Insight

“Free” College and Higher Taxes: The Guarantees Under Obama’s Proposals

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The president made waves this past week with a series of higher education related announcements. First was the announcement of a proposal to provide so-called free community college for everyone who wants it, followed by a series of tax changes to enhance the amount of aid available to low-income students. Despite the high price tag, the proposal’s impact could be limited. The added tax burden could also be avoided by making some common sense changes to programs already on the books.

It is hard to tell what problem the president is trying to solve with this proposal. Most students attending community college don’t pay large amounts of tuition out of pocket. In fact, almost 60 percent of community college students don’t take out student loans to attend school. For those who do borrow, half leave with less than $10,000 in debt. What’s more, roughly 40 percent of community college students receive Pell grant support, over $10 billion annually, so most students are able to attend community college at a reasonable rate – particularly when compared with more expensive four-year institutions.

The president’s proposal to provide so-called free community college isn’t cheap, estimated to cost roughly $60 billion over the next 10 years. For some perspective the president’s proposal would cost roughly one-fifth of all spending on the Pell Grant program over the next decade. That’s a lot of money, even in Washington.

Another problem is that this proposal does nothing to address the fact that the vast majority of students at community colleges required to enroll in remedial courses fail to graduate. In fact, 78 percent of students do not complete their studies within two years according to the Complete College America organization.

To help pay for this proposal, the president includes tax proposals as well as consolidation of tax credits for low-income families and students. Some of the better changes would be the consolidation of several higher education tax credits into only two. While still one more than necessary, the simplification is a welcome effort to address what has been a confusing mess of conflicting tax and financial aid programs.

The tax proposals would also increase the refundable portion of the American Opportunity Tax Credit (AOTC) for low-income families, which provides cash assistance for families incurring higher education expenses. That’s a popular approach, but a backward one, as refundable tax credits are awarded long after the tuition bill has already been paid. Up-front assistance is much more useful for low-income students and their families.

As a result of changes made to the Pay as You Earn (PAYE) repayment initiatives by the administration (not Congress), the federal direct student loan program is taking on large expenses every year. While the federal government is expected to make money on most direct loans issued, the reverse is true for every borrower that signs up for a PAYE option. As an example, the federal government expects to earn around 20 cents for every dollar loaned to students borrowing unsubsidized loans. Students with unsubsidized loans who enter extended or graduated repayments might pay back 24 or 25 cents on the dollar.   Once a borrower enters a PAYE option, those savings evaporate, costing the taxpayer 21 cents on the dollar – a swing of 40 cents per dollar loaned. Borrowers of subsidized Stafford loans incur a cost to the government, ranging from roughly 7 to 12.5 cents on the dollar, the same loans in a PAYE option would cost the government nearly twice as much, 21 cents per dollar loaned.

Reducing the take-up rate or managing eligibility for borrowers entering PAYE programs could produce real savings. Given the substantial volume of federal loans issued every year – over $100 billion – and the substantial volume of loans switching to PAYE repayment options – almost $30 billion annually – reducing the government's exposure to these unadvertised costs could save an impressive amount of money.

Rather than raising taxes to pay for programs that aim to help students after the fact, the president could improve the efficiency of existing programs and direct the savings to more effective programs. It's unfortunate, but the president's plan appears to be more talking points than taking aim at the issue of college affordability.