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HIGHER EDUCATION: CHALLENGES AND OUTLOOK

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abstract

The cost of higher education has made headlines as many worry that the combination of rising tuition and rising student debt will lead to long-term problems for students and potentially the overall economy. Tuition rates have skyrocketed, with average tuition for 2011-2012 rising over 8% from the previous school year. According to the Federal Reserve, student debt in the U.S. hit an all-time high of $867 billion last quarter, a figure higher than even U.S. credit card debt. This level of debt is concerning, especially amid an environment of high unemployment and stagnant salaries. The possibility of rising defaults and potential debt forgiveness could hit both private lenders and the federal balance sheet and cause a drag on the U.S. economy for years to come. However, there is evidence that improvements in higher education are on the horizon. As businesses demand more and better-educated employees and Americans become increasingly conscious of the cost of the education they seek, innovation in higher education seems inevitable in the decades to come.

INTRODUCTION

The cost of higher education has made headlines as many worry that the combination of rising tuition and rising student debt will lead to long-term problems for students and potentially the overall economy. Tuition rates have skyrocketed, with average tuition for 2011-2012 rising over 8% from the previous school year. The increase is even more dramatic over longer periods of time; over the last thirty years, tuition rates have gone up 3.5 times even after adjusting for inflation.[1] According to the Federal Reserve, student debt in the U.S. hit an all-time high of $867 billion last quarter,[2] a figure higher than even U.S. credit card debt.[3] This level of debt is concerning, especially amid an environment of high unemployment and stagnant salaries. Between 2000 and 2011, the share of recent graduates who were able to find jobs fell from 81% to 74%. An even steeper decline in the percentage of those graduates holding jobs requiring a college degree indicates that many graduates accepted jobs that were not commensurate with their qualifications.[4]

The rising cost of education amid this challenging job market has led to concern and protest, with the Occupy Wall Street movement listing student debt forgiveness among their demands.[5] Some have suggested that the price of college education and its associated debt is beginning to look like a bubble.[6] Bubble or not, it seems as though tuition and student debt cannot continue this dramatic rate of increase. In what follows, we examine the current situation and what changes may result from today's concerns.

OVER A LIFETIME, COLLEGE GRADUATES MAKE 84% MORE THAN THOSE WITH ONLY A HIGH-SCHOOL DEGREE, AND THIS WAGE DIFFERENTIAL IS INCREASING.

THE SUBSIDIZED MARKET FOR LOANS

The U.S. federal government began regulating and subsidizing student loans in the 1970s, at which time the government decided what interest rates commercial banks could charge for student loans, determined who qualified for loans, and protected lenders against default. In 2007, after political pressure led to the halving of interest rates on the primary type of student loans, Stafford Loans, banks responded by reducing lending to students. In an effort to remedy the reduced lending supply, three years later Washington gave the U.S. Department of Education the ability to lend directly to students. They granted this authority by attaching a rider to the healthcare legislation, giving the Department of Education the ability to make money by borrowing at Treasury bill rates and lending to students at a profit, creating a vast supply of loans.[7]

In many ways, increasing students' access to loans is a good thing. The increasing education of U.S. citizens has been vital to technological innovation and our economy's success over the past fifty years, and loans have facilitated the increase in the number of students attending college. In the past ten years, the share of eighteen to twenty-four year olds enrolled in college increased from 35% to 41%,[6] and college enrollments have increased 400% from the 1950s.[8] However, providing ever-increasing access to loans has also introduced a powerful disincentive to productivity within the higher education system. If students continue to consider college worth the cost and continue to be offered loans in order to pay for it, colleges have no great incentive to reduce costs. They do, however, see benefits to increasing spending, as nicer facilities may attract better students, and promising low teaching loads may increase the ability to attract and retain faculty. With better students, better faculty, and small class sizes, colleges see their rankings improve in magazines like Forbes and US News.[9] In fact, the rankings reported by US News give a 20% weighting to Faculty Student Ratio, hardly creating an incentive to achieve more with less money.[10]

THE VALUE OF A COLLEGE DEGREE

With tuition costs skyrocketing while wages remain stagnant, some argue that a college degree may not be worth the cost. For those students who manage to graduate, however, college degrees do seem to pay off over the long run. After controlling for the more-affluent backgrounds of those attending college, each year of college amounts to a 6% to 10% increase in annual income.[11] Over a lifetime, college graduates make 84% more than those with only a high-school degree,[12] and this wage differential is increasing. Since 1983, wages of high school graduates have increased by 13%, while wages of people with a bachelor's degree increased by 34%. The outlook for those who continue on to earn a post-graduate degree is even better: people with graduate degrees saw their wages increase by 55% over the same time period.[13] Unemployment rates

