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Personal Financial and Economic Issues for College Students

David M. Gordon[1*] & Shannon Brown[1]

[1] College of Business and Health Administration, University of Saint Francis, Joliet, IL, USA

[*] David M. Gordon, E-mail: dgordon@stfrancis.edu

Abstract

As students enter college, they typically encounter new responsibilities not experienced beforehand. The various financial decisions that college students encounter are one of the most important. These decisions often require students to educate themselves about banking, employment, budgeting, credit card usage, student loans, credit ratings, different types of debt, and insurance, among other things. This paper addresses those various issues. We offer both information and advice with regard to these issues. Consideration of how various financial events and choices effect the student's long term goals and opportunities is crucial to developing long-term financial well-being. The ability to make sound decisions regarding personal financial issues will help new graduates emerge from college upon solid financial footing.

Keywords

personal finance, insurance, credit

1. Introduction

Making the transition from high school student to college student can be demanding. As students enter college, they may encounter new responsibilities not experienced in high school. Perhaps the numerous financial decisions that college students encounter are one of the most significant. These decisions often require students to educate themselves about banking, employment, budgeting, credit card usage, student loans, credit ratings, different types of debt, and insurance, among other things. Unfortunately, students do not necessarily understand the importance and long-term implications of these financial choices, and high schools and parents do not always provide the tools and education needed to make the early adulthood years financially successful.

2. Financial and Economic Issues

2.1 Banking Decisions

Many college students will find themselves responsible for paying their own bills for perhaps the first time in their lives. This usually entails maintaining a checking account at a commercial bank or credit union. Before deciding which financial institution to choose, it is important that the student understands bank fees, minimum balance requirements, funds availability policies, overdraft penalties, and other policies governing their bank accounts.

Some financial institutions may offer interest on checking accounts or provide a cash bonus upon opening a new checking account. Other banks and credit unions may offer special terms to students, specifically regarding things like minimum balance requirements and free access to debit cards, online banking tools, ATMs, and the like. Regardless which incentive appeals to the student the most, it is crucial that he be aware of the terms so that he is not surprised by fees or other negative ramifications.

2.2 Employment Issues

Students may find themselves in a situation where they need or want to seek part time employment to help pay for the cost of school and/or personal items. In fact, the most recent US Census data indicates that 71% of undergraduate students work while they attend school. Employment can bring both benefits and drawbacks. One benefit is that the student earns some extra income and thus might be able to afford certain leisure activities, such as seeing a movie or dining out with friends. However, there is a substantial opportunity cost associated with working. The time a student spends on the job is time that he does not have available for studying or other school related activities. Associated drawbacks may include lower grades, missed opportunities for extracurricular or co-curricular participation, and missed class sessions when work schedules conflict with class times.

A student's main focus should be on schoolwork. Effort should be concentrated on doing well in classes, learning, participating in university/college events, and experiencing college life in general. As the student's time is kept busy doing all these things, he might not realize it, but he is already charting a course for his financial future.

As a result, students must be careful when deciding how many hours to devote to employment, if any, and which type of organization may offer the best flexibility to maximize the benefit of work without negatively impacting school. On-campus employment may offer a good compromise, as many campus-based positions are predicated on the understanding that student schedules will be flexible to prioritize course schedules, activities, exams, and the like.

2.3 Personal Budgeting

Whether or not the student works, he will have some sort of financial support to manage. This income might come from relatives, financial aid sources or, as mentioned above, individual work efforts. Students need to learn how to appropriately spend these funds through the budgeting process. Once the student understands his monthly sources and amount of income, he will need to produce a list of items that he *needs* to purchase (books, school supplies, food, gas) and a different list of things he *wants* to purchase (leisure activities, electronic items). There is an important difference between *needs* and *wants*. *Needs* must be managed first. If there is money left over after paying for all needs, the student may then choose to spend it on some of his *wants*, to save it for a larger purchase, or to build up an emergency fund.

2.4 Credit Card Usage

Credit card use is another major financial decision for a student. Credit cards are extremely useful in our economy. They provide a convenient method of paying for almost anything. They enable individuals to not have to worry about carrying around large sums of cash, and some cards even offer discounts on certain items, such as gas. However, credit cards generally come with hefty interest rates which, if not understood and handled properly, can quickly drive a student into debt.

The most financially responsible use of credit cards requires that the balance of each credit card be paid in full every month. If not, the student may end up with substantial interest that will eventually have to be paid. While paying the minimum balance each month appears attractive because of its lower financial impact to the student's monthly budget, it is a dangerous financial strategy with several potential negative outcomes. Carrying a balance may result in extreme interest payments that will take a long time to pay off. Students must be diligent to insure they do not get caught in this trap. If a student finds himself unable to pay off the full credit card balance each month, that usually means he is spending too much each month. Should he find himself in that position, he should review his budget and devise a strategy to stick to it. Most college students' expenses should not be that high. Creating a realistic budget and sticking to it will help students develop good spending habits and avoid incurring the substantial long-term debt that can accumulate through careless credit card usage.

