Student Debt: Earnings Premium or Opportunity Cost?

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Are college loans worth the risk? For decades, educators and politicians have promoted a college degree as the one sure ticket to middle-class comfort. But every year, more students rely on loans to cover rising tuitions, and some economists now worry that those debts may sabotage the middle-class dreams they are supposed to help realize.

Recent Bush administration changes making federal loans more expensive add to the fears. As of July 1, the interest rate on all new federally guaranteed Stafford loans—the most popular student loans in the country, used by over 10 million students and representing nearly $50 billion in college financing in 2004—will change from a variable rate capped at 8.25 percent to a fixed 6.8 percent rate. The new fixed rate is higher than the historical average for Stafford loans, and according to the *Seattle Post-Intelligencer* will add $2,000 to the lifetime repayment cost of a $20,000 Stafford debt.

The proportion of U.S. 18- to 24-year-olds enrolled in college hit an all-time high of 38 percent in 2003, according to the most current data from the U.S. Census Bureau. Some researchers give student loan programs much of the credit for this enrollment expansion. The 2002 National Student Loan Survey published by Nellie Mae, the Braintree, Mass.-based student loan company now owned by Sallie Mae, found that "a consistent majority of students who borrow to pay for their higher education believe they could not have gone to college without student loans." Nearly six in 10 survey respondents said loans gave them the opportunity to attend the institution of their choice. And while up to a third of the Nellie Mae respondents felt that their loans were a major financial burden, most reported that their monthly payments were at or below the threshold of 8 percent of gross earnings that the loan industry estimates is comfortably affordable.

But other evidence suggests the enrollment boom has come at a cost to students and their families. In the 1992-93 academic year, 34 percent of full-time undergraduates took out loans, borrowing an average of $4,924 (in 2003 dollars) per year, according to the National Center for Education Statistics. By 2003, the share of undergrads borrowing had reached 50 percent, and their loans averaged $6,200. In other words, half of all students were on course to graduate with as much as $25,000 of debt—and the numbers were growing, raising particular concerns about students interested in lower-paying service careers.

Although 59 percent of respondents in the Nellie Mae study felt that loans "were worth incurring because of the career opportunities provided," nearly one in five reported that their loans "had a significant impact on their career plans." And a more recent State PIRGs report, *Paying Back, Not Giving Back*, notes that average salaries in teaching and social work are now too low to repay the average loans incurred to enter those fields.

Meanwhile, indebted college graduates are far more likely than their counterparts without debt to live paycheck to paycheck, according to an Internet of 21- to 35-year-olds by AllianceBernstein Investments, whose products include college savings plans. Many survey respondents reported delaying home-buying and putting off medical or dental procedures among a long list of negative impacts of college loan debt.

The concern that student indebtedness would restrict career and lifestyle choices is as old as college loans themselves, though the would-be Cassandras have not always been vindicated.

Fifty years ago, when the Massachusetts Higher Education Assistance Corp. (now American Student Assistance) was founded, one Massachusetts newspaper fretted that no woman in her right mind would marry a graduate who was deeply in debt before he even had a diploma. And 20 years ago, then-Bowdoin College president A. LeRoy Greason observed in this journal that "students who graduate with large debts will feel that they cannot afford to go into such fields as teaching, religion and social service—for the remuneration will not enable them to carry large debts." [CONNECTION, Summer 1986]

Despite the decades of dire predictions, a crisis is hard to discern. Though marriage rates have dropped since the 1950s, few would attribute the trend to student loans. And *contra* Greason, since 1986, graduates *have* managed to pay back their education debts and pursue nonprofit careers.

Today, though, there are signs of widespread financial strain among the middle class. In May, the Center for American Progress reported that middle-class wages have barely moved since the 1970s, while debts for essentials like housing, health care and education have exploded. And while earning a bachelor's degree adds nearly $1 million to a worker's lifetime income, workers with no more than high school diplomas have seen their wages drop over the period. Where a college degree once offered a

leg up in the job market, it now seems more like a life preserver. It's hardly surprising then that the debate about who should pay for college has become more vocal and emotional.

