The Economics Of Student Debt

Stafford Loan Interest Rates Are A Short-Term Problem Reflective of A Long-Term Tension

As Congress returns from the Fourth of July recess, one of the first pieces of unfinished business it hopes to address is the rising interest rate on federal student loans. Specifically, the interest rate for newly originated subsidized Stafford Loans – loans provided interest free until six months after graduation to students with a financial need – rising from 3.4 percent to 6.8 percent.

While subsidized student loans comprise just 25 percent of all federal student loans, the overall issue of student loan debt has the potential to become a significant drag on the economy, with debt now totaling nearly a trillion dollars and 17 percent of borrowers delinquent in their repayment.[1] And these macro dynamics are set against the backdrop of rising costs in higher education coupled with comparatively lower financial rewards.

While the return on investment in higher education is falling due to higher costs and less income growth, college is still worth it. For a host of reasons, increasing access to higher education remains a legitimate public policy objective.

The irony of the economics in the student loan debate is that by subsidizing demand, Washington has actually been enabling the college price increases that it aims to solve. The underlying tension between policies to improve access and the adverse impact those policies have on cost and student debt is the real challenge facing policymakers.

Key Findings:

- **College tuition and fees have increased over 200 percent since 1974.**
- **Student loan debt at graduation has increased far more than the median college salary and starting salaries.**
- **Yet, the college wage premium is still significant, with college graduates earning 93 percent more than high school graduates.**
- **Policymakers have yet to deal with the tension between increasing access for college and the associated unintended consequences of higher costs and more debt.**

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Rising Tuition Costs And Increasing Aid

As the price of college tuition has increased over time, policy-makers have come under increasing pressure to ease the cost burden. College has become more important to economic mobility, and thus access to college and its affordability have become worthwhile policy priorities.

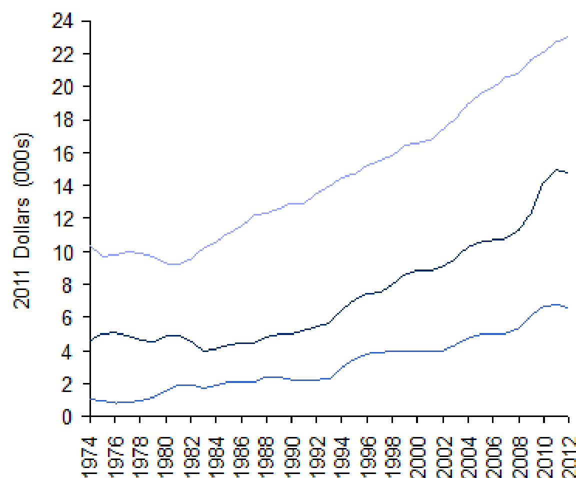
To that end, policymakers have focused on increased access to student loans, both public and private. However, the loan support designed to improve access to college has had the unintended consequence of increasing the cost of college (Exhibit 1).

Exhibit 1

Subsidizing Student Debt Accumulation Enables Tuition Price Growth

Increases in costs and funding sources of college education

— Average Total Aid per FTE
— Average Tuition and Fees 4-Year
— Average Federal Loan per FTE



College tuition and fees have increased over 200% since 1977, far outpacing CPI. Even more dramatic increases in debt and aid is helping enable this cost growth. Increased access to debt is a growing component of education finance.

Moreover, over the past decade, there has been a substantial rise in the need and access to private loans. The collective result has been increased college costs and more debt at graduation.

Source: National Center for Education Statistics, College Board Trends in Student Aid

Third party lenders' willingness to lend money and the federal government's willingness to subsidize student debt has made students comparatively less price sensitive, as it is easier for students to borrow the money today than to fully comprehend what will be required to pay it back tomorrow.

