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INFORMED BUDGETEER

2002 STUDENT LOAN LAW TAKES EFFECT, LOWERS INTEREST RATES

Informed budgeteers who have graduated from an institution of higher learning in the past decade (or those who have children in college) know that the most interesting month for back-to-school news is not September, but July. July 1 is the date every year that the Department of Education sets the interest rates as prescribed by law for all the various direct and guaranteed loan programs for students who are about to borrow money to pay for school in the fall.

The July 1 milestone that came and went about a month ago loomed much larger this year than other years because of all the speeches and media attention given to that date since the Deficit Reduction Act (DRA) was enacted in February 2006. A typical, but erroneous, media report went as follows: "On July 1, interest rates for student loans are expected to increase up to 40%. . .[because t]he Deficit Reduction Act raises rates on all new student loans disbursed after July 1, 2006 to a fixed interest rate of 6.8%."

So what really happened on July 1, 2006? Did DRA do it, or did something else? Let's review the history and facts.

Background. The federal government has helped make loans available to college students since the 1960s through the Guaranteed Student Loan program (now called the Federal Family Education Loan program) and through the addition of the Direct Loan program in 1993. Under the guaranteed loan program, the federal government provides incentives to private lenders to make the loans to students that they otherwise would not make. Such incentives include a federal guarantee against default risk and payments to compensate lenders for making loans at below-market interest rates. Under the Direct Loan program, the Department of Education lends to students with U.S. Treasury funds. Despite these different delivery mechanisms, loan terms (including interest rates) for borrowers are nearly identical under both programs.

STUDENT LOAN INTEREST RATES AVERAGED 7.5% FROM 1965-2006

Academic Year	Repayment Interest Rate (%)
1965-1968	8.00 fixed
1968-1981	7.00 fixed
1981-1988	9.00 fixed
1988-1992[1]	10.00 fixed
1992-1993[2, a]	6.94
1993-1994[2, a]	6.22
1994-1995[3, a]	7.43
1995-1996[3, a]	8.25
1996-1997[3, a]	8.25
1997-1998[3]	8.25
1998-1999[4, a]	7.46
1999-2000[4, a]	6.92
2000-2001[4, a]	8.19
2001-2002[4, a]	5.99
2002-2003[4, a]	4.06
2003-2004[4, a]	3.42
2004-2005[4, a]	3.37
2005-2006[4, a]	5.30
2006-2007 (and thereafter)	6.80 fixed

1. Rate was 8% fixed for first four years of repayment
2. 1-year variable rate equal to the 91-day T-bill + 3.3%, capped at 9%
3. 1-year variable rate equal to the 91-day T-bill + 3.1%, capped at 8.25%
4. 1-year variable rate equal to the 91-day T-bill + 2.3%, capped at 8.25%
a. Borrower had the option to lock in a fixed rate for the life of the loan through consolidation

Virtually all of the terms of federal student loans are set in law to ensure students receive certain benefits -- primarily low interest rates. From the program's beginning in 1965 through 1993, interest rates on the loans were fixed. In 1993, Congress changed the interest rate on student loans to a variable rate that would fluctuate year to year based on market interest rates. Specifically, rates were reset once each year in July to that of the 91-day Treasury bill plus 3.3 percentage points (see table at left). This new interest rate structure was intended to be only a temporary measure (it was supposed to expire in 1998), because the new Direct Loan program was supposed to make it unnecessary.

With enactment of the Direct Loan program in the 1993 Omnibus Budget Reconciliation Act (OBRA), the Democratic Congress intended for direct loans to compromise an increasing proportion of new student loans over a number of years, ultimately supplanting the guaranteed student loan program by 1998. Once the Direct Loan program became the sole student loan program, there would be no need to ensure interest rates on the loans were set at a rate high enough to incentivize private lenders to participate in the program. Therefore, acting under the assumption that most new student loans would be directly made by the federal government by 1998, Congress enacted a new interest rate structure as part of OBRA 1993. This new structure would have matched the loan's interest rate to that of a Treasury bond with the same maturity.

