Do for-profit universities induce bad student loans?

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**A B S T R A C T**

Despite its great social and financial importance, little of the prior empirical research on student-loan default focuses on the role of for-profit universities. This study finds a positive association between student loan default and an institution’s for-profit status—even when controlling for previously identified important factors, including graduation rates, the percentage of students who are low-income and from minority groups, and whether the institution is two- or four-year. Overall, my results are consistent with for-profit institutions systematically encouraging ill-advised loans. The results are economically significant, with default rates generally 5–6 percentage points higher for for-profit institutions.

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1. Introduction

In the US, there is strong public interest in expanding access to higher education to lower-income individuals and broader swaths of the social spectrum. This increased interest in expanding higher education is occurring while per student costs are increasing. Johnstone and Marcucci (2010) note the drivers of these costs: technology, competition and ambition, consumer demand and other change-related factors. These costs are generally rising faster than changes in consumer prices. Also, higher education is a likely candidate for what has been described as “cost disease,” or rising relative costs in labor-intensive productivity-resistant sectors such as education and the arts (Baumol & Bowen, 1966; Bowen, 1968; Johnstone & Marcucci, 2010).

Illustrating the social and fiscal urgency of financing tertiary education in the US, Avery and Turner (2012) point out that accumulated student loan debt now exceeds roughly $1 trillion. Indeed, a 2015 report from the New York Federal Reserve notes that a current student loan debt figure of $1.16 trillion is greater than total credit card debt ($700bn) and total car-loan debt ($955bn). Only mortgage debt ($8tn) is greater. It is clear that a weak labor market and rising student debt are putting the squeeze on young people. The Consumer Financial Protection Bureau (CFPB) estimates that more than seven million Americans are in default on student loan balances totaling $100 billion. 1 Meanwhile, as tuition costs rapidly rise, student-loan debt rises even faster—and default rates concomitantly increase (Rhode, 2014). This has repercussions for both individuals, through depreciated credit, and on the economy as a whole, through reductions in household formation, consumer spending and retirement saving (Rhode, 2014).

As reported by Tett (2015), the US Department of Education reports that Americans who were due to start repaying their student debts in 2011 had a 13.7% default rate last year, which is higher than the credit-card default rate. In light of the recent mortgage-debt crisis, the public and policy makers are concerned about the burgeoning student-loan debt and concomitant default situation. Despite the great financial impact of student-loan debt and default, few large-scale studies examine the phenomenon across institutions.

Of particular concern is whether for-profit institutions are systematically encouraging ill-advised student loans, a question that, anecdotally at least, has been the subject of much media attention.

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1 Of additional consideration, Cunningham and Kienzl (2011) note that many borrowers become delinquent on federal education loans but manage to avoid default.

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In sum, there is a very important societal need for a large-scale study that examines whether for-profit universities have higher default rates. In this paper, I examine the determinants of student-loan default with particular emphasis on the role of for-profit institutions. Data for student loans at the institutional level is obtained from College Insight. This database includes a wide array of institutional variables. This data is merged with data on default rates at the institution/year level from the US Department of Education. This database covers the most recent default rates available since the global financial crisis: 2009–2011. (For a default rate of 2011 to be recorded, data up to 2013 is required).

I find that higher-education student-loan default is positively associated with an institution having for-profit status. This positive association holds even when controlling for percentages of low-income and minority students, graduation rates, and whether the institution is two- or four-year. Empirical results also point to a positive association of default rates with student financial need and a negative association with student age. In addition, default rates are higher for institutions with lower tuition and smaller enrollment. State-level factors are also significant, with default rates positively associated with an older population, greater percentage of males and greater economic inequality. Overall my results are consistent with for-profit higher-education institutions encouraging ill-advised loans, with default rates of for-profits generally 5–6 percentage points higher than non-profit institutions, even when controlling for important identified factors. These results should be of considerable interest to policy makers.

