Subprime mortgages, subprime student loans
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With college participation rates and the college wage premium at an all-time high, the market for student loans and the market for subprime mortgages may have more in common than you think. Are the warning signs for another looming financial crisis being ignored?

Here is a simplified version of how the subprime mortgage saga began:

Large numbers of people took out large loans that they could not afford to repay, to invest in a risky asset whose value they thought would keep on rising.

When house prices stopped rising, trouble started.

Loans secured by residential housing are the largest component of household debt in the USA. But for nearly a third of college-educated 18 to 30 year-olds, it is student loans that put the bigger strain on their budget.

Today, more college graduates than ever before owe money from student loans. This is both because the cost of college has continued to soar, as has the number of young people attending college. Around 66% of students graduate with debt, with an average debt level after four years of college of around $19,000.

Unfortunately, complexities in the aid application process and limits on the size of loans available through government-sponsored programs mean that more and more students are graduating with ‘bad debt’: mortgage-style loans with fixed repayment schedules or credit-card debt with high interest rates. The type of loans that quickly become unaffordable when things turn sour in the labor market.

Wisely, these borrowed funds are not being spent on vacations and video games. They are being invested in an asset that pays a good return - a college education. If we think of a college education as an asset that pays its dividend in the form of higher earnings, then right now we are twenty years into the longest bull market in history. The returns on a college education, known as the skill premium (the difference between the average wage for college graduates and high-school graduates) increased by over 50% from 1980 to 2003.

The skill premium hasn’t always been rising. It fell steadily, by 20%, during the 1970’s. And even if the average return to a college degree does continue to rise, not all college graduates will see a positive return on their individual investment. As the number of students rises and tuition costs soar, an increasing number of graduates will enter the
labor market to find that their degree is not worth the price they paid. A college education provides a positive return on average, but for each individual student, it is a risky asset.

Large numbers of people taking out large loans that they cannot afford to repay, to invest in a risky asset whose value they think will keep on rising.

Sound familiar?

Of course, borrowing to go to college is very different from borrowing to buy a house. For a start, laws against slavery prohibit lenders from seizing human capital when borrowers default on their loans. So this is not to say that the debt problem will implode in the same way that subprime mortgages did. It is easy, however, to envisage other ways that growing levels of unaffordable student debt could snowball into problems for the rest of the economy. For example, if graduates are still paying off student debt into their forties, there doesn’t leave much time to save for retirement. And who knows in what state the Social Security system will be in thirty years, after the baby-boomers have bled it dry?

Fortunately, there is a simple, albeit ironic, solution. More loans.

Fight loans with better loans. If government-provided income-contingent loans were made universally available to cover the full cost of college tuition and board, there would be little or no need for students to revert to expensive credit card debt to finance their education. The trick to averting the potential dangers of uncontrolled borrowing is to recognize that it is not the size of the loan that matters, but the type of the loan.

What is special about these loans is that monthly repayments are linked to income and collected through the tax-system. The more you earn (or alternatively, the higher the return on your investment) the more you repay. And if money is still owed by mid-career, because earnings turned out to be particularly low, the loan is written off. Systems with these features are already in place in the United Kingdom, Australia, Singapore and New Zealand.

President Bush took a big step in this direction with the College Cost Reduction and Access Act of 2007. However under the current system, the loans are not available to all students and fall well short of covering the full cost of college. Unfortunately, none of the current presidential candidates have announced plans to change this.