Supplemental Loans

Some states have established loan programs for students who do not qualify for GSL or PLUS loans or who may need more funds than those programs provide. The loans provided through these supplemental programs are not guaranteed by the federal government, nor does the federal government bear any portion of the interest cost other than the subsidy implicit in tax-exempt financing. The costs of these programs to the federal government, then, are the tax expenditures resulting from forgone revenues.

CHAPTER V

POLICY ALTERNATIVES

The Congress might consider several alternatives to current law governing the use of tax-exempt student loan bonds. The options will vary depending upon whether the policy objective is to increase the availability of funds for student loans, to reduce or eliminate the surpluses state authorities accumulate from issuing bonds, or to reduce the deficit and the costs of tax-exempt financing.

- If its goal is to increase the availability of funds, the Congress either could provide additional incentives through higher special allowance payments (SAP) to make more taxable funds available for GSL and PLUS loans, or it could ease the restrictions on tax-exempt financing.

- If its primary purpose is to eliminate student loan authorities' profits, the Congress should consider lowering the special allowance payment for student loans financed with tax-exempt bonds or changing the arbitrage provisions of current law. This would have minimal effect on the availability of student loans.

- If the Congress wants to reduce the deficit and the costs of tax-exempt financing, it could consider lowering the special allowance and either imposing additional limits on the use of student loan bonds or eliminating them entirely, which would decrease the amount of available credit.

These measures are not mutually exclusive. For example, the Congress could ease the volume limits and, at the same time, tighten the arbitrage regulations for student loan bonds; or, it could impose additional limits and tighten arbitrage regulations. Alternatively, the Congress could increase the special allowance for taxable loans and eliminate tax-exempt student loan bonds entirely, or it could lower the special allowance and ease restrictions on the bonds.

This chapter examines policy alternatives and analyzes the effects of pending legislation on both tax-exempt and taxable student loan financing. In general, the bills to reauthorize the Higher Education Act of 1965 (H.R. 3700 and S. 1965) would facilitate tax-exempt financing of student loans, while certain pending tax reform provisions (H.R. 3838) would have the opposite effect. The Congress may wish to consider the tax-exempt bond provisions of pending tax legislation in the light of pending education legislation and vice versa to assure against unintended effects from the interaction of the two measures.

INCREASE THE AVAILABILITY OF STUDENT LOAN FUNDS

The Congress might increase the availability of student loans either by increasing the special allowance payments for loans financed with taxable funds or by easing restrictions on tax-exempt financing. The extent to which tax-exempt bonds affect loan availability, however, is difficult to quantify. To some degree, both direct lending and secondary purchases from the proceeds of tax-exempt bonds have displaced lending from taxable sources. In some states, however, it appears that tax-exempt financing has made a difference in the amount of lending because state authorities were willing to offer more favorable terms than Sallie Mae in buying loans from banks or because they were willing to lend when banks refused to do so. The state authorities compete with Sallie Mae in purchasing loans, and, by and large, they have been willing to buy loans at par from smaller banks, even when balances are small and servicing costs are therefore relatively high. Before the creation of the authorities, Sallie Mae tended either to buy such loans at prices below par or to avoid them altogether.

Today, the secondary market for student loans consists of Sallie Mae; money center banks, such as Manufacturers Hanover Trust, Citibank, Chase Manhattan, Chemical Bank, and Marine Midland; and the state student loan authorities. The degree of competition within this market is limited largely because the GSL legislation prevents the establishment of a fully private institution that would compete with Sallie Mae and be exclusively devoted to student loans. Moreover, for private banks, holding student loans is less profitable than for Sallie Mae because their borrowing costs are higher. If, under these circumstances, state authorities could not issue tax-exempt bonds, the already limited competition within the student loan secondary market could lessen, with possible negative effects on the availability of loans, unless private lenders had more incentive to make and purchase student loans.

