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Understanding the Student Loan Explosion

Implications for students and their families

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Understanding the Student Loan Explosion: Implications for students and their families

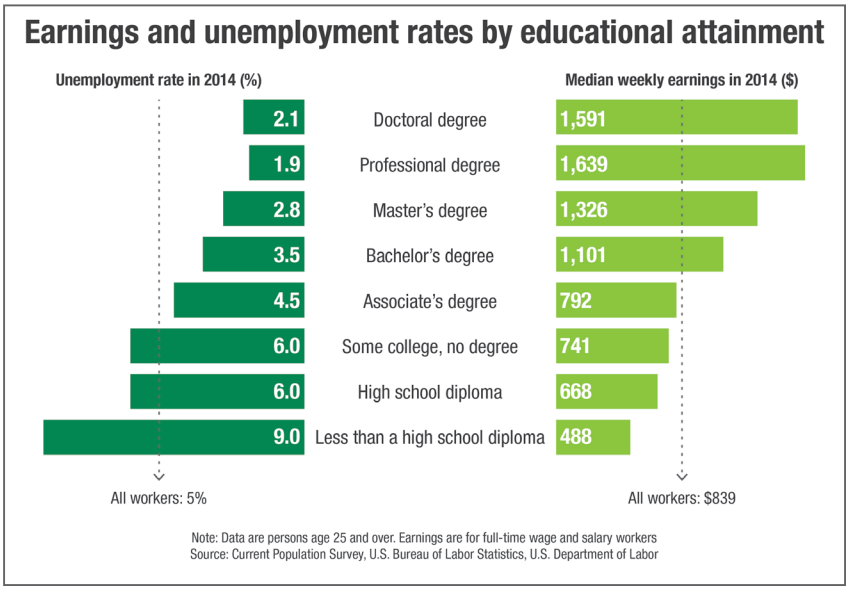
"True wisdom is knowing what you don't know"
Confucius

Emily and her family are about to celebrate her graduation from the state university. It hasn't been easy—courses were tougher than she expected and she had to work about 12 hours a week to fill the financial gap between the cost of attending, the scholarship she earned, and the loans she and her parents had to take out. But she is finishing in four years and has secured a great position as a management trainee in a highly regarded global company. She owes about $10,000 on her student loans but feels she will be able to handle that easily over the next five-10 years.

College: A Good Investment?

Literally millions of students like Emily are pursuing a college degree in the hope that it leads to a successful career and a meaningful life. There is a considerable volume of data and experience that suggest such an investment in higher education reaps large "returns" in the form of higher pay and less vulnerability to unemployment. The nature of these returns is shown in Figure 1.

Figure 1



As you can see, the unemployment rate falls and weekly earnings rise, on average, with the level of educational attainment. For example, in 2014 those with a college (bachelor's) degree made $1101 weekly, compared to only $668 weekly for those with only a high school diploma; over the course of a year, that $433 weekly difference cumulates to over $22,000! And, over one's entire working career, spanning 40-50 years, the gap can easily be in the $1-$2 million range. (Note, these are averages and actual outcomes for individual students will vary above and below such averages depending on major, school attended, work ethic, etc.)

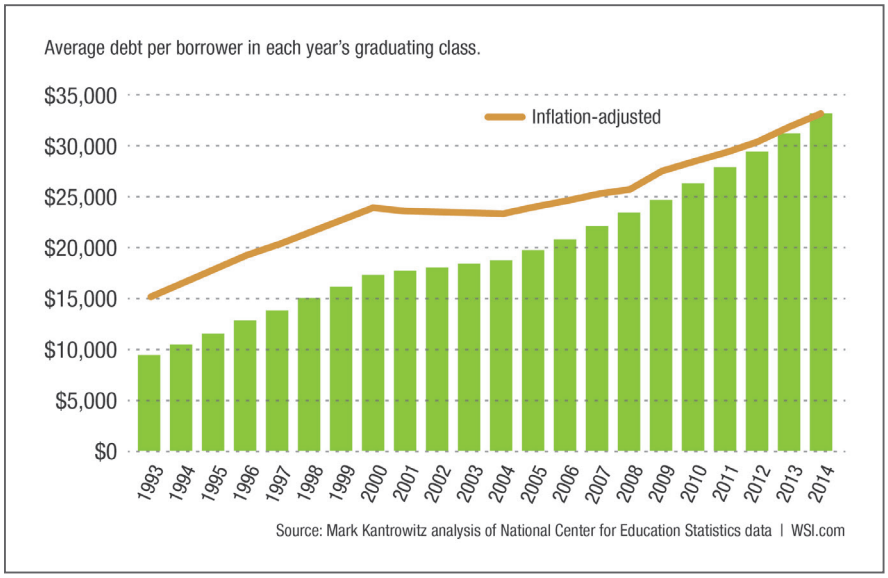
In considering whether to take out a student loan to invest in one's future and thereby capture the financial gains depicted in Figure 1, it is helpful to view the process as akin to businesses that borrow funds to invest in expanding their productive capacity. More specifically, businesses build new plants, for example, to produce more goods and services to sell to consumers. Despite the cost of the borrowing they undertake to pay for the

