Policy Briefings

Student Loan Debt: A Personal Finance Dilemma with Long-term Public Implications

Americans have incurred over a $1 trillion of college loan debt. This "factoid" has circulated in a number of media outlets in recent months. The overwhelming majority of student loans are guaranteed by the Federal government, obviating any "systemic risk" to our financial system. But loan defaults, particularly among the private, for-profit higher education providers, have increased. Equally important, the college loan dilemma has raised questions about rapidly rising tuition costs and the value of a baccalaureate in post-"Great Recession" America.

These questions are particularly important in South Florida, where access to college is critical if we are to "morph" our low-wage economic base in a fiercely competitive global economy. But the demographics of South Florida and the frequent matriculation pattern of many in the region (from traditional two-year community colleges to four-year institutions) highlight critical issues related to the debt issue.

Ultimately, college education has proved to be portal to the middle class. The success of the G.I. Bill which allowed millions of World War II veterans to attend colleges and universities, or obtain some other type of training, should serve as a reminder to individuals and society of the value of a college degree. For most families, debt will be an essential ingredient in obtaining the degree. But the ability to service debt over a projected lifetime of earnings is challenging for financially illiterate graduates facing a tough job market. How colleges address affordability, and how their graduates cope with the price of entry to the middle class, is a shared policy dilemma. I do not pretend to solve it here, but I urge readers to consider the pecuniary and non-pecuniary returns of a college degree over a lifetime and avoid the urge to "college bash" during tough economic times.

My colleagues and I welcome your feedback. I can be reached at howardf@fiu.edu or (305) 779-7870.

Cordially,
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I. Debt for College Attendance

Outstanding higher education student loans now exceed $1 trillion. This debt, held by 37 million current and former students, exceeds all auto loans and is greater than currently outstanding credit card debt (Laing, 2012: 23). Delinquencies comprise 21% of all outstanding student loans, approximately twice the level expected in a study conducted by the newly-created Consumer Financial Protection Bureau. This increase reflects the capitalizing of outstanding loan balances on defaulted loans, giving a more realistic estimate of the debt faced by current and future graduates.

Closer to home, the ***Miami Herald*** recently reported (Brannigan, 2012: 12B) that the Florida default rate of 9.7% was slightly higher than the national average. While the University of Miami's default rate was 1.6%, FIU's was 7.5% and Miami-Dade's was 10.4%. While the latter rates are by no means catastrophic, they reflect the economics of the surrounding community and the financial situation of its borrowers.

The enormous growth in outstanding tuition debt is largely attributable to three factors: exploding tuition in the "traditional" public and private higher education sectors, stagnating personal and family incomes, and burgeoning tuition debt in the private, for-profit higher educational sector. These intertwined drivers are unlikely to abate in the near-term.

Notwithstanding the absence of wholesale financial risk, the tuition debt dilemma is likely to carry important implications for access to higher education and choice of vocation. These choices have critical long-term impacts on public finance, social mobility, and America's competitiveness in the world economy. This Policy Briefing examines the tuition debt issue's etiology and its implications for individuals and policymakers.

Fortunately, the increased debt engendered by tuition increases is unlikely to cause "systemic risk" to the nation's banking or financial sectors. Roughly eighty-seven cents of every outstanding loan dollar is guaranteed by the federal government, which can garner wages, income tax refunds, and Social Security payments to collect its debts. Moreover, guaranteed debt is difficult to discharge in bankruptcy, further insulating lenders from widespread write-downs.

In the remainder of the paper we examine some drivers of higher education costs. Next is a discussion of recent revelations regarding the business practices of the private, for-profit higher educational sector, and what this critique says about consumer rationality in the higher education market. In closing, we place the national problem into local context, with its implications for economic development in South Florida.

II. Why Does College Tuition Increase So Rapidly?

Since World War II, tuition has increased at roughly 1.5 times higher than the cost of living. Since 1986, the CPI has increased 115%, while college tuition has increased 498%, far exceeding housing, energy and health care. This is the result of many factors (Johnstone and Marcucci, 2007); it is hard to pinpoint any as the "the driver" but all contribute to a remarkably complex problem.