Increase the Special Allowance Payments for Student Loans Financed with Taxable Funds

The justification for tax-exempt financing is that it provides funds for loans that private financial institutions otherwise would not make. These loans tend to be higher-cost loans with low face amounts. If the SAP were high enough, however, private lenders would make these loans, too. Moreover, unlike the costs incurred through tax-exempt financing, the costs of making or purchasing these loans would be direct rather than indirect, and on-budget rather than off-budget. For most GSLs, the SAP is high enough to induce lender participation, so the SAP would have to be higher only for some loans. A possible measure would be to vary the SAP with the size of the loan. The Department of Education could take competitive bids and auction off blocks of loans grouped by size. This, however, could turn the currently simple loan process into an administratively cumbersome one. Alternatively, the Department of Education could take bids on the more limited number of loans that state authorities identify as not being serviced by private lenders, which might be a simpler approach.1/ The amount by which the SAP could be increased and still cost the federal government less than tax-exempt financing would vary with interest-rate levels and would decline as T-bill rates rose. At high T-bill rates, an increase in the SAP could be more costly to the federal government than tax-exempt financing.

Ease Restrictions on Student Loan Bonds

If the Congress wants to make more student loans available without increasing the SAP, it might consider easing restrictions on tax-exempt bonds.

Eliminate Volume Limits or Department of Education Review. Under current law, student loan bonds and industrial revenue bonds are subject to a combined volume limit (see Chapter II). Student loan bonds are also subject to review by the Department of Education, which determines eligibility for the SAP. At the time the legislation mandating the Department's review went into effect, the Congress had not yet enacted the volume caps. State authorities have since complained that their activities are subject to double constraints and that the two sets of limits are unnecessary. The present administration has taken the position that student loan bonds benefit from a double subsidy--exemption from taxation and

1. This proposal was originally put forth by Tom Neubig in "The Needless Furor over Tax-Exempt Student Loan Bonds," *Tax Notes*, April 1, 1984, pp. 93-96.

federal guarantees of student loans--that warrants the imposition of these limits. Current law maintains the subsidy, but with strong safeguards against abuse.

Pending legislation would ease some of the current restrictions on student loan bonds. The bill reauthorizing the Higher Education Act of 1965, which was passed by the House of Representatives at the end of 1985 (H.R. 3700), would require that state governors, rather than the Department of Education, review authorities' plans for doing business. This would be consistent with the continuation of volume limits, which are also administered at the state level, making it unnecessary for state authorities to negotiate with two levels of bureaucracy in order to issue bonds. It would also avoid some of the delays involved in issuing bonds. The reauthorization legislation recently passed by the Senate (S. 1965) eliminates altogether the requirement that states submit a plan for doing business.

An alternative would be to eliminate the volume limits but to continue review by the Department of Education. This would leave to the federal government all decisions regarding tax-exempt financing for student loans. The question before the Congress is whether over the long term two sets of limits are desirable.

In addition to legislation reauthorizing the Higher Education Act, the House late last year passed a tax reform bill (H.R. 3838) that would impose even more stringent limits on student loan and several other types of tax-exempt bonds. The current state volume caps of $150 per person, which apply to student loan and most industrial revenue bonds, would be increased to $175 per person, but they would include bonds for multifamily housing and private hospital and educational facilities owned and operated by tax-exempt organizations, which are not subject to any volume cap under present law, and bonds for single-family housing, which are currently subject to a separate cap. Tax reform legislation approved more recently by the Senate would retain the volume limits in current law. To the extent that the need for the Department of Education's continued review of student loan authorities' bond issues may be questionable under current law, it might be even more so if more stringent volume limits were enacted.

Eliminate Restrictions on Issuance of Student Loan Bonds. The Congress could, of course, remove all restrictions on the use of student loan bonds on the grounds that they improve access to federally guaranteed student loans in many areas and that, even where they may be substituting for taxable borrowing, they are less costly than other tax-exempt bonds because of the lower SAP. Unlike tax-exempt financing for many other purposes, student

loan bonds advance the goals of a federal program. Moreover, the volume of new issues of student loan bonds, which peaked at $3.1 billion in 1983, so far has been fairly low, compared to bonds for many other purposes.

The argument against removing all restrictions is that, under many circumstances, student loan bonds yield large arbitrage profits, which provide an incentive to issue bonds even when they merely displace taxable financing and therefore provide no additional aid to students. Since overissuance has been a problem among some authorities, particularly in Arizona and California, some limits are necessary. Moreover, student loan bonds do result in a net budgetary cost under most circumstances and therefore should be as subject to deficit reduction efforts as other programs.