Written by Ray Lombra, Professor of Economics, Pennsylvania State University

expansion, they expect such actions to increase their profitability—that is, revenues minus costs. Similarly, even if one needs to borrow some to make going to and completing college possible, it can make a lot of sense. Of course, the details matter—how much is borrowed, the cost of the borrowing, and the "returns" expected post-graduation in the form of better employment options and better pay.

A Need for Caution

Figure 2
THE DEBT BURDEN ON GRADUATING COLLEGE STUDENTS HAS SOARED



So far so good. Unfortunately, students and families typically will face a number of challenges in navigating through the college selection and college financing minefields.

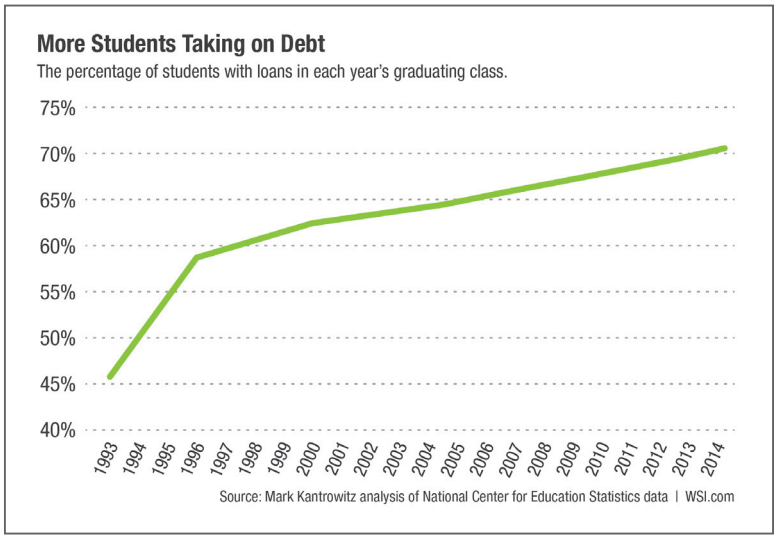
As a wise person once said, "A good picture is worth a thousand words." Figure 2 shows the growth in average debt per graduating student over the last 22 years.

As you can see, the average debt load has soared to nearly $35,000 from only about $10,000 in the mid-1990's.

The data in Figure 3 are also startling; while about half of the graduating class had student loans outstanding in the mid-1990's, the proportion has increased to 70 percent today.

Everyone always talks about how much more everything costs today, compared to years ago. But, let's stop and think about this surge in student borrowing for a minute. If household income and college costs had both increased by about the same amount over the last 20 years, then you might think that the degree of borrowing would have stayed roughly constant. Unfortunately, college costs increased by 150 percent, far more than the 67 percent increase in household income and, indeed, most other prices.

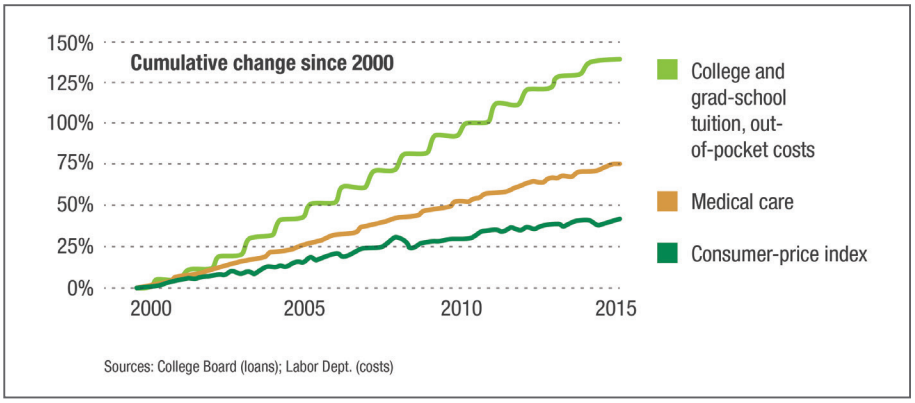
Figure 3



Why Have College Costs Increased So Much More?

An obvious question is why are more students borrowing and why has the average amount borrowed increased so much? Part of the answer lies in the growing number of high school students, particularly those from families with lower incomes, seeking a college degree. Young people have been responding to the obvious implications of the data in Figure 1; an investment in a college education can pay off handsomely. Beyond this, the financial hardships associated with the Great Recession in the United States (2007-2009 and beyond) hit many students and their families very hard, forcing them to borrow more; you can see this in the inflection point for the tan line in Figure 2 in 2008.