1) ***Institutions of Higher Learning Require High-Salaried Labor and Costly Physical Plants***: The theory of the firm suggests that relatively expensive labor should be replaced with less expensive capital. But colleges, like hospitals, and other institutions, require high-priced labor and state-of-the-art facilities.
2) ***Many Colleges are Playing Catch-up on Deferred Maintenance and Capital Investment:*** The economic downturns of the Seventies and Eighties short-circuited refurbishment of facilities built in the immediate post-World War II era for the first "Boomers." Meeting the needs of significant growth over the last decade adds to capital needs.
3) ***Competition for Students and Faculty Creates a "Keeping up with Joneses" Effect:*** Spartan, non-air conditioned dorms and second-rate labs do not attract the best students or faculty.
4) ***Frequent Discounts from "Sticker Price" Tuition Distort Price-Value Comparisons among Institutions:*** Prospective students and their parents will often pit one institution against another to garner the best financial aid package. From a family budgeting perspective this is rational behavior. But some experts argue this practice leads to systemic distortion of tuition pricing, limiting 'apples-versus-apples' cost effectiveness comparisons across institutions.
5) ***Deregulation of the Higher Education Market:*** State control of higher education has lessened over the last quarter century, allowing greater autonomy at the institutional level. This deregulation makes colleges and universities more responsive to their local markets in terms of program offerings. But it may also foster greater duplication of effort and programmatic redundancy statewide.
6) ***General Fund Support of Higher Education has Decreased:*** The fact that public tuition is still roughly half the private rate provides state legislators "wiggle room" for tuition increases that allow reallocation of general funds to other pressing budget needs.
7) ***Heightened Cost-Effectiveness May Be Challenging to Implement:*** Public and private non-profit institutions are influenced by constituencies (legislators, alumni, faculty unions, students, accrediting bodies) with conflicting demands for programs, facilities, and policies that augur against rational allocation of scarce human, physical, and financial resources.

The College Board and others have noted the "The Great Recession" has damped tuition increases in recent years. Nonetheless, the above-referenced drivers remain. The attention given to the college debt issue may foster greater debate over affordability and accountability in terms of educational outcomes. Nonetheless, that discussion will take place against the backdrop of high unemployment and declining inflation-adjusted earnings.

III. The Private For-Profit Sector Default Rate and What it says about the "Bounded Rationality" of Student Borrowers

Enrollment in the private, for-profit sector has greatly increased in recent years. This sector had 550,000 students in 1998. That figure increased to 1.8 million in 2008. A generation ago, the proprietary sector was primarily focused on vocational-technical training. Over the last decade, it has experienced large enrollment gains at the bachelors, masters and doctoral levels, once the province of traditional public and non-profit private providers. But with increased enrollment has come increased scrutiny regarding this sector's default rate. The national default rate on student loans is 12%; for public universities it is 7%. But for proprietary schools, the default rate is 20%. Students in the private, for-profit sector account for only 10% of the nation's student body, but receive a quarter of all student loan dollars and account for 44% of defaults (Zinshteyn, 2010:2).

Given the above-referenced loan guarantees, it is unsurprising the federal government would increase its scrutiny of the proprietary sector, with particular emphasis on the 14 publicly traded companies. In August, 2010 the U.S. Government Accountability Office released a report detailing what it termed the "fraudulent, deceptive or otherwise questionable marketing practices" (p. 1) of the private, for profit sector. Findings from the study were based on undercover mystery shops, effectively testing in vitro, the interaction between college representatives and prospective students.

The study found that staff at the for-profit colleges encouraged students to lie about their financial status to increase loan eligibility. They also misled students about accreditation status, understated matriculation duration, overstated graduation rate, and misstated transferability. Findings set off a regulatory firestorm which pitted the proprietary sector versus a number of consumer groups and mainstream academic operations such as the American Association of Collegiate Registrars and Admission Officers, the American Federation of Teachers, and the American Association of University Women. Senator Tom Harkin (D-Iowa) added fuel to the debate over for-profit business practices in a recent report (July, 2012) that repeated the previous GAO findings and detailed high tuitions relative to identical offerings in the public and private, non-profit sectors. The study also highlighted a tendency of some for-profit institutions to avoid federal financial aid penalties by categorizing student loans in arrears as being deferred or in forbearance, rather than defaulted. This categorization circumvents federal rules designed to restrict financial aid availability at institutions with high default rates.