ELIMINATE STUDENT LOAN AUTHORITIES' PROFITS

Under current law, the returns on student loans may often substantially exceed an authority's administrative and servicing costs. An authority may either use its surpluses to make or purchase additional student loans or it may turn them over to the state treasury. The prospect of generating profits is a stimulus to bond issuance by state authorities and a reason for federal limits on bond volume. Another means of removing the incentive to issue bonds that merely substitute for taxable financing would be to reduce profits from issuing the bonds. The main ways of cutting down on surpluses are to reduce the special allowance payment or to enact more restrictive arbitrage regulations.

Reduce the Special Allowance Payment for Loans Financed with Tax-Exempt Bonds

A lower special allowance payment would result in lower profits, but if the minimum floors were retained, the reduction in profits and in costs to the federal government would both be relatively small. As an example, suppose 8 percent student loans financed with tax-exempt bonds were eligible for a SAP that was 40 percent instead of 50 percent of the regular payment. At T-bill rates ranging from 5 to 15 percent, spreads on variable- and fixed-rate bonds would in many cases be larger than necessary to cover servicing and operating costs. Maximum permissible spreads would range between 3.0 and 5.7 percentage points, compared with between 3.0 and 6.75 percentage points under current law. In other words, allowable spreads would still far exceed the amount necessary to cover costs.

As long as authorities can choose between fixed- and variable-rate financing and can benefit from a guaranteed minimum special allowance, reducing the SAP will have a very limited effect on their ability to generate surpluses. If, on the other hand, the floors were removed and the SAP was reduced to 40 percent of the regular payment, permissible spreads would be more than sufficient to cover costs at T-bill rates between 8 percent and 15 percent, but insufficient at T-bill rates below 6 percent. The floors might be reduced, but at low interest rates spreads would still be inadequate.

At present, with variable-rate financing, most agencies can manage without a SAP as long as the T-bill rate is at or below 9 percent. This assumes that student loans remain at 8 percent (or higher) and that current market conditions prevail. If short-term tax-exempt rates were to rise in relation to the T-bill, additional assistance would be necessary in order for tax-exempt bonds to be a viable method of financing student loans. For example, if short-term tax-exempt rates rose to 75 percent of the T-bill, then once the T-bill rose above 8 percent, some form of assistance would be necessary; otherwise, the spread between borrowing and lending costs would be insufficient to cover the servicing and operating expenses of student loan programs. With fixed-rate financing, borrowing rates would have to be 6 percent or lower for a SAP to be unnecessary. If the borrowing rate was 7.5 percent, then a floor would be necessary to cover operating and servicing costs when T-bill rates were lower than 8 percent.

In 1980, adjusting the SAP seemed to be a simple, equitable, and straightforward way to assure against windfall profits to student loan authorities. This adjustment, however, was geared to issuing practices at the time, which heavily favored fixed-rate financing. Variable-rate financing, although not unknown, was uncommon. Today, the variety of borrowing methods available to state authorities makes a simple adjustment of the SAP an ineffective way to avoid surpluses and excess arbitrage profits. This is because with variable-rate financing, the lower the T-bill rate, the wider the spread between borrowing and lending costs; with fixed-rate financing, the lower the T-bill rate, the narrower the spread. No simple adjustment of the SAP can effectively deal with both of these situations. The adjustment of the SAP could vary with the method of financing, but this would be administratively cumbersome because the Department of Education would then have to keep track of a large number of bond issues.

Another alternative would be to base the yield for loans financed with tax-exempt bonds at a fixed percentage of the T-bill with no minimum. For example, the yield on loans could be set at 75 percent of the T-bill plus

3.25 percent.2/ The problem is that tax-exempt interest rates have no fixed relationship to the T-bill or any other taxable rate, so that at times the formulas might work well from the standpoint of both the authorities and the federal government and at times not.

Impose the Usual Arbitrage Restrictions on Student Loan Bonds

Instead of cutting the special allowance, the Congress could reduce profits to state authorities by imposing on student loan bonds the same or similar arbitrage restrictions that apply to other tax-exempt bonds. These restrictions deal with yield spreads, investments in nonpurpose obligations during the temporary period immediately following bond issuance, and earnings on reserve funds.