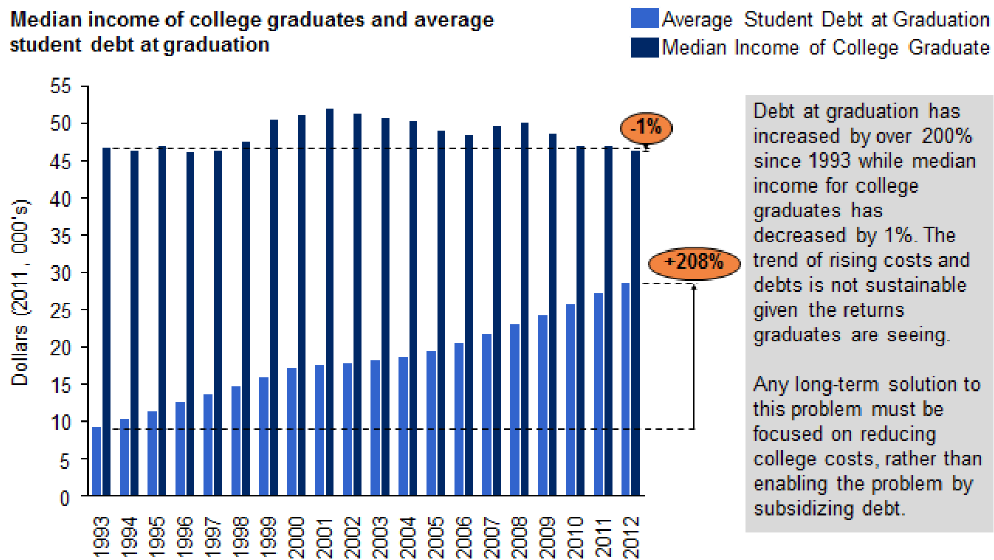
Thus we are enabling the run up in debt, both by lending to the student and accepting the ever-increasing costs of educational institutions. By subsidizing debt, we open up access to higher education to more people while ignoring an important question – what is the relationship between the degree conferred on a graduate and the income that graduate stands to earn?

For example, engineering majors make significantly more than humanities majors. Lending institutions largely ignore the difference in default risk between majors since the federal government guarantees the loans. Students and parents can likewise ignore the returns on different degrees and college more broadly, because culturally many see college as a "moral good." "How can we place a price on studying great literature?" We may not want to as we enter college, but employers clearly think about it as we exit.

All of these factors have facilitated higher levels of student indebtedness, which, coupled with stagnant median incomes for even college graduates, has led to a decline in the immediate return on a college education (Exhibit 2).

Exhibit 2

Growth In Debt At Graduation Far Outstrips Income Growth



Source: FinAid, 2012 Current Population Survey

The rapid growth in college debt at graduation translates to significantly higher monthly payments for recent graduates. For example, a typical college graduate in 1993 faced a little over $9,000 debt in 2011 dollars. Over a 10-year term at 6.8 percent annualized interest, the typical graduate's monthly payments were just over $100 dollars, or about 3 percent of pre-tax monthly income for a $20/hour job. However, the typical 2010 graduate faced a debt of over $25,000 and faces a monthly payment of nearly $300, or about 9 percent of pre-tax monthly income at $20/hour job. Unfortunately entry-level salaries have not increased significantly during this time.

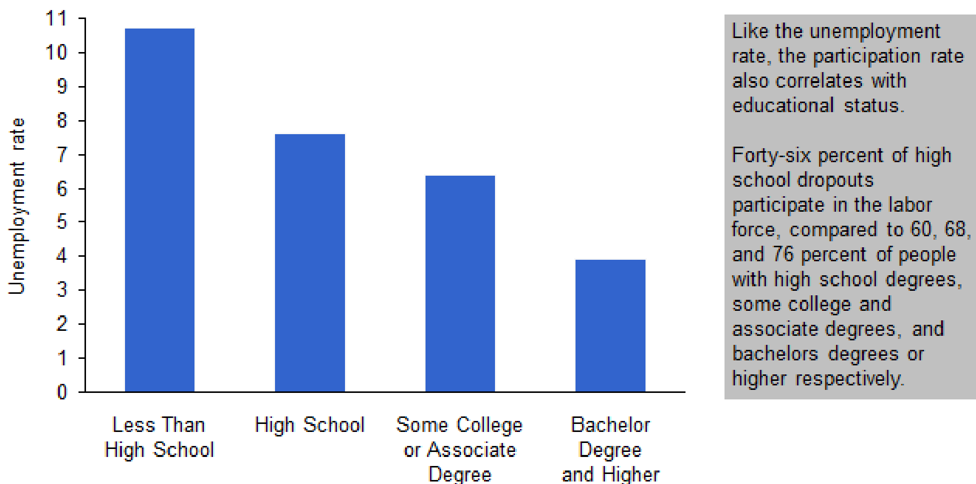
The Value Of Education Persists

Even in the context of rising debt and slowing wage growth, education still remains critical to competing in the modern economy. A look at unemployment rates by educational attainment shows the drastic impact education has on a career in today's economy (Exhibit 3).

