Insight

Why Debt-Free isn't Free

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Focusing on student loans is a common summertime policy theme. The latest proposal focuses mainly on the left's favored campaign tag line of "debt-free" college and calls for all students to have access to a debt-free college education within five years. It offers up debt relief by 1) refinancing loans for existing borrowers, and 2) mandating that all borrowers enroll in income-based repayment plans with loan forgiveness options – all at the expense of the taxpayer.

Refinancing Student Loans

As AAF has pointed out, the refinancing of all students loans raises serious questions about the merits of federal activity in student lending and the cost to taxpayers. These proposals allow borrowers with college debt to obtain a lower interest rate by refinancing with the government. In order to pay off the current holder of the loan (even if the current holder is the U.S. Treasury) and to refinance at a lower rate, the government takes on the loss by paying fair value (principal, interest, late fees and administrative fees that may have accrued) and reissues a new loan at a lower interest rate. The table below details an example of one loan and the cost to taxpayers.

Table 1. Cost to Taxpayer of Refinancing

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*Using Standard 10 year Repayment Plan

**Interest rates estimated using historical rates

$3,585 may not seem like a lot, but it adds up when you take into account the $1.1 trillion portfolio of outstanding student loans.

The Congressional Budget Office estimated costs for a similar student loan refinancing proposal, and found that it would increase direct spending by $58 billion over ten years.

Income-Based Repayment Plans (IBR)

Setting aside the bad policy of forgiving debt for student borrowers that are likely to earn relatively high incomes, AAF has demonstrated that the increasingly popular income-based repayment programs are also adding billions of unadvertised costs to the federal budget. These costs haven't gone unnoticed. Reflected in President Obama's 2016 budget proposal is a $21.8 billion shortfall largely attributed to the rapid growth of the Pay as You Earn initiative (an IBR program). This is the largest adjustment for any federal credit program anywhere in federal budget history.

How is this possible?

Using data from the FY 2015 budget, we calculated a $100,000 graduate loan (unsubsidized Stafford loan) would net the government $22,530 in interest revenue if the borrower stayed in standard repayment. A borrower entering extended or graduate repayment would pay back in the government's favor over $31,500. In stark contrast, a $100,000 loan that switches into IBR would become a liability for the government, costing up to $18,590. That's over a $40,000 switch into the red.

When one considers that the federal government expects to make over $55 billion in unsubsidized Stafford loans in fiscal year 2015, that potential swing gets to be pretty enormous.

Conclusion

"Debt-free" college policies are not new and over the last few years have been shown to cost taxpayers billions of dollars. The goal of ensuring college access and affordability for all students seeking to attend institutions of higher education is a worthy subject. However, proposals that simply focus on shifting the burden of student loans on to taxpayers fall short of bolstering either higher-education access or affordability.