negative. That is, for the first year, at least, it is a money making proposition. As the years progress, expenses

counting of the prevailing interest rate is important because it is tied, directly or indirectly, to virtually every component of cost. The dollar volume of subsidies to students, the value of special allowances, and the cost of Treasury funds used in the DLP are some of the most obvious examples. We found it initially surprising that a one-year lag of the interest rate was a better predictor than the contemporaneous rate. Upon further study, we discovered reasons for this apparent paradox. The most intuitive is the fact that fees received may exceed the cost of a student loan in the year the loan was issued. A less intuitive reason stems from the first-order autocorrelation structure of interest rates with their past values.

Unfortunately, all time series suffer from correlated error that, without appropriate adjustment, can lead to misspecification of the model. The time series of real, net, student loan program cost is no exception. To account for first-order autocorrelation, we include the one-year lag of real, net cost. To control for spikes in partial autocorrelation at the second and fourth lags, we use moving average adjustments. We speculate – and speculate *only* – that these moving average adjustments may be correcting for the influence of the legislative (2-year lag) and executive (four-year lag) political cycles.

mount. Nonetheless, the number of loans originated in one year is temporally correlated with past values, and the contemporaneous value is the best predictor.

FINDINGS

In this section of the paper we report the results of our two autoregressive, moving average time series models. As described in the previous section, both models use a time-series methodology to estimate the extent to which the DL program impacted loan program costs, as well as the extent to which our models explain the total variation in inter-temporal program costs. The first of these models, presented in Table 1, estimates the total real cost of running both the FFELP and the DLP, while the second model, presented in Table 2, estimates the total real cost of running just the FFELP. For each of these models, we present the estimated coefficients, *t*-statistics, and level of significance for each of the independent variables used in the analysis, as well as several goodness-of-fit statistics.

As shown in Table 1, the results from our FFELP and DLP cost model are both powerful and intuitive. For example, the model explains 97 percent of the inter-temporal variation in total programmatic costs and tracks exceedingly well; in fact, all of the independent variables used in the analysis were of the predicted sign and significant at the p=. 01 level, making it highly unlikely that these particular results occurred by chance. More importantly, the estimated coefficient of the Direct Loan dummy variable (-684,835) suggests that the introduction of the DLP in 1994 lowered the average annual cost of running the loan programs by almost $685 million per year.[32]

Table 1. Estimated Coefficients, Levels of Significance, and Goodness of Fit Measures for the Regression Examining the Real, Total, Combined Cost of the FFELP and DLP.

Independent Variables	Estimated Coefficient	*t*-statistic
Intercept	-676,674	-2.79**
Total Loans (1000s)	512	9.32***
Lag of Real, Total Cost	0.41	6.14***
Lag of 90-day T-Bill Rate	140,918	4.98***
Direct Loan Dummy	-684,835	-2.80**
MA (2)	-0.32	-4.28***
MA (4)	0.92	12.57***

*R^2 = .97 Adjusted R^2 = .97 p < .05 * p < .01 ** p < .001 ****

Since an implication of our competitive market hypothesis is that the introduction of the DLP should have prompted cost-saving innovations within the FFELP, we now examine the results of our FFELP-only cost model over the same time period. In this model, we focus only on FFELP costs and loans issued; in other words, with the exception of the Direct Loan dummy variable, the DLP is completely removed from the equation.

[32] The reader should be aware that, consistent with the budget documents from which these figures were drawn, the dependent variables used in out analyses are measured in units of $1,000.

The results of this model are presented in Table 2, and as was the case with our combined cost model, the model tracts exceedingly well. Again all of the estimated coefficients were of the expected sign, and with the exception of the Direct Loan coefficient, which was significant at the p=.05 level, all of the independent variables used in the analysis were significant at the p=.001 level. In addition, this model explained almost 96 percent of the inter-temporal variation in FFELP costs. More importantly, the estimated coefficient on the DL variable in the model (-620,176) suggests that the introduction of the DLP in 1994 produced slightly more than $620 million dollars in average, per year savings in the FFELP.

Taken together, the results of these two models offer convincing evidence that the competition between the two student loan programs has resulted in cost savings for federal taxpayers. As shown in Tables 1 and 2, the introduction of the Direct Loan program in 1994 lowered costs in the loan programs by approximately $685 million, with about $620 million of that coming from the FFEL program. Interestingly, the difference in the estimated coefficients for the Direct Loan variable in the two models ($685 million vs. $620 million) lends some credence to the notion that, at least initially, the DLP was somewhat cheaper than the FFELP. Nonetheless, it is clear that the FFELP responded well to competition.