But as the Direct Loan phase-in proceeded more slowly than intended, Congressional support grew for maintaining both loan programs. It became clear that the new formula would make guaranteed loans too unworkable for most private lenders since they would lose money instead of earning some profit by making student loans. (See CBO study: http://www.cbo.gov/ftpdocs/3xx/doc391/ffeloans.pdf)

If the new formula were not averted, the Department of Education would have become the lender of last resort, which, given the slow adoption rate of the direct loan program, it was not prepared to do. Instead, Congress postponed the change to the long-term interest rate index when it passed the Higher Education Act Amendments of 1998, opting to retain the interest rate structure that had been in use.

Note that the 1998 Act only postponed, and did not cancel, implementation of the unworkable interest rate structure. Because the authorizing committee decided it would only partially follow the Senate's pay-as-you-go rule and offset the cost (relative to the baseline) of this interest rate change over five years instead of the required 10 years, the 1998 Act provided its interest rate fix only until 2003. Congress was forced to readdress the issue before 2003 if private lenders were to remain in the program.

Current Law Has Been Current Law. By early 2002, the Congress enacted legislation (P.L. 107-139, which was reported by the Democratic chairman of the HELP Committee and passed by unanimous consent by the Democratic-controlled Senate) to prevent the impending interest rate changes from taking effect. It set a new interest rate structure that would fix student interest rates at 6.8% beginning in July of 2006. The 6.8% rate was about the average rate that CBO projected (at that time) would result in 2006 from the variable rate formula in place in 2001, maintaining essentially the same incentives for private lender participation that had been in place. Specifically, section 1 of the law read as follows: (frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_public_laws&docid=f:publ139.107)

> (1) AMENDMENT- Section 427A of the Higher Education Act of 1965 (20 U.S.C. 1077a) is amended--
>
> `(l) INTEREST RATES FOR NEW LOANS ON OR AFTER JULY 1, 2006-
>
> `(1) IN GENERAL- Notwithstanding subsection (h), with respect to any loan made, insured, or guaranteed under this part (other than a loan made pursuant to section 428B or 428C) for which the first disbursement is made on or after July 1, 2006, the applicable rate of interest shall be 6.8 percent on the unpaid principal balance of the loan.

What DRA DID and Didn't Do. The next Higher Ed reauthorization essentially took place in the Deficit Reduction Act of 2005, which made a number of changes to reduce bank and lender special payments and profits by $20 billion over the next five future years, just as critics of such lenders had been asking for since 1993. While about half of that amount went for deficit reduction, $10 billion in new spending was provided for new student benefits.

One thing DRA did not do, however, was change the fixed 6.8% student interest rates set for the past four years (as enacted in 2002) to begin on July 1, 2006 for new loan disbursements. Today, the law that governs the interest rate for the basic loan that students take out still reads the same as it did in 2002: (frwebgate5.access.gpo.gov/cgi-bin/waisgate.cgi?WAISdocID=628647111552+15+0+0&WAISaction=retrieve)

It is clear that DRA had nothing to do with the 6.8% interest rate that took effect in July. It was actually done four years ago in a bill planned by the HELP Committee. But what about the headlines claiming the "biggest student loan interest rate increase ever"?

The interest rates on existing (already disbursed) variable-rate loans will continue to change annually on July 1, based on the last 91-day T-bill auction in May. Before July 1, 2006, the interest rate on such loans was 5.3% during the repayment period. On July 1, this rate increased to 7.14%, representing a return to historical average rates. If the law had been changed to leave interest rates on new loans in the variable rate structure that applied before July 1, then students borrowing money for college this summer could look forward to repaying at an interest rate higher than the fixed 6.8 % that now applies. By <u>not</u> changing the law, DRA actually has preserved a lower interest rate for students this year.

AML MAKES TRIFECTA A SUPERFECTA

The Estate Tax and Extension of Tax Relief Act of 2006 (H.R. 5970, aka the Trifecta bill), which passed the House, includes Title III that reauthorizes the Abandoned Mine Land (AML) Fund while dramatically changing the way it works.

Background. The Surface Mining Control and Reclamation Act created the AML Fund in 1977 by requiring coal companies to pay annual fees (per ton of coal produced each year), which are collected as revenues by the federal government. The fees are deposited in the fund, and based on the amounts in the fund, the appropriations committee has provided discretionary resources each year to restore sites that were mined and then abandoned before 1977. In seven out of the last ten years, appropriators have provided an amount equal to or greater than the President's request.