College Board economist Sandy Baum, co-author of the 2002 Nellie Mae study, believes student loans are catching the blame for ballooning housing and health care costs. "There's a drumbeat to blame student debt," she says, "but the statistics just don't hold up."

What matters in assessing the student loan burden, Baum contends, is not the overall amount borrowed, but rather the monthly payment in relation to a borrower's gross monthly income. Thanks to historically low interest rates over the past 15 years, those payment-to-income ratios remained stable, even as principal amounts grew.

As a result, the typical student can pay back loans with little hardship, according to Baum. The panic about students "drowning in debt" is exaggerated, she says. The problem is that not enough families understand borrowing for college is "good" debt. Nonetheless, Baum does see problems in the current system, including federal loan limits that are too low, irrational and inequitable repayment policies and inadequate protections for students with unmanageable payments. She warns further that students from low-income backgrounds and those who enter low-paying fields will have a harder time repaying loans and be at higher risk of default as a result of July 1 interest rate hikes.

Baum adds that part of the responsibility must belong to the student. "As a student you have to make smart choices," she says. "If you take out $50,000 in loans to go into [a career in] early childhood education, you're going to have a problem."

To help address that problem, Baum has worked recently with economist Saul Schwartz of Canada's Carleton University to develop a system of benchmarks for what constitutes "manageable debt," based on where borrowers' income falls in relation to the national median income. Such a system could enable lenders to make better judgments about what repayment levels are appropriate for which students, while helping students make more informed decisions about loans and careers. (Indeed, the State PIRGs report used Baum and Schwartz's proposed system to gauge loans' effect on service careers.)

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Still, Baum's discussion of investment and risk departs from the higher ed industry's simpler rhetoric centered on upward mobility. In fact, colleges, in their quest for students and resources, were the first to promote the idea of an "earnings premium" attached to each level of degree attainment. The notion that not every degree brings more money, and that some education risks may not pay off, is nearly heresy.

Tamara Draut is trying to bring attention to that risk in hopes of changing the college financing system. Draut is the director of the Economic Opportunity Program at the think tank Demos and author of the 2006 book *Strapped: Why America's 20- and 30-Somethings Can't Get Ahead*. Draut's book takes a broad look at the financial pressures facing the younger generations. She believes that the "debt-for-diploma" system fails at what should be its most important task: expanding college access to those least able to afford it.

"Indebted graduates get all of the media attention, but they're only part of the problem," Draut told CONNECTION. She argues that low-income students are leery about taking on debt to finance their education, and studies have shown that loan-based aid does not encourage them to attend college.

Robert Shireman, executive director of The Institute for College Access and Success, echoed Draut's point in recent testimony before Congress. Among "college-ready" high school graduates from higher income families, he said, 83 percent enroll in a four-year college within two years of leaving high school. But among low-income families, just 52 percent do. "More than one in five qualified low-income students does not go [to college] at all," he added. And a disproportionate number of lower-income students drop out of college before earning a degree.

Those borrowers who drop out of college are left with the worst of both worlds: a heap of debt and no earnings premium. Roughly 20 percent of borrowers at four-year institutions drop out of college before earning a degree, according to the National Center for Public Policy and Higher Education.

Elite colleges like Harvard and Princeton have recently switched to grants-only aid packages for lower- and middle-income students. But while such generosity grabs headlines, most institutions lack the resources to offer similar deals. Draut concludes that the problem goes beyond defaults and dropouts, to the wider ripple effects of debt on the economy. "A whole generation is leaving college already in debt and encountering higher housing and health care costs." To deal with high payments and low starting salaries, she says, young people rely more on credit cards to pay for basic needs, landing them still deeper in debt and forestalling savings for a first home or their children's education.

The elephant in the room is the surging cost of a college degree and the utter failure of colleges, government and the market to restrain that cost. So long as a college degree remains a necessity for middle-class life and the price hikes keep coming, someone will have to pay. And though a college degree may be indispensable in the job market, going deep into debt to earn one will remain a gamble.

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