Some have argued that the federal government actions are an ideologically biased attempt by the Obama administration to attack student choice and the private sector's efforts at supplementing overcrowded community colleges and public vocational-technical institutions. Others have argued that the unseemly business practices of a handful of institutions does not justify a broad brushstroke indictment of a sector that has a long and positive track record serving nontraditional students. And lastly, there is the claim made by the for-profit providers that restricting their efforts will hurt the predominantly non-white, single-parent, first-time-in-college clientele that fills their ranks, a claim buttressed by the fact that several Democratic members of the Congressional Black Caucus have opposed tightening financial aid rules on the for-profit sector.

Equally important, federal actions at curbing the unsavory business practices of the for-profit sector have shaped consumer behavior. Share prices of the publicly-traded companies in this sector have taken a nosedive over the past year. For example, Apollo Group, parent of University of Phoenix, has seen its shares drop 54% over the past year, while the Standard & Poor's 500 Index has advanced 20.0%. University of Phoenix has also downsized significantly, along with Kaplan and others in the sector. In so many words, stock prices and downsizing indicate a change in the perceived utility and cost-effectiveness of the for-profit offerings.

Stock prices and downsizing aside, the steps taken by the federal government to curb unsound business practices in the for-profit sector speak to a broader issue in the context of the college debt dilemma: the rationality of young adults as college "consumers," and their ability to make sound choices among higher education providers when confronted with debt obligations to be serviced over a 10-20 year period. Financial illiteracy is an American epidemic. Most Americans are unable to obtain competing insurance quotes, compare loan offers, understand inflation impacts, or compute net worth (often thought to be a critical foundation of personal financial planning). Financial literacy in the "future tense," which entails activities such as retirement planning or amortization calculation, is thought to be virtually impossible for most Americans without third-party assistance. Reining in the bad practices of the for-profit higher education sector is a plus for students and taxpayers (Lewin, 2010; 2012). But the recent experience at for-profits underscores the difficulties many have in judging the cost-effectiveness of college training prior to matriculation, and difficulties many students have in dealing with debt subsequent to graduation.

IV. How is this Problem "Localized?"

The biggest threat resulting from this staggering debt is arguably long-term social mobility via reduced access to higher education. The college debt crisis may have indirect impacts on limiting access as well. Policymakers may call into question the cost structure of public institutions whose tuition has risen even faster than their private, non-profit counterparts. Private institutions may be forced to change their pricing as well given limits to affordability. And reforms of the private, for-profit higher education sector are consumer-friendly (i.e., foster greater transparency of true costs and likely long-term debt burdens). But greater truth-in-advertising for this higher education segment may have the unintended consequence of limiting access to lower socioeconomic status students who may be shortchanged by other traditional providers.

Another hidden cost of this crisis may be changes in educational preferences. Students may choose vocationally-oriented degrees and certifications that provide less costly and more rapid entry to the labor market. But over the long term, these choices may limit lifetime earnings; from a macro-perspective, they will disadvantage the U.S. labor market's relative competiveness in the global economy.

I would agree that throwing out the proverbial baby with the bath water and portraying all proprietary educators as overpriced and of inferior quality is excessive. I would argue that $26,000 of debt (the national average for a baccalaureate) to garner an incremental $500,000 to $800,000 of lifetime earnings (the band of estimates from a number of sources) is a good return on investment. Dollars aside, survey evidence suggests that college graduates are much happier than their high-school diploma-only counterparts. They are more civically engaged. They also experience lower divorce and unemployment rates, and have five years greater life expectancy. Simply put, much of the current hoopla over high college debt is associated with the economics of "The Lost Decade" from which we are exiting. The long-term payoffs of a four-year degree are tangibly and intangibly significant; some vocal critics of college education and its concomitant debt are at best myopic, at worst misinformed. Realistically, individuals who want their inflation-adjusted earnings to grow in a fiercely competitive global economy will need a four-year degree.