Fifty percent of fees are recorded in the fund under the name of each of the 26 states and tribes whose companies have paid into the fund. Referred to as the "state share," these amounts are drawn down in annual appropriations for reclamation projects in each of those 26 jurisdictions. The remaining fifty percent, commonly referred to as the "federal share," is reserved for appropriations to the Office of Surface Mining, which uses them to distribute grants for other reclamation projects and for administrative expenses.

In addition to supporting reclamation efforts, the AML Fund has another purpose. Beginning 1996, interest "earnings" have been credited to the fund based on its balances (which are currently $1.8 billion, of which $1.4 billion are earmarked for the 26 states and tribes). Such interest constitutes mandatory budget authority that is transferred to the private United Mine Workers of America (UMWA) Combined Benefit Fund (CBF) to help pay health benefits for retired miners, aka orphan retirees, who worked for coal companies that have gone out of business. This interest transfer is capped at $70 million per year.

Large Costs without Debate. The Surface Mining Control and Reclamation Act Amendments have been dropped into H.R. 5970, a bill that is before the Senate as if it were a conference report. While the Senate Energy Committee held a hearing a year ago on related versions of these amendments, no Senate committee has reported these amendments as a bill (or any other AML bill for that matter), and no debate has occurred in the Senate.

According to CBO's cost estimate of Title III of the bill (http://www.cbo.gov/ftpdocs/74xx/doc7460/hr5970pass.pdf), the deficit would increase by almost $4 billion over the next 10 years. Title III would create $5 billion in new mandatory (automatic pilot) spending that would <u>more than double</u> the annual spending that occurs under current law (over the first five years, new spending would be $2.1 billion). Why mandatory spending? Bill proponents argue that reclamation is not occurring now while spending is subject to appropriations. But states do not have to use their share for reclamation; they can use it for any purpose, so why create new federal mandatory spending for unspecified purposes? The Senate has debated on the floor for years the merits of turning discretionary programs (No Child Left Behind, IDEA, Land and Water Conservation Fund, Highway Trust Fund) into mandatory programs, yet all those programs remain discretionary. In this case, however, the House simply sent the AML amendments over in H.R. 5970, which the Senate does not have an the opportunity to debate and amend.

Claims Without Merit. The proponents argue this reauthorization pays for itself through the extension of AML fees, which expire under current law in 2007. In truth, coal companies would pay lower fees (10% lower from 2008-2012 and 20% lower thereafter) compared to what they currently pay, while the majority of the spending ($3 billion over the next 10 years) would come from the general fund of the Treasury, i.e. the American taxpayer.

If states truly wanted their money that has already accumulated in the fund, the bill simply could have paid out the $1.4 billion that has the states' names on it. But the bill does not do that. Why? Because the proponents want to leave the money in the fund for another purpose.

The bill eliminates the $70 million per year cap on interest transfers to the CBF, increases such transfers to cover two additional UMWA health plans, and adds mandatory payments out of the general fund to the three plans. Thus, the bill makes sure that the fund maintains its principal going forward so that it can "generate" the interest necessary to support the health benefit payments for an expanded pool of retired miners and their dependents.

Also, going forward, the bill could have simply told coal companies to keep half of the fees they would pay in under the bill and, instead, let the states be responsible for collecting the money from them. Since the bill plans to send the "state share" portion of the fees right back to the states they came from in the first place, why not cut out the federal government as the middleman?

Proponents suggest that, without this bill, "taxpayers' burden" will grow exponentially in the future. So far under the law since 1977, taxpayers have not paid for these activities – the coal company fees have, and those fees expire next year. What <u>will</u> happen is that the burden for more than half of the spending in the bill will shift from the coal companies to the taxpayers for the first time.

The *Bulletin* is pleased to announce its Senior Analyst for Budget Review, David Pappone, is tying the knot on August 5, 2006 in Iowa City, Iowa. His fiancée Michelle has asked for a one-time allocation of $0.5 million to cover wedding costs. Since David plugs all the numbers in the Budget Resolution, he will easily be able to offset his wedding costs.