

## **Saving for college: historical and projected costs**

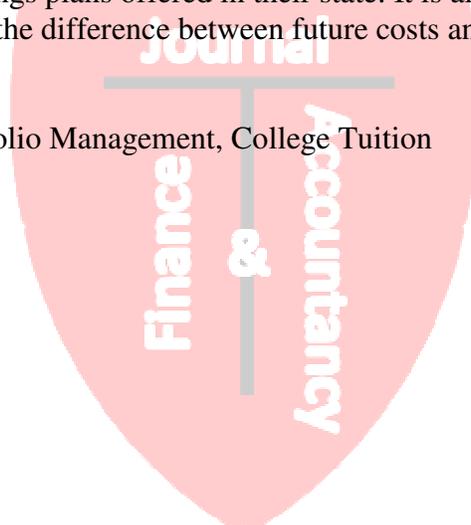
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### **ABSTRACT**

College costs continue to outpace inflation. Interest rates for savers are low, and equity returns continue to underperform. How can parents or guardians plan for these increased higher education costs in such a difficult financial environment? The outlook is a bit bleak, but investors can do a few things to help soften the blow. Namely, this article suggests that investors benefit from the tax-advantaged savings plans offered in their state. It is also suggested that investors be mentally prepared to borrow the difference between future costs and the savings they've set aside.

Keywords: Investment, Portfolio Management, College Tuition



## INTRODUCTION

On an inflation-adjusted (real) basis, the cost of attending a college or university continues to grow, and costs are predicted to continue rising. According to Sallie Mae, a college education for a child born in 2010 will cost an average of \$175,000 at a four-year public university and \$365,000 at a private college. Sallie Mae also predicts that the average family will have only saved \$48,000 for college by the time the student starts their higher education (Sallie Mae, 2010). With a more and more educated populous it is almost a necessity for a person to have a college degree in order to be valuable in the workplace. This paper examines the historical costs of education, projects those costs into the future, and lists and appraises the characteristics of the different tax preferred investment vehicles that exist for investors today. We conclude with a few comments on implications for the portfolio manager.

## LITERATURE REVIEW

The topic of saving for a child's college tuition has been the subject of numerous articles in academic journals, trade magazines, and newspapers. The themes of those articles range from just a simple synopsis of the currently available tax-advantaged investment vehicles for investors saving for higher education to specific portfolio strategies a financial professional could advise their clients to choose when preparing for future college costs. Details on the various investment vehicles are included in the next section.

Stolz (2010) discusses the popularity and growth of the age-based 529 plan including the positives and negatives. The paper goes into detail on how to mitigate the risks of an age-based 529 plan. The quantity of assets you have invested in equity at a given age of a child is crucial to your ability to manage risks. Managing your risk is made easier by becoming more conservative as you near the date the child will need the asset. Clark (2009) addresses the harsh reality that the assets in the 529 plan for your child could decrease and put you in a bad spot. The paper talks about the different mixes of assets you should have for the different ages of your child. If the 529 plan doesn't peak your interest the author suggests you look into either a pre-paid tuition plan or the independent 529 plan both of which have their drawbacks. The paper also states that the government has changed the amount of times you can change your portfolio from once a year to twice a year. The expense ratios and performances of different 529 plans are discussed in Kalwarski (2009). The performances are broken down in percentage of equity in the portfolio while the fees are broken down by their expense ratios. The paper also makes light of the fact that the assets in such accounts have fallen by 21% at the time the paper was written. Orr (2008) discusses the options a parent has if they want to back out of the 529 plan they invested in for their children's higher education expenses. The article also talks about what you can do if your fund is showing a zero or negative return. Ryst (2008) discusses the growing popularity of the 529 plans and the perceived increase in awareness the public has shown over recent years. The author provides a positive outlook on the future of the 529 plan because approximately half of the U.S. that could benefit from these plans has not even begun to save for future tuition costs. The growth is expected to take place in the future but not immediately. The article concludes with a list of the top ten state sponsored funds in order of assets. Sanders (2007) provides statistics showing the cost of a four-year private college for the 2006-2007 school year. The paper details the 529 savings plan including what the benefits and restrictions of the plan are,