WHILE HIGH STUDENT DEBTS ARE A BURDEN ON INDIVIDUALS AND THE ECONOMY AS A WHOLE, EDUCATING FEWER PEOPLE IS LIKELY NOT AN OPTION, BECAUSE THE U.S. NEEDS MORE COLLEGE GRADUATES IN ORDER TO COMPETE IN AN INCREASINGLY GLOBAL ECONOMY.

tell a similarly compelling story. According to the BLS, unemployment for those with a bachelor's degree was 5.4% in 2010, compared to 10.3% for those with a high school diploma and 14.9% for those who did not complete high school.[14]

THE CHALLENGES OF RISING COSTS

Because of the better earnings and employment outlook for those with college degrees, students continue to choose college despite the rising costs, with more than 75% of high school graduates going to college.[8] Increasing college attendance alone would lead to a larger overall debt load, but with costs increasing while household incomes stagnate, per-student debt has doubled in the past ten years, [16] reaching an average of $23,300 per student today.[15] Meanwhile, real wages of college graduates have fallen over the past ten years, and recent grads face high unemployment.[6] One result of these pressures is higher delinquency; today 27% borrowers in the repayment period for their student loans are late on their payments,[15] and experts think this rate may rise even higher. Hedge funds that buy student loan packages are assuming higher default rates than in the past, expecting the default rates to go as high as 30 to 40%.[17]

What might such high default rates mean for the economy? For the 70% of student loans made by the government, default rates could be kept in check by the government's power to garnish wages and tax returns.[18] Of the loans made by the private market, lenders have responded to the challenging outlook for graduates by increasing lending standards. Sallie Mae, for example, required almost 70% of students to have co-signers on their loans in 2008, up from only 50% between 2002 and 2007.[19] As a result of such steps, credit quality of private loans has improved a great deal. Furthermore, student debt cannot be discharged even in bankruptcy. The worry for lenders, then, is that students and protesters might become powerful enough to achieve some degree of debt forgiveness. Because of the high proportion of student debt guaranteed by the government, such an action would, for the most part, land squarely on the federal balance sheet, potentially creating a burden on the U.S. taxpayer.[7]

Not only is the potential default on loans a concern, but even the loans being paid on time are causing a drag on the economy. There is evidence that student debt is affecting home sales, for example. Graduates saddled with debt may not qualify for home loans even if they land a job that would allow them to afford the payments, which has in part led to the share of home buyers between ages 25 and 34 falling to the lowest in a decade, from 33% in 2001 to 27% in 2011.[20]
While high student debts are a burden on individuals and the economy as a whole, educating fewer people is likely not an option, because the U.S. needs more college graduates in order to compete in an increasingly global economy. Sixty percent of jobs in the U.S. require postsecondary education, and experts foresee that number rising.[21] Furthermore, the U.S. is falling behind the rest of the developed world in the goal of increasing human capital. The U.S. previously ranked highest in the world in the percentage of adults with college degrees, but it currently ranks only 7th out of 29 advanced economies.[4] McKinsey & Co., a global research and consulting firm, estimates that by 2020 the U.S. will need an additional one million college graduates each year in order to sustain a healthy economy. That means the number of students graduating would

have to increase by 40%, a number that seems unachievable unless colleges find a way to educate more students, graduate a higher percentage of enrollees, and do so while curtailing the cost increases of the recent past.[22]

INNOVATIONS AHEAD

While those objectives may seem difficult to achieve, some institutions are already beginning to change the way they think about providing and evaluating their educational services. Andrew S. Rosen, the chairman and CEO of Kaplan, Inc, a global for-profit education company, has written in his book *Change.edu: Rebooting for the New Talent Economy* that better metrics are needed to evaluate whether schools are doing a good job of educating students. According to Bill Gates's review of Rosen's book, Rosen "is quite pointed about how the competition to have the best resort-like atmosphere has diverted funds away from the classroom in many schools….These colleges know more about how many kids attend basketball games and which alumni give money than how many students showed up for economics class during the week and which alumni are having a hard time meeting their career goals because of shortcomings in their education."[23]

ONE POWERFUL INCENTIVE FOR SCHOOLS TO INCREASE EFFICIENCY WILL BE THE CURRENT TREND OF STUDENTS CHOOSING TO REDUCE THEIR COSTS WHERE POSSIBLE.

