December 2014

Student loan debt: a deeper look

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In the last few years, student loan debt has hovered around the $1 trillion mark, becoming the second-largest consumer obligation after mortgages and invoking parallels with the housing bubble that precipitated the 2007–2009 recession. Defaults have also been on the rise, adding to concerns about the repayment ability of struggling borrowers. But what are the causes and socioeconomic ramifications of these developments? Are they driven solely by cyclical factors? And is there a difference in the way student loan debt has affected borrowers of different ages? In her paper "The economics of student loan borrowing and repayment" (Federal Reserve Bank of Philadelphia Business Review, third quarter 2013), economist Wenli Li attempts to answer these questions with the use of loan data, mainly from the Equifax Consumer Credit Panel, for the 2003–2012 period.

Li's analysis suggests that the observed rise in student loan balances and defaults, while certainly affected by business cycle dynamics, represents a longer term trend largely driven by noncyclical factors. By comparison, the upward and downward movements in balances, past dues, and delinquency rates for other types of financial obligations, such as auto loans and credit card bills, coincided with the onset and the end of the latest recession, thus exhibiting a more cyclical pattern. Li claims that two proximate drivers—an increasing number of borrowers and growing average amounts borrowed by individuals—account for the considerable rise in student loan debt. Her data show that the proportion of the U.S. population with student loans increased from about 7 percent in 2003 to about 15 percent in 2012; in addition, over the same period, the average student loan debt for a 40-year-old borrower almost doubled, reaching a level of more than $30,000.

Looking a bit deeper, Li attributes these upward movements to both demand and supply factors operating over the long run. On the demand side, she points to technological innovation at the workplace, tuition and fee hikes due to cuts in government funding for higher education, and deteriorating household finances (especially during the recession) as the primary reasons for increased borrowing. The key supply factor, Li explains, is the growing role of the federal government in the student loan market, a role that has involved a gradual withdrawal of subsidies to private lenders and a replacement of loan guarantees with direct and cheaper loans to prospective borrowers. As of 2011, lending by the federal government accounted for 90 percent of the market.

Besides offering insights into the secular nature of the rise in student loan debt, Li observes that, over the study period, loan balances increased most for borrowers ages 30 to 55. Middle-age and older borrowers also were the ones who struggled the most with their student loan repayments, as evidenced by their growing past-due balances. According to the author, these findings not only challenge the popular notion that student loan burdens are mainly the problem of younger people but also imply different policy prescriptions. While younger borrowers have more time to repay their loans and can be aided by policies that favor job creation, those in older age groups have shorter horizons over which to recover from their financial predicament. In the case of older borrowers, then, Li suggests that a policy involving some degree of loan forgiveness may be warranted.

In the concluding part of her analysis, Li examines the broader economic implications of rising student loan debt. Drawing upon previous research, she argues that high levels of indebtedness could potentially suppress future consumption as borrowers divert a substantial portion of their income to pay off student loans. Unlike other types of financial obligations, student debt is not dischargeable, and repayment failure or delay may result in garnishing of wages, interception of tax refunds, and long-term credit score repercussions. These outcomes may, in turn, lead to reduced access to credit and further declines in consumer spending. The author also points to evidence that higher indebtedness makes students more likely to skirt low-paying jobs, which often include occupations (such as school teacher and social worker) that advance the public interest. Further, student debt burdens may work alongside other factors in delaying household formation, which, in Li's view, has had a negative effect on the housing recovery.