2.5 Student Loan Issues

Another important financial decision students may consider is the use of student loan money. It is important to remember that this money is not free. Students must repay all of it, with interest, and interest rates and associated monthly payments will be substantial. Students sometimes fail to factor this payment amount into their budget when considering post-graduation employment. This may result in accepting a position that does not pay enough to cover the loan payments, putting a new graduate under immediate financial stress.

To avoid this, students should pay close attention to the terms and repayment plans when deciding to use student loan money. Generally a standard payment plan is determined upon loan approval. This agreement sets out the due dates and payment amounts the student (as the borrower) will eventually have to meet. Students must include this payment as they create a new budget to use upon graduation—one that matches earnings and expenses anticipated after college. Students should remember that they do not have to spend all of the student loan money received. If the student has funds left over, he can simply save that money and use it to pay off the student loan balance.

2.6 Credit and Credit Card Usage

As students advance towards graduation, a job and career choice become more important. Students might begin considering major purchases such as an automobile or perhaps even a house or condo. The feasibility of these purchases as well as many other life circumstances will be impacted by the student's credit rating.

Just what is a credit rating? A credit rating is an evaluation or assessment of the credit worthiness of a borrower. Credit ratings are assigned to individuals, governments and business firms. There are three main agencies that collect the data utilized by firms, such as banks, when assessing the credit worthiness of individuals: Equifax, Experian and TransUnion. These agencies determine "credit worthiness" based upon information regarding on time bill payment (including utility bills such as natural gas and cell phone service), currently available lines of credit (including the number of credit cards open), how much debt is owed to certain creditors, and whether an individual has recently filed for bankruptcy. Any entity considering extending credit or simply wanting to know the student's credit history will use these sources of data in their decisions. This list includes landlords, utility companies, financial institutions, and insurance companies. Potential employers may also ask to access these data sources, and a bad credit history may be used against a potential job applicant.

A numerical credit score is computed, in large part, from the information found in an individual's credit history. This score is just as important as scores on the many exams students will take during their college career. Lending institutions, such as banks and credit unions, seek information on what is referred to as the 5 C's of credit analysis. These are Character (are you financially responsible?), Capacity (how much debt do you currently have relative to your income?), Capital (any money saved already?), Conditions (are you going to be able to hold on to your job given the local economic conditions?), and Collateral (what assets do you presently possess?). A credit score, in essence, provides a lender with a condensed, numerical assessment of the 5 C's. Additional information may be requested on some of the 5 C's, but the credit score gives a reliable synopsis of your credit worthiness.

There are several credit scores available. For example, each of the three credit agencies mentioned above computes its own credit scores. The most popular credit score is called the FICO score. It is estimated that 90% of all lenders use the FICO score in making a credit extension decision. FICO scores range from 300-850. The median FICO score is around 710, but this varies slightly from year to year. This means that half of individuals have a score above 710 and half below 710. The higher the score, the better a person's credit worthiness.

How can a student's decisions today impact his credit score? The exact FICO formula is kept secret, but there are several factors involved. It is estimated that the biggest component (about 35%) of an individual's FICO score is based on his payment history. How a student pays his bills today (and remember this includes utility and cell phone bills) can have a major impact on his FICO score in the future. About 30% of the score is based on how much the individual already owes other creditors, therefore it is a good practice to try and pay off all credit card balances monthly whenever possible. Around 15% is based on length of credit history. Students should try to have at least one credit card, preferably two, while in college. Students should use these cards once every month or so for minor expenses and then pay off the balance, in full, at the end of every month. If the student does this successfully, he will build up his credit history. The types of credit shown (i.e., revolving debt, such as credit cards versus secured debt, such as a car loan) and any newly acquired credit will also influence his FICO score. As a result, students should not have too many credit cards or other open sources of debt.

The Fair and Accurate Credit Transactions Act (FACT Act) entitles each U.S. resident to a free copy of his/her credit report every 12 months. There is only one government sanctioned website to utilize when obtaining a free credit report, annualcreditreport.com. Other sites exist where individuals can obtain a credit report, but there are almost always strings attached, so make sure to use the one cited above. Be wary of credit report sites that require credit card information to obtain a report, as often this means the individual is agreeing to some sort of monthly monitoring fees.

2.7 Automobile, Health and Life Insurance

Upon graduating, if not before, students will have to make many important decisions regarding insurance. If the student plans to own a vehicle, he will definitely need auto insurance. In addition, everyone eventually needs life insurance, and students must begin thinking about health insurance as they age out of their parents' policy.

The typical auto insurance policy contains six types of coverage: liability, collision, comprehensive, Personal Injury Protection (PIP), medical payments and uninsured/underinsured motorist protection. There are also secondary types of coverage that individuals may consider such as emergency road service coverage, mechanical breakdown coverage, and rental car reimbursement insurance.