Yield Spreads. The usual arbitrage rules limit the difference between the yield on tax-exempt bonds and the yield on investments made with bond proceeds. If the SAP was included in calculations of arbitrage profits, then the bond issuer would be required to rebate on a regular basis as much of the special allowance as necessary to bring the yield on the loans down to a permissible level.

The ordinary arbitrage rules permit a difference between the yield on student loans and the yield on student loan bonds of 1.5 percentage points plus the administrative costs associated with bond issuance, or a higher amount if the bond issuer demonstrates that a higher amount is necessary. These rules could apply to student loan authorities. Most authorities could cover their servicing costs with a 1.5 percentage point spread. They might have difficulty covering overhead expenses also; however, current law permits a larger spread as long as the issuer can demonstrate its necessity.

An alternative would be to change the arbitrage rules for student loan bonds to allow a maximum spread of, say, 2.0 to 2.5 percentage points, plus administrative costs associated with bond issuance. Under this option, most state authorities would be able to cover their overhead, loan servicing and administrative costs, including letter of credit or insurance fees, trustee's fees, and remarketing fees. Whenever the spread exceeded the specified level, student loan authorities would rebate the surplus to the federal government. The amounts rebated would reduce the costs of financing student loans with tax-exempt bonds.

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2. This would end an anomaly that has existed since 1980, namely that the total yield to lenders using tax-exempt bonds varies with the student loan interest rate, while the yield to lenders using taxable financing maintains a constant relationship to the T-bill rate.

This approach has the advantage of encouraging efficiency among student loan authorities. Some authorities have already cut their operating and servicing costs below the 2.0 percent level. These authorities could keep the difference and use it to make or purchase additional student loans. Under current law, they could also rebate any surpluses to the state. The surpluses would, however, be small and would not accrue to all agencies.

The National Council of Higher Education Loan Programs (NCHELP) has recommended a variant of this approach. Under the NCHELP proposal, the SAP would be included in determining the yield on student loans, and state authorities would be permitted a spread between the yield on bonds and the yield on loans of 0.75 percentage point after taking into account servicing costs and administrative costs associated with bond issuance. The 0.75 percentage point would cover overhead, rent, auditors' and accountants' fees, and the like. This proposal would reduce surpluses from current levels in most, if not all cases. A possible drawback is that it might not provide the authorities with sufficient incentives to cut costs. At present, the prospect of realizing profits encourages authorities to seek lower fees and to service loans more efficiently. The advantage of the proposal to the authorities is that it would cover their servicing costs regardless of inflationary increases or changes in the composition of student loan portfolios.

Rebate Requirements. The House and Senate have passed tax reform bills with significantly different provisions regarding arbitrage earnings on investment of student loan bond proceeds during temporary periods. The House bill would impose on student loan bonds the rebate requirements currently applicable to IDBs (see Chapter II). If both houses ultimately approved this provision, authorities would have to rebate to the federal government all their arbitrage earnings from investments in nonpurpose obligations unless they fully expended the proceeds of a bond issue within six months. In determining arbitrage earnings, authorities would not be able to take issuance costs into account. The Senate bill generally requires arbitrage earnings to be rebated; however, it would permit student loan authorities to use these earnings to the extent necessary to cover issuance costs. Both of these provisions differ markedly from current law, which permits authorities to take up to three years to use the proceeds of a bond issue.

At present, authorities use the arbitrage earnings during temporary periods to pay the costs of bond issuance. These costs, which range between 1 percent and 3 percent of a bond issue, include underwriters' discounts, bond counsel fees, printing fees, and initial bond carrying costs, including letter of credit fees. Some authorities can pay these fees from surpluses

that have accumulated from other bond issues, but, if these surpluses do not exist, authorities have no independent source of income to cover costs, other than bond proceeds. At the time that bonds are issued, however, authorities cannot assure bondholders or providers of credit support that the return on student loans will be sufficient to pay back issuance costs and initial bond carrying costs. In most cases, authorities can recover their issuance costs over the term of the bond, but if they lack the surpluses to meet upfront expenses, either the state has to provide the funds, or the authority has to resort to taxable financing.

