The Option Value of Human Capital

Donghoon Lee∗ Sang Yoon (Tim) Lee† Yongseok Shin‡

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Abstract

We study college enrollment and completion decisions in the presence of risk in individuals’ returns to college. College education comes with two inherent options: (i) college students may quit after obtaining additional information on their post-graduation wages (i.e., college dropout) and (ii) college graduates may take jobs that do not require a college degree (i.e., underemployment), effectively protecting themselves from the left tail of the returns-to-college distribution. We show that the interaction between these option-like features and the rising wage risk—especially among college graduates—is key to understanding the muted response of college enrollment and completion rates to the substantial increase in college premium in the United States since 1980.

Keywords: College enrollment, college dropout, college premium, underemployment

∗Federal Reserve Bank of New York
†University of Mannheim
‡Washington University in St. Louis and Federal Reserve Bank of St. Louis