2. Background

2.1. The importance of student finance

As noted by Johnstone and Marcucci (2010), higher education is not just important to individuals, but to societies as well. Access to higher education is integral to economic prosperity and concomitantly a well-functioning democracy. Additionally, access to higher education is, as emphasized by Rajan (2010) and others, very important to societies endeavoring to partially control levels of economic and social inequality. In the US in particular, there is also strong public interest in expanding access to higher education to lower income individuals and broader swaths of the social spectrum. This increased interest in expanding higher education is occurring while costs per unit or per student in the US are rising.

From a broader perspective, access to student financial aid is a form of access to finance—financing to invest in a larger present value of future earnings. The supply of credit for education and job training has been identified as critical to engendering workers to undertake job training and education toward higher careers (Popov, 2014). These results are consistent with the accumulation of student-loan debt influencing life-long career choices. The demand for access to higher education financing will also vary with the labor market, the value of higher education, the lack of financial literacy, lack of social trust, and the costs and burden of the required paperwork. Further, the demand for access to finance is also affected by factors that influence the need for borrowing. The need for borrowing will likely increase with an increased opportunities provided by higher education and changes in the distribution of income.

Previous literature suggests that access to finance is a major determinant of economic growth (Beck & Demirguc–Kunt, 2008; Beck, Levine, & Loayza, 2000; Claessens, 2006; Rajan & Zingales, 1998). Access to financing for higher education in order to receive necessary labor-market training is of course particularly important.

Zumeta (2004) notes that the correlation of economic growth and participation in higher education, while always strong, is much more pronounced today than at any time—particularly because the ongoing transition to knowledge economies. It is noteworthy therefore that excessive student debt is now being put forth by observers as a factor in the retarding of economic growth.

This speaks to unique considerations with regard to debt financing for tertiary financing. For instance, firms, when considering whether too much debt has been undertaken, can compare leverage ratios across their respective industry. Investment opportunities of private firms can potentially be financed with either external debt or external equity. Similarly with regard to nation states one can look to the government deficit or public debt to GDP in comparison with countries. Discretionary public spending and taxation can be likely be adjusted annually. With prospective students on the other hand, assessing how much debt is too much debt must include long-range predictions of what the labor market will be in the future as well as general assessment of the future earning power of individuals and groups. For potential students with no other way to pay for education than to borrow, the cost-benefit analysis of committing to a degree program is daunting and complex.

2.2. Bad loans? Anecdotal evidence

Anginer, de la Torre, and Alain (2014) remind us of the amplifying effect of bad loans in the context of education financing by highlighting the student loan model of Mankiw (1986). In this model, students’ honesty varies over the population; however, there is asymmetric information regarding what the lender knows about the characteristics of a particular student and what that particular student knows about himself or herself. Clearly, lenders have opportunities to lower default rates when they possess more information about potential borrowers (see for instance Miller, 2015). However information about whether respective student loan borrowers plan to repay is typically not available. Further, the student loan environment is far more general and so inherently different from say general consumer loans. Consequently, according to Mankiw (1986) student-loan lenders must thus raise the interest rate on all loans to cover the expected losses on the unpaid loans. But, raising the price of all loans the lender gives rise to an adverse-selection problem where the pool of borrowers shifts toward a higher percentage of borrowers who do not intend to repay, partially crowding out other borrowers who do intend to repay. Consider in the context of Mankiw’s problem, that coercive practices that induce bad loans will exacerbate this problem in two different ways: (1) some well-intentioned borrowers will subsequently develop resentment toward the university that encourage their indebtedness and so be less inclined to repay loans; and (2) more bad intentioned borrowers will be granted loans because those involved in coercing loans do not care—the government is at risk of non-repayment not the university.

As described by Schlanger (2015), students from Everest College, one of the for-profit schools that belong to the Corinthian Colleges Inc. brand, declared a debt strike in 2014. The CFPB alleged in a lawsuit last year that Corinthian lured students with “bogus” job-placement statistics and saddled them with predatory loans, even going so far as to “strong-arm” students into making loan payments while still in school. Most of those loans are owed to the U.S. Department of Education—so while one branch of the government has said these loans are predatory, another government agency is committed to collecting interest and repayment.

Schlanger (2015) illustrates the case of a student who stated that she incurred $20,000 in debt and a low-paying job after completing a one-year nursing program at Everest College. She asserted that she was heavily encouraged or coerced into debt:

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