This provision in the House version of H.R. 3838 could substantially reduce tax-exempt financing for student loans. For other types of bond issues, the provision presents less of a problem because governmental entities generally have the funds to pay for these costs. They cover the costs by raising the interest rate on the loans they make. Student loan authorities, however, have no control over the interest rate they charge their borrowers, nor can they predict future interest rates, which are legislatively determined. If a student loan authority used the proceeds of bond issues to pay issuing costs that it could not cover with arbitrage earnings or surpluses, it would be risking default if it had to call a bond issue.

Student loan bond issuers maintain that they cannot assure prospective bondholders of their ability to make and purchase loans within six months and, even if they could, they would have difficulty in covering their issuance costs. On the other hand, the arbitrage profits that student loan authorities earn over three-year periods often exceed issuance costs and encourage overissuance. In view of these considerations, the Congress might consider requiring authorities to expend the proceeds of bond issues over a period of between one and two years, instead of the six months proposed by the House, and to rebate all arbitrage earnings in excess of issuance costs. Alternatively, the Congress might adopt the measure in the Senate bill, which would retain the three-year temporary period but require authorities to rebate to the federal government all arbitrage earnings on nonpurpose obligations in excess of issuance costs. Or, the Congress could take the position that regardless of special circumstances, student loan authorities ought not be exempted from the rebate requirements that apply to all other issuers of tax-exempt bonds. Accordingly, if earnings on bond proceeds were insufficient to cover issuance costs, state legislatures should appropriate the necessary funds. Over the life of an issue, authorities can usually recover their issuance costs. If they do, they might refund from any accumulated surpluses the amounts advanced to them to cover issuance costs.

Reserve Funds. Under current law, up to 15 percent of the proceeds of a bond issue may be deposited in a reserve fund and invested in nonpurpose obligations. H.R. 3838 would change the amount to 150 percent of the debt service for the bond year and require that the investments be reduced as the bond issue is repaid. This provision might reduce surpluses and would be unlikely to have any adverse effects on the operations of student loan authorities. The Congress might also consider requiring student loan authorities to rebate earnings on reserve funds once a bond issue has been retired.

Treasury Regulations. Both the House and Senate Finance Committee versions of H.R. 3838 retain the current law provision empowering the Department of the Treasury to write arbitrage regulations for student loan bonds that could, among other measures, alter the treatment of SAP payments. The only restriction on these regulations is that they must be consistent with the rebate requirements and the limits on investment in nonpurpose obligations in H.R. 3838, whatever they may ultimately be. As written, this provision could make it possible for the Department of the Treasury to write regulations that impose even more stringent restrictions on student loan bonds. For example, it could include the SAP in calculations of arbitrage profits and limit the spread between borrowing and lending costs to 1.5 percentage points or less, which would make tax-exempt financing for student loans impossible. If the Congress wishes tax-exempt financing for student loans to continue, then it may wish to reconsider the amount of authority now vested with the Treasury Department.

Refinancing. Under current law, authorities may issue bonds to refinance student loans up to 180 days before redeeming the original issue. This gives authorities considerable flexibility to refinance at lower interest rates and entails no risk for them because they can invest the refunding bonds in federal securities yielding the same return. Advance refunding, however, can increase the volume of outstanding tax-exempt bonds and thereby be a drain on federal revenues. H.R. 3838 sets new limits on refinancing. The House version requires the redemption of refunded bonds within 30 days; the Senate version requires redemption within 90 days. Current Department of Education regulations require redemption within 30 days for student loan bonds. A 30-day period may present administrative or technical problems, particularly for currently outstanding issues. The Congress might consider extending the period to 45 days for all student loan issues or to between 45 and 60 days for currently outstanding issues.

Specify Permissible Uses of Surplus Funds

Coupled with or instead of other measures, the Congress could require surplus funds to be invested in more student loans or rebated to the federal government. Under current law, surpluses must either be used to make or purchase additional loans or be paid to the state or one of its political subdivisions. From a federal perspective, the use of surpluses to make payments to the state amounts to off-budget revenue sharing. On the other hand, limits on use are hard to enforce because of the difficulty in tracing the use of funds to their source. Thus, a requirement that surpluses be used to make additional loans would entail setting comprehensive limits on state authorities' use of surplus funds both while the bonds are outstanding and after the principal and interest have been paid back. If, for example, a state authority issued bonds, used the proceeds to make student loans and subsequently sold the loans to Sallie Mae, the proceeds from the sale of the loans either would have to be used to make more loans or to retire the bonds, and any surplus that remained after the bonds had been retired would have to be used to make more loans or rebated to the federal government.