Figure 4
College Costs Have Increased Substantially More Than the Cost of Medical Care or the Overall Rate of Inflation (as measured by the consumer price index)



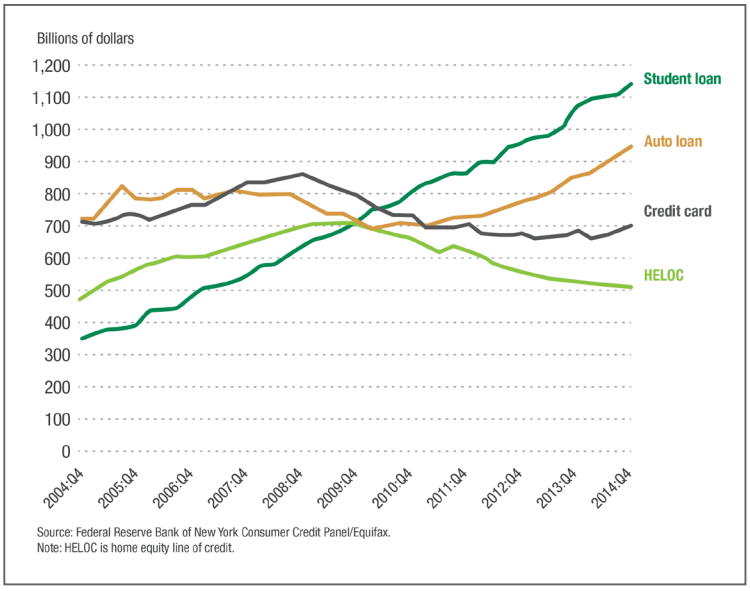
Over a longer period of time, the costs of a college education, shown in Figure 4, have soared. There are many factors behind the increases in tuition, the largest contributor to the increase, room and board, books and fees, but addressing them would take us too far afield now. Suffice to say that coping with such costs, and the increased availability of student loans, as the Federal government tried to make a college education more available, has led more students to borrow more. Over 40 million students and former students now have loans outstanding! (Of course, more students borrowing and going to college, has to some degree allowed schools to charge more for tuition; increases in demand, here, as in other markets, tends to lead to higher prices!)

Are Storm Clouds On the Horizon?

With rising costs, larger enrollments, and increased loan availability driving up student borrowing, total student debt outstanding, shown in Figure 5, has **tripled** over the past decade to $1.2 trillion, a level surpassing credit card debt, auto loans and home equity lines of credit.

To address the question about possible storm clouds, let's ask a simple question: how long would it take and how much would it cost to pay off a $35,000 student loan, the average amount outstanding for 2014 graduates shown in Figure 2 above? For a 10-year payback period, typical for student loans, at an interest rate of 6 percent, the monthly payment would be about $400.

Figure 5
Student Loans Have Increased More Than Most Other Types of Loans



Is that a "large", burdensome amount? Well, it depends. Let's suppose a new graduate secures a first job earning $40,000 annually, or $3,250 per month—not bad right? After taxes and other deductions for health care and retirement, the typical take home pay would be in the neighborhood of $2200 (see http://www.calculator.net/take-home-pay-calculator.html to make such calculations). We will let you do the budgeting for a car, rent, food, entertainment, etc., from here, but it's clear that the $400 to pay back a student loan would be a significant portion of the net paycheck. And, if the annual salary is less, say $35,000, the resulting lower take home pay of about $1800 suggests our new graduate will be under some financial pressure. To drive the point home, go to the website noted and calculate what happens if the total loan due is, say, $50,000.

7 million Americans with student loans have not made a payment to the government in a year or more

For Many Borrowers, the Storm is Already Here

According to the US Education Department, as of the end of August 2015, about *7 million Americans with student loans have not made a payment to the government in a year or more*! This is an increase of 6 percent, or 400,000 borrowers from 2014. Credible estimates suggest that 25-30 percent of all loans outstanding, ignoring those held by students still in school, may be delinquent—meaning payments have not been received for 90 days or more—or in formal default—meaning payments have not been received for 270 days or more. These are staggering figures, much worse than the situation five-10 years earlier.

What Are the Consequences of the Explosion in Student Loan Debt and Accompanying Defaults?

Unfortunately, the level of financial literacy in the nation about the possible consequences of the explosion in student loans is not where it should be. At the micro or individual level, not enough families and students understand the possible consequences for an individual of defaulting on a student loan. Here is a partial list:

- The government can report the default to credit agencies; this will lower a former student's credit score which, in turn, will make it more difficult to get a car loan, a mortgage loan, and perhaps a job or promotion—**Federal law allows potential and current employers to view a modified version of your credit report for employment purposes such as hiring and promoting**.