Taken together, the results of these two models offer convincing evidence that the competition between the two student loan programs has resulted in cost savings for federal taxpayers.

Table 2. Estimated Coefficients, Levels of Significance, and Goodness of Fit Measures for the Regression Examining the Real, Total, Combined Cost of the FFELP

Independent Variables	Estimated Coefficient	*t*-statistic
Intercept	-655,104	-2.51*
Total Loans (1000s)	470	5.62***
Lag of Real, Total Cost	0.52	6.81***
Lag of 90-day T-Bill Rate	111,414	3.73***
Direct Loan Dummy	-620,175	-2.34*
MA (2)	-0.39	-6.96***
MA (4)	0.90	11.48***

*R^2 = .96 Adjusted R^2 = .95 p < .05 * p < .01 ** p < .001 ****

CONCLUSIONS

We have presented evidence that, since 1994, the federal government has saved appreciable sums of money when providing loans to students. We have also demonstrated that, when the Direct Loan program is factored out of the equation, the estimate of savings is somewhat diminished. This provides some ammunition to those who would argue that the Direct Loan program is inherently cheaper that the Federal Family Education Loan program. We argue that while this may be true in the short term, adoption of a system wherein government becomes the sole supplier and administrator of the student loan program is doomed, in the long-run, to at least the same level of inefficiency and upward price-ratcheting as was the case for the FFELP. Something approaching the characteristics of a competitive market – through inter-program competition — is preferable.

In many respects, this result should not be surprising at all. After all, economic theory argues that monopolists charge higher prices than do those in a competitive market, and we know that as markets become more competitive they generally become more efficient, so at least at one level our estimates of cost savings are quite predictable. However, the uniqueness of this competition -- in essence, between a program created by the government and one managed by the same governing body – suggests that market forces have the ability to be harnessed within the typical confines of government. Of course, the ability to sustain this programmatic competition is key, since in the short run one program may indeed be cheaper than the other.

To achieve this end, we urge legislators and educational policy makers to come together to preserve the competitive structure that now exists, and to work hard to make the competition as fair and equitable as possible. In doing so, not only will federal taxpayers benefit directly in terms of reduced programmatic expenditures, but they may also benefit indirectly if the success of this unusual experiment leads governmental policymakers to experiment in the competitive delivery of other inefficiently delivered services.

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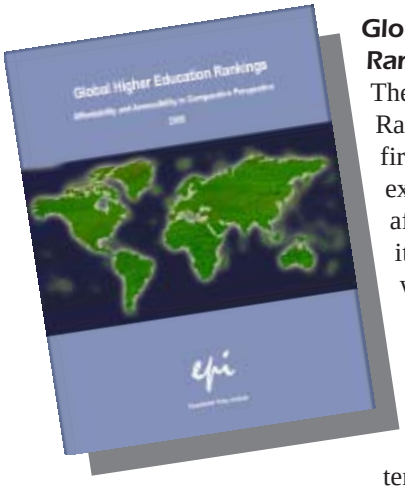

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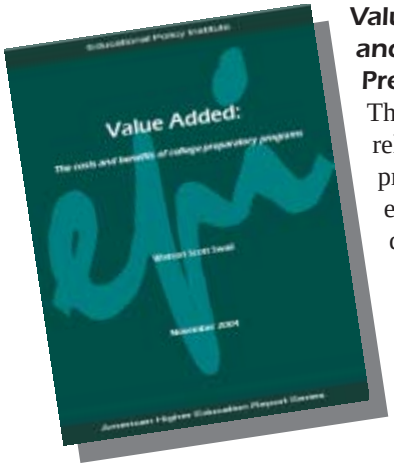

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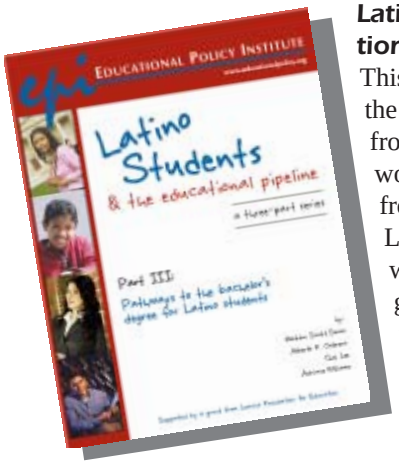

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