But just as "all politics is local," so too is the college debt issue. And from my vantage, three local factors impact the willingness and ability to service the college debt.

1) The No-Debt/Low Debt Mindset of Community College Matriculation is a Roadblock to Higher BA Graduation Rates

To their credit, community colleges typically foster a no- to low-debt matriculation mindset. This is not the case with four-year institutions. But students who transfer with AA and AS degrees may not realize that debt incurred for a four-year degree is beneficial to their long-term financial well-being (Burdman, 2005).

South Florida has a high proportion of BA students who transfer in from the area's community college. The national average of two- to four-year transfer is, depending on estimates, 20 to 30 percent. Florida International and Florida Atlantic enroll upwards of one half of their students via AA transfer. Persistence of the "no-debt, low-debt" mindset leads, however, to longer matriculations with lower graduation rates.

2) South Florida's "Majority-Minority" Population will Suffer from Higher Financial Illiteracy than Elsewhere

The challenges of managing debt apply to all Americans. But women and minorities suffer from greater levels of financial illiteracy than other population segments. Most college students are responsible with repaying credit card and automobile loans, which serve as a proxy measure for college loans. But the track record for "The New America" is not as encouraging (Lyons, 2004). Research suggests that a combination of limited experience with asset management and limited personal finance training combine to put these segments of the population at greater risk of credit default, controlling for income.

3) Income Dynamics and the High Cost of Living Allow Little Margin for Error in Household Budgets

The Great Recession has lopped off over $5,000 of inflation-adjusted earnings from South Florida's household. The Center for Housing Policy's (Bindell, 2012) research finds that in South Florida, moderate income earners ($25,444 to $50,888) spend 72 percent of their budget on housing and transportation, compared to the national average of 48 percent. This was the least affordable of America's 25 largest metropolitan areas. Recent federal court decisions and Department of Education regulations suggest 12 percent of pre-tax earnings devoted to tuition debt service are "reasonable." The ineluctable conclusion is that even moderate levels of college debt are burdensome in an area characterized by declining real wages and increasing cost of housing and transportation. This squeeze explains, in part, the decision of younger, college-educated workers to leave South Florida.

V. Concluding Thoughts

My immigrant father attended Brooklyn College after World War II thanks to The Servicemen's Readjustment Act of 1944, better known as the GI Bill. I've often reflected that my presence on the FIU faculty reflects in part the enormous investment America made in its future with the act. Writ large, the success of the 2.2 million "Greatest Generation" who attended college under the GI reminds us of how college is a portal to America's middle class.

College access in our day and age is likely to entail debt. In the immediate aftermath of the housing bust and millions of loan foreclosures, debt of any kind may appear unseemly. But as anyone who has taken an introductory economics course knows, human capital is the most adaptable with the longest shelf-life. Responsibly-handled college debt is a burden—but it may also be a lifeline to higher earnings and a higher quality of life. If America is to compete on innovation and valued-added jobs, college training will be vital. And tuition indebtedness is a likely funding component of that equation for families earning less than $100,000 (Millett, 2003).

Important corollaries emerge from that reasoning. It's clear that high school counselors will have to do more than provide appropriate college placements: They will have to provide a rationale for the cost of college relative to future earnings and explain how indebtedness "fits." Colleges and universities need to reinforce that insight with practical, easy-to-understand information on servicing college debt service relative to projected earnings and career choices. On a broader note, I share Federal Reserve Chairman Bernanke's deep concern for financial illiteracy. In a STEM (science, technology, engineering, and math)-dominated (some might say obsessed) educational environment, we need to find ways of instilling the basics of Capitalism 101 in junior and senior high schools. Americans should understand the basics of personal finance long before college matriculation. And last but not least, we should not forget the earnings and life dynamics of those who earn the baccalaureate. The relatively short-term financial impact of the "Lost Decade" should not blind us to the importance of college to millions of Americans over their lifetimes. 'College bashing' seems acceptable in some circles given the difficulties many graduates are having in today's labor market. But 10 to 30 years down the road, those graduates—and their communities—will reap a multitude of pecuniary and non-pecuniary benefits. Taxpayers and decision makers in all sectors should recognize that essential truth.

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