where its assets can be applied, and also how it effects the student's eligibility for financial aid. The article then briefly discusses the pre-paid college tuition plan. Harrington (2006) specifically addresses the financial planner and a specific problem a client of theirs could have. The paper discusses what a retiree would do with their RMDs if they did not need them for living expenses and had a child in the family that they could help when it came to their costs of higher education. RMD stands for required minimum distribution and is minimum withdrawal the IRS requires a person to take from their IRA once a year starting at the age of 70.5 years. The author lists the number of benefits a 529 Plan can have for the estate of the retiree and how it would keep their money working instead of it becoming stagnant. Lim (2005) covers the basics of the UGMA, 529 plan, and Coverdell ESA. The bulk of the paper is devoted to when a client should withdrawal the money from each of the different types of tax advantaged accounts. The reason that withdrawing is such an important topic is that each type of account has different tax and financial aid implications. The end of the paper is a list of pros and cons of each type of account and their effects on both the financial aid eligibility of the student and the taxes involved with each account. Hogan & Kroeger (2005) attempt to determine a mix of investment options that provides the investor with an optimal return. The beginning of the paper explains the idea of financial aid and the concepts involved in coming up with a number for you. They realize that an option you may think to be the least expensive may not be the least expensive to you through the proper utilization of financial aid. The paper states that it is much more complicated for a family to find the best strategy if there is a chance they could be eligible for financial aid. Various strategies are listed at the end of the article; these are determined by what amount of aid, if any, would be available to the family. Lim (2004) discusses how a family should weigh the pros and cons of each individual account and find which option, or options in some cases, best suite your needs. The art of picking the right portfolio mix for your child become more difficult since the entire process is so unpredictable. The article also shows research showing that a 529 would give a much higher return than a strictly equity account earning the same rate of return. The increased number of accounts available allow for different mixes of assets that create more sophisticated portfolios yet allow for greater benefits to be realized. This paper also uses different scenarios to go over the benefits of 529 plans, the usage of UGMAs, and the drawbacks of prepaid plans. Caplin, Wang & Weisser (2004) give six different examples of how families in very different situations found the money to pay for college. UGMAs, 529 plans, grants, loans, and scholarships are addressed as different ways for a family to come up with the funds for the costs of higher education. Money (2004) states three broad income levels a family could possibly belong to and what the best strategy would be for them when it comes to funding a child's education as well as the goals each of the families should have for their given scenario. The pros and cons of a taxable account, Coverdell ESA, and state 529 savings plan are listed as well as a list of recommendations on how to go about undertaking the saving of money for college education. Asnes (2004) highlights a family that has a ten year old daughter who has dreams of attending Harvard University one day. The study lists the issues the family has and the advice they receive from *MONEY* magazine. The advice they receive is to start saving immediately through the use of their current accounts and to set a goal for the future that includes what types of accounts to use and also how much they want to raise. Lastly they are told to use their home equity to take out another mortgage so the husband could continue use his expertise to turn over homes in their neighborhood. Included at the end of the article is a table that shows the amount they must contribute to fund (based on the age of the child) a certain proportion of the costs and

also three commonly asked questions and their corresponding answers. Kiplinger's Personal Finance (2003) speaks on the rising costs of tuition at both public and private universities while also showing how the markets and the amount of aid (both from individually held accounts and from institutions) a student receives has decreased over the years. Opiela (2003) claims that it is an ever increasing trend for schools to deny acceptance to students because they are unable to afford the costs. The author states that it is no longer a good strategy to plan on financial aid but to save as much as possible. 529 plans are covered in length as well as pre-paid tuition, Coverdell ESAs, variable universal life policies, UTMA/UGMAs, and Roth IRAs. The article then discusses the impact that the investments will have on the amount of financial aid you may be eligible to receive, what types of aid you may qualify for, and what institutions may be able to offer you aid. Lastly the paper discusses strategies that could be pursued. The author stresses that you must be financially secure yourself before you start saving for your child or you will end up having to dip into their college savings anyways.