Liability coverage is perhaps the most important type of coverage. This consists of two components: bodily injury liability and property damage liability. If an individual is involved in an accident and it is deemed to be his fault, the liability protection will kick in. With appropriate levels of liability insurance, the insurance company will pay medical bills and property damage incurred. Most states, including Illinois, have a minimum liability coverage required to drive legally. It is highly recommended to have a significantly greater amount than the minimum requires.

PIP covers the medical expenses of the driver and any passengers if an individual is in an accident. Collision coverage takes care of damage to the policy holder's own vehicle in the case of an accident. Deductibles are associated with this type of insurance and are the part of a covered loss that the policy holder pays with his own funds. The higher the deductible amount, the lower the cost of insurance premiums. However, only after the deductible amount is met will any insurance payments be made. With that in mind, the student must balance the cost of the premiums against his ability to pay the deductible amount in the event of an accident.

Comprehensive insurance covers damage not related to an accident. This may include damage caused by hail, fire, or a collision with a deer, which is quite common in Illinois. Theft is also covered under the policy's comprehensive component, but there may be a deductible that applies to this coverage as well. Depending on the age and value of the covered vehicle, this type of coverage might not make financial sense.

Uninsured/underinsured vehicle coverage protects the student if he is involved in an accident and the other party does not have insurance or lacks the full coverage needed for repairs and medical payments. Even though everyone is legally obligated to carry a minimum amount of liability coverage, there are some people who do not.

While children may be covered under their parents' insurance plans up until age 26, this coverage generally expires once the child is no longer a student. With that in mind, as students approach graduation, care should be taken to evaluate health insurance choices offered with any job opportunity. Depending upon the size and type of company, the new graduate may have health insurance options including HMOs, PPOs, POS, HSAs, and FSAs, and the differences between them can be confusing. Yet, it is important that the employee understand the nuances of the different plans to make an informed decision.

HMOs, also called *Health Maintenance Organizations*, offer a network of providers who agree to offer services to members based upon the overall coordination of care provided by a primary care physician. Premiums are often highest with an HMO, but out of pocket expenses are generally lower. PPOs, or *Preferred Provider Organizations*, are similar to HMOs in that they offer a network of providers. However, with a PPO, the insured individual does have the choice to go outside of network if desired. Premiums are generally lower than an HMO; however, out of pocket expenses may be higher, especially if using an out of network provider.

POS plans, also known as *Point of Service* plans, blend the characteristics of HMOs and PPOs to provide a network of providers with a certain level of choice, but with lower premiums and higher out of pocket costs. An HSA, or *Health Savings Account*, provides a health plan with a high deductible but allows the insured to deposit tax-free money into an account to be used to pay for covered medical expenses. Finally, a FSA or *Flexible Spending Account* is a health-related benefit that may be offered by some employers. It allows employees to deposit pre-tax dollars into an account to be used in the covered calendar year to pay for out-of-pocket medical expenses.

In addition to auto and health insurance, students should consider investing in life insurance. While life insurance is something that no one wants to think about, it is an important component of overall financial responsibility. If the student is married and/or has children, he will definitely need it. However, given the current costs associated with funerals and burial plots, individuals should consider life insurance even if single with no dependents. Adequate life insurance spares loved ones the financial burden of handling those final expenses upon an individual's death.

There are two basic types of life insurance policies: whole life insurance and term insurance. Whole life policies include an investment component; term policies do not. The payments made to insurance companies are referred to as premiums, just as with auto insurance. With a whole life policy, part of the premium is applied towards the actual life insurance (pure insurance), and part goes towards investments that are made by the insurance company. Think of it as having part insurance and part savings account. As a result of the investment component, the policy builds up a tax deferred cash value that the policy holder can borrow against if he so desires. Term insurance, on the other hand, is pure insurance. It is purchased for a certain period of time, hence the name "term", and it has no cash value. Normally the term ranges from 10-30 years. Premiums typically do not change over the term of the policy, but the timeframe for policy initiation is important. Generally speaking, the older the policy holder is at the time of purchase, the higher the premiums.

There are pros and cons associated with each type of life insurance. Whole life insurance will typically be more expensive than term insurance given the investment component. In either case, the student will need to decide on the amount of coverage to carry. Higher coverage (benefits) means higher premiums. Many factors contribute to this decision including how many children the policy holder has (or plans to have), how much wealth he has already accumulated, what debt would need to be paid upon death, and the like.

In all cases, the nuances of various insurance policies are important. As a result, it is best to consult with a trained and licensed insurance professional who can assist in making insurance decisions best for each individual's unique life circumstances. Information on licensing and insurance in general can be found on various state government websites, such as the following one from our home state of Illinois: the Illinois Department of Insurance website (http://www.insurance.illinois.gov).

3. Conclusion

While many college students feel that they are young and life is just beginning, college marks an important milestone in each student's life. Understanding how various financial events and choices may ultimately effect the student's long term goals and opportunities is crucial to developing healthy and effective long-term financial well-being. Taking time to make sound decisions regarding banking, credit, insurance, and revolving debt will help new graduates emerge from college upon solid financial footing, laying the foundation to achieve those long term goals with minimal financial stress.

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