Perhaps merely having useful metrics is the first step to true innovation in postsecondary education. According to an opinion piece by Richard Vedder and Matthew Denhart of the Center for College Affordability and Productivity, "customers are ignorant of college outcomes because we do not measure in any coherent and consistent manner what students actually learn, how well they do after graduation or whether they think better in a critical manner as a result of the college experience. Even basic financial information on how colleges spend money is often not fully shared with trustees or key politicians who help fund or oversee college operations…If information and incentives are provided, innovation will come."[5]

One powerful incentive for schools to increase efficiency will be the current trend of students choosing to reduce their costs where possible. Between 2003 and 2009, the percentage of college students taking at least one online course increased from 10% to 30%. As the number and quality of online-only universities increases, the overall share of classes taken online may well increase along with it.[24] Students are shortening the amount of time spent in school, as well. In 2009, only 12% of students from families whose incomes exceeded $100,000 attended public two-year schools in lieu of a more expensive four-year school. For the 2010-2011 school year, that number nearly doubled to 22%. In part because of choices to reduce costs, families at all income levels spent an average of 9% less in 2010-2011 on college spending than in the previous year despite rising sticker prices of school.[25] These forces should, over time, increase the competitive landscape of the educational system in the U.S., thus bringing down the costs associated with traditional four-year universities.

SCHOOLS ARE FINDING WAYS TO ENSURE THAT THEY ARE PROVIDING THEIR STUDENTS WITH THE SKILLS EMPLOYERS NEED.

While there are ways for students to choose to spend less on school, there is a limit to the degree to which these measures can alleviate the problem of increasing college costs. However, these signals that students are concerned with costs are already pushing institutions to make strides toward educating more students with fewer resources. For example, under the leadership of Michael Crow, Arizona State has been successful in rethinking its approach to the cost of education. When Crow came on board as President in 2002, he began to build what he called the "New American University," striving to educate as many students as possible at the highest level without raising costs. Since Crow has taken office, Arizona State has doubled research spending, risen up the ranks on lists of best schools, and increased the number of low-income freshmen by nearly ninefold.[26] Crow strives not to have a low acceptance rate in order to seem elite, but rather he believes a school should accept every qualified candidate, educating more people using fewer resources, and he has been largely successful in doing so.

Additionally, schools are finding ways to ensure that they are providing their students with the skills employers need. The city of Chicago, for example, has announced a partnership between the community colleges and local employers to design programs that will help them fill open jobs for which they are unable to find appropriately skilled workers.[17] Virginia and Ohio have launched similar partnerships.[31] Policymakers are also making a push for reforms. In the State of the Union address, President Obama spoke of his plan to keep college affordable. While much of the plan is focused on continuing government support of education costs, he also addressed the issue of rising costs. His plan would reward colleges that graduate low-income students and keep costs down, and he proposes collecting information about earnings and employment of graduates to help prospective students make wise decisions about incurring costs.[27]

CONCLUSION

As businesses demand more and better-educated employees and Americans become increasingly conscious of the cost of the education they seek, innovation in higher education seems inevitable in the decades to come. In the near term, however, students are faced with an expensive decision, and while college is still the clear choice for maximizing lifetime earnings, now more than ever students must consider how much they are willing to pay for school and what earnings they can expect upon graduation. Businessweek has created some interesting analysis on which schools offer the greatest return on investment,[28] and while elite private schools landed near the top of the list, there are good values to be found outside of the Ivy League. Additionally, choice of major can have a significant impact on future earnings. Georgetown University's Center on Education and the Workforce, in its report comparing the earnings of various majors, found that the median income for those with a major in Petroleum Engineering, the highest-earning major, is over three times higher than the income for that of students majoring in Counseling Psychology, the lowest-earning major in their study.[13] While financial gain is clearly not the only important factor in choosing a career, students need such information in order to make an informed decision in today's environment of high tuition and stagnant earnings.

Although the current level of student debt is alarming, and the possibility of rising defaults and potential debt forgiveness could hit both private lenders and the federal balance sheet and continue to cause a drag on the U.S. economy for years to come, there is evidence that improvements in higher education are on the horizon. Choices by students to consider cost more carefully in selecting schools, decisions by schools to increase productivity, and the government's effort to encourage cost-effective and affordable higher education for American students may lead to a sorely-needed revolution in U.S. higher education. Indeed, U.S. institutions of higher learning have evolved before, for example under the leadership of A. Lawrence Lowell in the early 1900s.[29] As Lowell stated in his inaugural address at Harvard, "We are justified in believing that the college of the future has a great work to do for the American people."[30] Now, in the 21st century, colleges must do that great work more productively. If you have questions regarding the topics discussed in this paper, your current portfolio, or any other investment matters, please feel free to contact your relationship manager or email us at invest@signaturefd.com.

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