## **HISTORICAL COSTS OF HIGHER EDUCATION**

Tuition and fees for colleges and universities across the U.S. has consistently risen more per year than inflation over the same period of time. As our great country struggles to pull itself out of one of the worst recessions on record, the real cost of higher education still continues to rise. Over the last ten years alone, the average cost of tuition and fees in current dollars has more than doubled for four year public universities and colleges. Both four year private universities/colleges and two year colleges have increased over the same time period but not by as much as the four year institutions of higher learning (69%, 54% and 109% respectively). The same trend is also observed over a twenty year period. Over the past twenty years the average cost of tuition and fees has more risen by an astounding 324% for the four year public institutions. This rise in cost is also reflected at the public two year and private four years schools resulting in increases of 202% and 203% respectively. See Table 1 (Appendix) for details on tuition and fees over the last 21 years.

The percentage increase every year of the costs of higher education has historically been fairly consistent for the private four year institutions (at a much higher cost, of course) but has been more volatile in the public two and four year schools. The average percentage increase in the cost of tuition and fees for all 3 categories of schools is well over the increase in inflation over the same time period. The College Board also reports that the average annual percentage increase in the cost of tuition and fees for a four year private college and a 2 year public college from the years 1971-2009 was 7.3%. The average annual increase for four year public schools over the same time period was slightly higher at 8.2%. In 2008 the U.S. Census Bureau released data about the median incomes of families in 4 specific regions. This data when combined with the increase in cost of higher education data is able to show the true effect the rising costs have on a family. The Northeast region of the United States exhibits the highest cost for a college education but it also has the largest median family income at \$69,317. The Western region of the country comes in second place with a median family income of \$65,672. The Midwest and Southern regions of the United States come in third and last with median family incomes of \$61,976 and \$55,877. Over the past ten and twenty years the smallest increases in costs of higher education have come in the middle region of the U.S. which is a good thing since the Midwest has the second lowest median family income. This means that even though the costs of

continuing your education are rising they are still going to be tolerable in this region. Unfortunately, the American Southwest has seen the largest increase in costs and is also shown to be the region with the lowest median income. This proves to be a very bad trend for southerners who are trying to better themselves by going to school longer. For a breakdown of household income by various characteristics, see Table 2 (Appendix).

Of course, future college costs are uncertain, but there is no reason to assume that the real cost of college will decrease. Table 1 indicates that in order for a \$1.00 contribution to future education to buy \$1.00 worth of tuition and fees on a real basis twenty-one years from now, an investor must earn about 7.37% to send their child to a public four-year institution. That's the amount that the portfolio needs to earn in order for the investment to not lose purchasing power. Of course to gain ground on a real basis, the portfolio must gain even more than this amount. Return requirements for public two-year schools is slightly better at 5.67% and private four-year schools at 5.82% - although, on average, the cost of private college is more than three times that of a public equivalent.

## AVAILABLE INVESTMENT VEHICLES

When a parent, guardian, or family member makes the decision that they want to invest money for a child's higher education they can choose from any of three tax-preferred investment options. The Coverdell ESA, UGMA/UTMA, and 529 Plan all have differing styles in which they invest the money. The broad range of styles allows for most if not all investors a plan to fit their needs.

