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Uncle Sam's Phantom Loan Revenues

Underestimating costs and defaults lets the feds claim billions in profits that will never happen.

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You may have heard that lawmakers in Washington struck a deal last week to preserve the current low student-loan rates for at least another year. You may not have heard that for fiscal year 2013 the federal government booked $32 million in revenues—profits, if it were a private entity—for every $100 million in loans for students. The year before, it booked revenues of $4.4 billion on its $233 billion mortgage-insurance program for low-income families.

These high returns make it appear that Uncle Sam is an unusually skilled lender. In reality, they are a testament to the fantasy world of government accounting.


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The federal government books all future interest paid by a borrower as income in the year the loan is made—and does the same for all current and future costs associated with servicing the loans. The phony accounting problem arises because Congress forces the federal government to underestimate the default rate for its loans, as well as the cost of administering them.

These underestimates make it look like the loans are profitable for taxpayers. Instead, the government will ultimately lend more money to borrowers than borrowers will repay.

Take student loans. By the close of fiscal year 2013 (Sept. 30), the federal government's baseline projections claimed these programs would generate $36 billion in revenues on $113 billion in student loans. Between 2013 and 2023, direct student lending is projected to raise $184 billion for the government.

These revenue estimates are based on Treasury borrowing costs, which carry a much smaller risk of default than student borrowers. Yet as of 2012, about one-third of student-loan borrowers in repayment were delinquent. The Education Department has reported that 6.8 million federal student loans are now in default. That amounts to $85 billion in unpaid debt.

The nonpartisan Congressional Budget Office argues that revenue estimates from federal lending programs should be based on Treasury costs plus a risk premium that reflects the likely default rates. In a March 2012 report, the CBO concluded that fully incorporating market risks of default "would provide a more comprehensive way to measure the costs of federal credit programs." However, federal budget estimates must follow procedures that Congress laid out in the Federal Credit Reform Act of 1990—which underestimate the amount of loans that will go bad.

The CBO estimates that federal direct lending will actually cost the federal budget $95 billion over the next decade—instead of raising revenues as the current accounting system implies. That's a swing of nearly $280 billion in phantom revenues from its projected student loans.

The illusory profits of student loans also prompt some to argue for lower interest rates on government-sponsored student loans. They believe that the government is earning too much from its lending programs. Of course, it isn't. Any expansion of loans to students and others will simply raise the costs to taxpayers over time.

Change is needed. Washington must install a more forthright accounting system—one that fairly values the obligations that taxpayers are being asked to finance.

A good place for Congress to start is by requiring a "fair value" accounting standard for calculating the costs of government loan programs, which is the rule in the private sector. The fair value standard would add a cost premium above Treasury borrowing costs that reflects the actual market risks of default and the administrative costs that the government will need to bear when servicing these loans. Perhaps most important, a fair value standard empowers taxpayers with the knowledge of the true costs of the loans they are being asked to fund and guarantee.

The federal government's accounting system should be based on standards that provide the most accurate assessment of these future revenues and expenditures as possible. An accounting system that requires the government to book phantom revenues that cannot possibly materialize fails to meet this standard. If not corrected, the consequences will be dire for both taxpayers and borrowers alike.

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