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The Ripple Effects of Rising Student Debt

By PHYLLIS KORKKI MAY 24, 2014

What are the roads not taken because students must take out loans for college? A collection of studies shows that the burden of student debt may well cause people to make different decisions than they would otherwise — affecting not just individual lives but also the entire economy.

For one thing, it appears that people with student loans are less likely to start businesses of their own. A new study has found that areas with higher relative growth in student debt show lower growth in the formation of small businesses (in this case, firms with one to four employees).

The correlation makes sense. People normally have only a certain amount of "debt capacity," said Brent W. Ambrose, a professor of risk management at Pennsylvania State University and a co-author of a preliminary paper on the research along with Larry Cordell and Shuwei Ma of the Federal Reserve Bank of Philadelphia.

When students use up their debt capacity on student loans, they can't commit it elsewhere. "Given the importance of an entrepreneur's personal debt capacity in financing a start-up business, student loan debt, which cannot be discharged via bankruptcy, can have lasting effects later in life and may impact the ability of future small-business owners to raise capital," the study says.

Considering that 60 percent of jobs are created by small business, "if you shut down the ability to create new businesses, you're going to harm the economy," Professor Ambrose said.

Student loan debt also appears to be affecting homeownership trends. According to research by the Federal Reserve Bank of New York, fewer 30-year-olds in general have bought homes since the recession, but the decline has been steeper for people with a history of student loan debt and has continued even as the housing market has recovered.

Total student loans outstanding have risen to $1.1 trillion, compared with $300 billion just a decade ago, according to the Fed's study. The average total debt for student borrowers was around $30,000 in 2013. No wonder borrowers have been reluctant to start businesses or to buy homes.

Student loan debt may also affect career choices. Having a college loan appears to reduce the likelihood that people will choose a low-paying public-interest job, according to a 2011 study by Jesse Rothstein of the University of California, Berkeley, and Cecilia Elena Rouse of Princeton.

They arrived at their conclusion by studying a well-off university that began meeting students' financial needs through a combination of work-study money and grants, and dispensing with loans altogether. (The school insisted on anonymity as a condition for participating in the study.)

Before the new policy started in the early 2000s, students were more likely to choose well-paid professions like investment banking and consulting, Professor Rothstein said in an interview. After the policy took effect, more students chose jobs in areas like teaching and the nonprofit sector.

In many cases, the choices that student borrowers make are just common sense, based on the financial realities they face. Taken together, they seem to be having a substantive — many would say negative — effect on the economy.

Is that enough reason for schools or the government to step in with a solution? Not many schools are like Anon U (as the researchers above called it), which could afford to take loans off the table. If society wants to change the skewing effect of student loans, some tough decisions about allocating educational resources may well lie ahead.

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