The Coverdell ESA (Education Savings Account) is the continued evolution of what used to be named an Education IRA. In 2002 the investment vehicle was re-named and also some of the attributes of the vehicle were changed - mostly for the better. The more important change to the attributes of the vehicle was the list of qualified expenses, in other words, what the money in the fund could be used for. The Coverdell ESA was not only created to cover the costs of higher education but also to cover the costs of K-12 schooling. This has proven useful to many parents who were unable to cover the costs of lower education but had others that were willing and able to give to the child. Also in 2002 when the Coverdell was re-made, the contribution limit was raised to a maximum of \$2,000 a year. That \$2,000 is a cumulative number that can come from any number of donors but is not allowed to surpass that number without a penalty imposed by the government. The ESA is available to receive funds until the child beneficiary turns 18 - at which time tax law prohibits anyone from funding it anymore. An important caveat of the account is that once a person contributes to it they no longer have any dominion over the funds; once the money is in the fund only the child can use it, even if they don't use it for educational purposes. Another important characteristic of the account is that all donations made to it are made in after-tax dollars. This is to ensure that there aren't two tax benefits being given by the government - just one. Since all donations are made after-tax, withdrawals from the account (by the child) are tax free. The one stipulation is that the withdrawal must be made to cover any one of the qualified higher education expenses. If the withdrawal is not made for the reason of covering an education expense then taxes will be imposed on it.

The UGMA (Uniform Gift to Minors Act) and UTMA (Uniform Transfer to Minors Act) are custodial accounts established so that a donor can transfer assets to a minor in the form of a trust. These prove to be very valuable as it is illegal for a minor to hold the ownership of a

company. The UGMA is the easiest way for a minor to own securities without having to go through an attorney. The terms of these trusts are set by state statutes as opposed to a trust document for which you would have to hire a lawyer. The UTMA is very similar to the UGMA in all ways except that it also allows a minor to own other types of assets both tangible and intangible. Without the UTMA a minor would be unable to own real estate or patents. This makes the UTMA a bit more flexible than the UGMA. In order to set up one of these trusts the donor must appoint a trustee. The trustee for an account of this type is usually a bank or a brokerage firm. The trustee is tasked with controlling the money in the best interest of the minor until the minor reaches the age of trust termination. The age of trust termination varies by state but typically is 18 for the UGMA and 21 for the UTMA. Once the donor donates the money to the trust they do so without the possibility of ever recovering it. Once the minor reaches the age at which they can receive the money they can do with it whatever they want without the threat of penalty. This type of trust is considered to be an asset of the student so it does have a negative impact on the amount of financial aid the student could otherwise be eligible for. To work around this, the trustee can turn the trust into a 529 Plan which allows it show up as an asset of the parents' if the student is listed as a dependant on their taxes. The tax implications for the UGMA and UTMA are very favorable for both the parents and the child. The UGMA specifically allows each parent to contribute up to \$13,000 to the fund every year with the insurance that they will not incur a tax penalty. Whatever the child receives he or she will have to pay taxes on but it will be at a discounted rate which is often called the "Kiddie Tax".

A 529 Plan (also known as a Qualified Tuition Plan) is sponsored by a state, state agency, or an educational institution. It is basically a state's way of allowing its residents to either save for or pre-pay college tuition. If you invest in a 529 Plan on behalf of a minor, the earnings of the plan are not taxable at the federal level and more often than not the state will waive its right to impose a tax on the earnings. Every one of the 50 states including the District of Columbia have at least one type of 529 plan available to its residents; even some universities both public and private have them available. There are two types of 529 plans: State Sponsored Pre-Paid Tuition and a College Savings Plan. The pre-paid tuition method allows the investor to purchase credit hours and sometimes even room and board at participating universities ahead of time in order to avoid the inflation of the price of credit hours. This method also is many times guaranteed by the state so you won't have to make any additional investment later on top of the initial one you made to cover the costs in full. One requirement for the pre-paid tuition plan is that you must be a resident of the state you are trying to set it up in. If your child is not a resident, then the investor must be a resident. A big positive of the 529 Plan is that now - thanks to recent legislation - you can change the mix of your assets twice instead of just once a year. The college savings plan does not allow you to lock in the cost of college like the pre-paid tuition plan does but it does allow you to create a portfolio to pay for a child's future qualified education expenses. The college savings plan can also be used to supplement the pre-paid tuition plan since there are some costs that are not covered in the pre-paid tuition plan. One drawback of the college savings plan is that it is not guaranteed by the state and therefore may not increase in value or could possibly decrease in value. Both plans have the benefit of tax free withdrawals if the funds are used for any of the qualified education expenses. Lastly the fund is treated as an asset of the donor which will have a negative effect on financial aid eligibility but not as large an impact as if the asset belonged to the minor. For example, in the state of Texas you are able to purchase credit hours in three ways. You can use the lump sum method which allows you to buy up to 600