Exhibit 3

Higher Educational Attainment Is Currently Highly Associated With Employment Prospects

Unemployment Rate In June 2013 By Educational Status

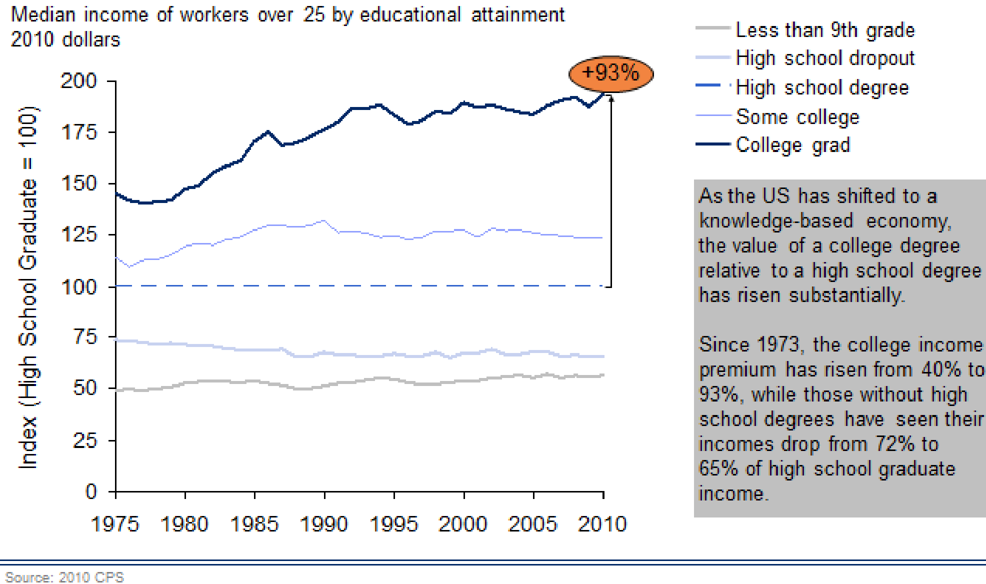


Source: BLS

A principle cause of the increasing rewards from education is the shift we have made toward a knowledge-based economy, and its implications in the diverging value between intellectual capital and physical labor and a changing economy. In 1973, college graduates over the age of 25 earned on average 40 percent more than a high school graduate. Today, college graduates' incomes have risen to 90 percent above high school graduates' incomes. Likewise, those who drop out of high school have lost ground against high school graduates (Exhibit 4). Thus, while the absolute return on education may have declined somewhat, the comparative return remains very high, making higher education still a good bet.

Exhibit 4

While Stagnating Recently, The College Income Premium Has Increased Significantly Since 1975



In the face of these trends, more Americans are pursuing, and have access to, a college degree than ever. Over the last decade, enrollment in higher education has increased roughly 40 percent. This is likely a good outcome, but with tax credits, grants and student loans facilitating increased demand against limited supply we are effectively “bidding up” the cost of college education, thus resulting in higher tuition and higher debt. In this context, the onus of navigating the value and cost of education is falling to students and their families.

Solving The Problem

The politics of this public policy problem seem to point toward an ongoing vicious cycle, with Washington continuing to incentivize both free-spending universities and debt-saddled students.

At the same time, there are innovations in higher education that point toward change from outside Washington. Innovative online learning tools, open online courses, and for-profit schools have all upended the conventional approach to higher education in recent years and signal more change in the years to come. As more and more students seek a degree, institutions will continue to change how they meet the need.

In Washington, there are signs of change as well. In his State of the Union speech, President Obama acknowledged, “taxpayers can't keep on subsidizing higher and higher and higher costs for higher education.”

Following the speech, the U.S. Department of Education released College Scorecard, an interactive tool with information about the cost and value of colleges across the country. This effort aims to improve transparency for the decisions students are making, and apply some level of scrutiny to the value universities are providing. It may be a small step, but it is a step in the right direction.

When policymakers return to Washington this week, they will be looking to find a solution to a problem that we've known was coming for some time. But the real problem is not about reaching agreement on Stafford loan interest rates; we need a long-term solution on how we can support student access to education without saddling them with a massive debt burden upon graduation. Otherwise we're really subsidizing student debt; not just access to education.

About Hamilton Place Strategies

Hamilton Place Strategies is a policy and communications consulting firm based in Washington. As a firm, our focus and expertise lie at the intersection of government, business and media. Our deep experiences on all of these dimensions allow us to serve industry leaders seeking to navigate the paths between Washington and the private sector.

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[1] Donghoon Lee, "Household Debt and Credit: Student Debt," FRBNY, 2/28/13