If the Congress decides to regulate the use of surpluses without making any attempt to reduce them, it would in effect be saying that, in the case of student loans, it is desirable to use surplus funds to circumvent at least partially the volume limits on tax-exempt bonds. At present, some authorities are using surpluses to pay underwriters' discounts and issuing expenses. In so doing, they can lower the effective interest rate on a bond issue. This piles subsidy upon subsidy and makes it possible for authorities to issue more bonds than they otherwise would. If, as under current law, limits are imposed on the volume of bond issues, then authorities can use surpluses to make or purchase student loans, thereby mitigating the effects of volume caps. Where authorities have no plans to use surpluses to make or purchase additional loans, they can increase spending for computer systems, salaries, and overhead.

REDUCE THE COSTS OF TAX-EXEMPT FINANCING

Tax-exempt financing is an indirect, off-budget subsidy that more often than not is more expensive than a direct interest subsidy. If the Congress wants to make student loan assistance more visible and to reduce the direct costs of tax-exempt financing, then it might eliminate tax-exemption for student loan bonds or withhold the SAP on loans financed with them.

Eliminate Tax-Exempt Student Loan Bonds

Since 1984, several state authorities have had to choose between receiving special allowance payments and using tax-exempt bonds (see Chapter II). In most cases, the authorities have opted for taxable loans. Most state authorities have borrowed from Sallie Mae, but some have borrowed from commercial banks. These commercial banks have tended to be foreign, mostly Japanese, Swiss, and German. By and large, U.S. banks have been unable to compete with Sallie Mae because their borrowing costs are much higher (see Chapter III). Some state authorities have assiduously sought lenders other than Sallie Mae because of a desire to avoid being in debt to a competing agency.

Most of Sallie Mae's loans to state authorities have been at a floating interest rate equal to the bond equivalent 91-day T-bill plus 125 basis points.3/ This means that state authorities have had to operate with a spread of 225 basis points, which is tight and, for some, unmanageable. Occasionally, commercial banks have offered the authorities slightly better terms, increasing the spread by between 10 and 15 basis points. Legislation passed by the Senate (S.1965) would reduce the SAP so that the rate on student loans would be 300, instead of 350, basis points above the 91-day T-bill. Assuming no change in borrowing costs, this would, of course, reduce the spread on Sallie Mae loans to 175 basis points, which might not be sufficient to cover the servicing and administrative expenses of many authorities. A 50-basis-point reduction in the SAP might also decrease commercial bank participation in the GSL program. As a result, some loans might not go forward or some lenders might cut back on their servicing operations, which in turn could lead to a larger number of defaults and increased costs to the federal government.

If the SAP is reduced and the institutions making loans do not lower their rates, taxable financing could become infeasible for a number of student loan authorities. This, if coupled with the elimination of tax-exempt financing, would reduce competition and restrict the availability of student loans. State authorities could try to float taxable bonds. If so, they probably would prefer to issue bonds at rates pegged to the T-bill because of the way the SAP is structured; however, if they did, they would have difficulty selling their securities in secondary markets because they would be competing with certificates of deposit and commercial paper, and the rates for these securities do not necessarily move in tandem with the T-bill. If CD and commercial paper rates rose in relation to the T-bill, the

3. A basis point is equal to .01 percentage point.

authorities could well find themselves having to manage with narrower spreads than those possible with a loan from Sallie Mae or a commercial bank.

Withhold the SAP on Student Loans Financed with Tax-Exempt Bonds

The Congress could permit student loan authorities to choose between receiving special allowance payments and issuing tax-exempt bonds. In the past year, some agencies--among them the South Dakota Student Loan Assistance Corporation and the Colorado Student Obligation Bond Authority--decided to issue tax-exempt bonds and to do without the SAP. In the one case, the authority's decision followed the Department of Education's refusal to approve special allowance payments in connection with a proposed tax-exempt bond issue; in the other, the authority perceived that market conditions were favorable to a bond issue without the SAP and decided to avoid the Department's approval process.