credit hours at one time. You can use the installment plan which secures the price of the credit hours you are buying at a set point but allows you to pay over a selected time period either 5 or 10 years or the number of years it takes for the beneficiary of the account to graduate high school. Lastly you can use the pay as you go plan which does not lock in the current cost of tuition; cost of tuition is updated every year on September 1st. The Texas 529 Plan allows you to attend any two or four year college in the state of Texas or most private and public schools outside of the state. You are able to invest up to a maximum of \$12,000 per year and a total of \$60,000 over a period of five years in order to not incur a federal gift tax. Compared to the other two investment vehicles, the 529 Plan allows you to save a lot more with the limit being a maximum of \$320,000.

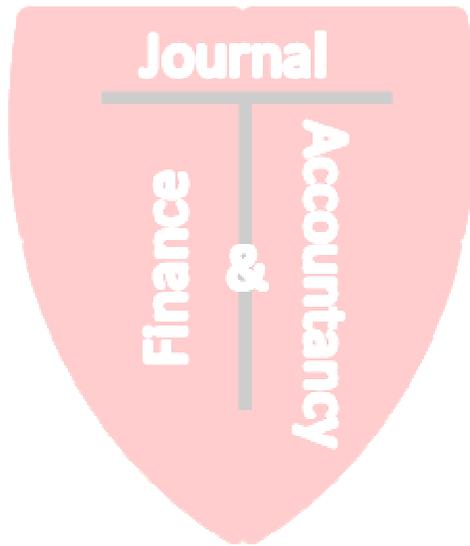
## **IMPLICATIONS FOR PORTFOLIO MANAGERS**

It is the obligation of a client to provide his or her money manager with a statement of investment policy. In the case of saving for college, investment policy is usually established by a parent or grandparent, and the level of financial knowledge a parent has varies greatly. He or she has most likely *not* laid out the appropriate guidelines for the investment manager. More often, they have not developed a statement of investment policy at all because most individual investors simply do not understand the process. As such, investment managers must walk a thin line between educating their clients on how to provide them with appropriate guidelines through a formal statement and remaining an independent fiduciary. Typically, the only thing investors know is that education costs are increasing rapidly, and they would like to put some money aside to help their child receive a higher education without the burden of a lot of debt upon graduation.

There are four classic portfolio objectives established in a typical statement of investment policy: (1) stability of principal, (2) income, (3) growth of income, and (4) capital appreciation. If a client is putting money away for the specific purpose of paying for college in the future, he or she will typically have a primary objective of capital appreciation. Given the discussion in the previous sections, capital appreciation is absolutely necessary to provide for the dramatic increases in tuition and fees. Parents also, however, are very skittish about the potential of losing the money they have set aside for the kids' education. They don't want to have to look at their child fifteen years later and say, "We put \$50,000 aside in a capital appreciation portfolio only to have lost 50% of it. The most we can pay for your schooling is \$25,000." Prior discussion about eroding value of investments highlights this problem. So, implicitly, parents will frequently have a secondary investment objective of stability of principal. Investors need equity appreciation to keep up with the real increases in educational costs, but they also do not want to lose the funds they set aside for later use. This presents a very difficult problem for the portfolio manager! Although this combination of primary and secondary objectives is not totally incompatible, a tailored portfolio must be developed to meet the needs of the client.

Regardless of the portfolio objectives established by the client, the discussion herein should make two things very clear for portfolio managers: (1) most folks do not invest enough funds to completely pay for college expenses, and (2) the return on the funds that folks do set aside is not sufficient to make up the difference. The most important implication for portfolio managers is that they should insure that their client is mentally prepared to borrow funds. Even folks who believe that they are doing the right thing by setting aside funds should understand that paying for college is going to involve some kind of debt - student loans (Stafford, etc.), bank

loans, credit cards, etc. While this is costly, portfolio managers should remind clients of the tax benefits afforded them through the various plans available in the saving process.