- The government can garnish wages (have funds deducted from your paycheck automatically), and take tax refunds, social security payments and other similar payments received from the government.

Less dramatically, available data suggest those with student loans requiring payments that are significant relative to their incomes postpone buying cars and houses, and delay marriage and childbearing. Thus, at the macro, economy-wide level, the debt overhang can affect the timing and level of overall spending and saving. And, as in the collapse of the mortgage market which helped precipitate and prolong the Great Recession, if defaults on student loans were to increase significantly from current levels, the resulting effects on banks and other financial institutions could slow significantly the pace of economic growth in the economy as a whole.

Now that we have probably scared the heck out of our readers, let's focus on what can and is being done to cope better with the challenges identified.

Responding to the Threat

Given what has happened, the Congress, the President, and government agencies responsible for the array of grants and loans available to students, dealing with delinquencies and defaults on existing loans, and making a college education more affordable, have been reforming existing programs and looking at alternatives that will reduce the risk for borrowers and lenders. For example, to cut down on the number of defaults, the government has developed programs that forgive portions of student loans and allow future payments to be based on a borrower's income rather than the original interest rate and payback period. This helps to reduce the burden of the debt.

Of course, it would be even better to avoid or minimize the problem in the first place! As the Confucius quote at the top of this article suggests, the route forward is, simply, *students and their families need to become better informed consumers of higher education*—that is, know what they don't know and need to know. It's not about having all the right answers, but rather about knowing the right questions. Then, by getting the answers to key questions, and analyzing the information received, better decisions will be made.

What follows is not meant to be "preachy" or a check list to avoid problems. Rather, it follows directly from focusing on developing the kind of analytical framework that is at the heart of the Junior Achievement experience. In this case, we want to build on the information above to help illuminate what a student and family need to know to *maximize the net return on an investment in higher education*, that is the difference between what it will actually cost and the value added it provides in the form of a higher income and, more generally, a more meaningful and satisfying life. Here are some examples and relevant links to get more information:

- *Realistic Estimates of the NET cost of attending a Particular College: What does a typical student really pay?* Include all tuition, room and board, fees, books, travel back and forth to home, the cost of study abroad, internships, etc. What proportion of students graduate in four years? If many students take 4.5 years to finish, that will be relevant to generating a realistic estimate of the total net cost of attending based on what actually happens as opposed to what one reads on attractive college web sites! How much has the cost of these various items increased over the past three years? You will need that to estimate the full cost of attending in coming years. What are the details of any financial aid package offered? Many schools will use grants and scholarships to, in effect, lower the sticker price of attending. Are these four-year reductions in cost or just for one year? What does a student need to do to continue to receive the grants and scholarships? For any loans, what will be the interest rate? What is the payback term and when does payback begin? Visit sites like www.edvisors.com and www.studentaid.ed.gov/sa to generate a full understanding of all the relevant issues.
- *Reliable Information on How the Choice of College and Course of Study Will Affect Options Upon Graduation:* How many students who graduate have a job related to their course of study within six months? How does this answer vary with major? Is it the same for History majors as for Chemistry majors? What proportion of students go to professional schools, such as law or medical school, or graduate schools for master's or doctoral programs? IF A COLLEGE CANNOT GIVE PROSPECTIVE STUDENTS SPECIFIC ANSWERS TO SUCH QUESTIONS, THIS IS A FLASHING YELLOW CAUTION LIGHT! What specific career exploration and support services are provided? The best of the best go well beyond reviewing resumes--they provide mentors, help to arrange career fairs and enrichment opportunities, including education and internships abroad, research opportunities with faculty, etc. Visit the US Department of Education's new website www.collegescorecard.ed.gov for valuable information on

costs of attendance, graduation rates and typical salaries 10 years after graduation by institution. Remember these data are also averages across many different students, majors and experiences, and individual outcomes will vary around these averages; that said, having such information available is a major step forward and should prove helpful.

- *Consider Alternatives to a Full four-year College Program:* Many meaningful careers do not require a college degree for success; they range, for example, from technical positions in information technology to the health professions. Community colleges and other entities offer many such opportunities. Costs, and ,therefore, the need to borrow are typically far lower. Here, too, however, ask the kinds of questions outlined above.

In the end, choosing a college or any post-high school institution is an intensely personal decision for individual students and their families. The process of choosing among public vs. private, four-year vs. community college vs. technical school, resident vs. commuting vs. online, and which major(s) and minor(s) to pursue can only be enhanced by being proactive, realistic, doing the necessary research, and then committing to a workable, affordable plan. Among other benefits, the result will be an easing of the student loan problem that so many are grappling with today.