Without the SAP, tax-exempt financing of GSLs under current law would entail some additional cost to the federal government only if more student loan credit becomes available and none if not (see Chapter IV). The Congress might, therefore, consider permitting the unlimited issuance of student loan bonds to finance GSL and PLUS loans as long as no special allowance payments are involved. The use of tax-exempt bonds to finance student loans that are not federally guaranteed is another matter. These loans are primarily for students who do not qualify for GSL or PLUS loans or who seek more funds than these programs provide. Both the House and Senate versions of H.R. 3838 expand the definition of a "qualified student loan bond" to include obligations issued to finance loans under state supplemental programs. These nonfederal programs entail additional federal expense.

The passage of legislation reauthorizing the Higher Education Act of 1965 could result in a change in the interest rate on GSLs. The House has passed legislation that would raise the interest rate to 10 percent after the student has been out of school for five years (H.R. 3700). The Senate has approved a bill (S. 1965) that raises the interest rate to 10 percent as soon as the student begins to repay the loan. If GSL interest rates were 10 percent, student loan authorities could easily manage without a SAP as long as their financing costs were 7.5 percent or less. This effect, however, would occur only after students have left school. Interest rates while students are in school would remain at 8 percent. On balance, then, if the SAP were withheld on student loans financed with tax-exempt bonds, the volume of issues would probably decline below the levels currently contemplated in pending legislation.

In general, the higher the student loan interest rate, the more tax-exempt financing will cost the federal government relative to taxable financing. This is because the SAP decreases as student loan interest rates increase. While pending education legislation could raise the costs of tax-exempt financing to the federal government, pending tax legislation would have the opposite effect. This is because lower marginal tax rates reduce the federal revenue loss per dollar of tax-exempt financing. At the same time, the differential between tax-exempt and taxable rates would become narrower. In other words, tax-exempt financing would become relatively more expensive to the issuer, reflecting the decline in the federal subsidy rate.

THE EFFECTS OF PENDING LEGISLATION

At present, several bills are pending in the Congress that could affect the future of student loan authorities in different and, in some respects, contradictory ways. In general, legislation to reauthorize the Higher Education Act of 1965 would make it easier for the authorities to finance student loans with tax-exempt bonds. H.R. 3700 removes the current law requirement that the Department of Education approve an authority's "plan for doing business" by transferring that responsibility to the state governor. S. 1965 removes altogether the requirement that authorities draw up a "plan for doing business." Under either bill, the major, if not the only constraint on an authority's ability to issue tax-exempt bonds would be the volume limits that are administered at the state level. Both bills would continue the SAP for loans financed with tax-exempt bonds at 50 percent of the regular payment; however, S. 1965, would reduce the SAP, which would make it more difficult for the authorities to use taxable financing. Both bills would eventually raise interest rates on student loans, which would increase authorities' profits from tax-exempt financing and also make it possible for authorities to forgo the SAP subsidy under more circumstances than at present.

Pending tax legislation, on the other hand, might make tax-exempt financing more difficult by imposing additional state-by-state restrictions on the volume of tax-exempt bonds and by tightening arbitrage restrictions. The House of Representatives has passed a bill that would clearly have such an effect. The Senate has approved a tax reform bill that essentially retains for student loan bonds the more liberal volume limits in current law and imposes less stringent arbitrage restrictions than the House bill. Both the House and Senate bills reduce marginal tax rates, which, in turn, would lower the cost to the federal government of tax-exempt financing by some currently unpredictable amount. An increase in student loan interest rates, however, could have an offsetting effect.

In combination, some of the features of S. 1965 and H.R. 3838 could make it extremely difficult for state authorities to continue financing student loans from either taxable or tax-exempt sources. This could happen if, for example, the Congress adopted the provisions in the House version of H.R. 3838 dealing with tax-exempt bonds and the provisions in S. 1965 reducing the SAP. In the past, the combination of tax legislation and education legislation has produced effects that the Congress neither anticipated nor intended. Without coordination, it could happen again.

APPENDIXES