## CONCLUSION

Unfortunately for the children of our nation, the drastic increase in the cost of higher education appears to be a trend that will continue. The prescription for parents and/or guardians who are trying to plan - financially - for these increased costs involves several steps. First, benefit from the tax-advantaged savings plans offered in your state. Second, put aside as much money as is feasible. Third, be prepared to borrow the difference between your savings and the actual costs when the bills finally appear. Portfolio managers should be prepared to guide their clients through this process and educate them along the way.

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Table 1. Tuition and Fees by Institution Type versus Inflation (1988-2010)

Year	Public Two-Year		Public Four-Year		Private Four-Year		CPI-U
	Cost	% Inc	Cost	% Inc	Cost	% Inc	
88-89	\$ 799		\$ 1,578		\$ 8,004		4.4%
89-90	841	5.26%	1,696	7.48%	8,663	8.23%	4.6%
90-91	906	7.73%	1,908	12.50%	9,340	7.81%	6.1%
91-92	1,171	29.25%	2,107	10.43%	9,812	5.05%	3.1%
92-93	1,116	-4.70%	2,334	10.77%	10,448	6.48%	2.9%
93-94	1,245	11.56%	2,535	8.61%	11,007	5.35%	2.7%
94-95	1,310	5.22%	2,705	6.71%	11,719	6.47%	2.7%
95-96	1,330	1.53%	2,811	3.92%	12,216	4.24%	2.5%
96-97	1,465	10.15%	2,975	5.83%	12,994	6.37%	3.3%
97-98	1,567	6.96%	3,111	4.57%	13,785	6.09%	1.7%
98-99	1,554	-0.83%	3,247	4.37%	14,709	6.70%	1.6%
99-00	1,649	6.11%	3,362	3.54%	15,518	5.50%	2.7%
00-01	1,642	-0.42%	3,508	4.34%	16,072	3.57%	3.4%
01-02	1,608	-2.07%	3,766	7.35%	17,377	8.12%	1.6%
02-03	1,674	4.10%	4,098	8.82%	18,060	3.93%	2.4%
03-04	1,909	14.04%	4,645	13.35%	18,950	4.93%	1.9%
04-05	2,079	8.91%	5,126	10.36%	20,045	5.78%	3.3%
05-06	2,182	4.95%	5,492	7.14%	20,980	4.66%	3.4%
06-07	2,266	3.85%	5,804	5.68%	22,308	6.33%	2.5%
07-08	2,294	1.24%	6,191	6.67%	23,745	6.44%	4.1%
08-09	2,372	3.40%	6,591	6.46%	25,177	6.03%	0.1%
09-10	2,544	7.25%	7,020	6.51%	26,273	4.35%	2.7%
10-Year	\$ 895	54.28%	\$ 3,658	108.80%	\$ 10,755	69.31%	
20-Year	\$ 1,703	202.50%	\$ 5,324	313.92%	\$ 17,610	203.28%	
Geometric Mean		5.67%		7.37%		5.82%	2.82%
Arithmetic Mean		5.88%		7.40%		5.83%	2.82%

Sources: The College Board, *Annual Survey of Colleges*; and U.S. Bureau of Labor Statistics

Table 2. Median Family Income by Selected Characteristics, 2008

Region	
Northeast	69,317
Midwest	61,976
South	55,877
West	65,672
Race	
Asian	73,578
White, non-Hispanic	70,070
Hispanic	40,466
Black	39,879
Age	
15-24	31,964
25-34	52,845
35-44	68,304
45-54	75,651
55-64	72,444
65 and over	44,188
Education	
< High School	30,534
High School	49,414
Some College	60,355
Associate	69,232
Bachelor's or More	101,099

Source: U.S. Census Bureau, *Current Population Survey*, 2009 Annual Social and Economic Supplement, FINC-01.