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There are alternatives to high student debt

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Letters from Academia

In the last couple of years, there has been a lot of talk about making higher education affordable. With the cumulative student debt in the United States at more than a trillion dollars, it is not surprising that this issue has become part of the political discussion, especially during the current political campaign. And proposals abound. Bernie Sanders' free college for all, or President Obama's free community college nation-wide, or the push by some of the members of the Board of Overseers of Harvard University to provide free tuition to their students, are just some examples.

Although some may see these proposals as too idealistic, possible only with wide (and unrealistic) bipartisan support, or confined only to a few private institutions with very wealthy endowments, there are other alternatives available but that are rarely discussed with the general public. One of those alternatives is the "human capital contract." This unclear wording needs some explanation.

The term "human capital" was coined by Adam Smith in his 1776 "The Wealth of Nations" book, where he referred to knowledge and skills of workers as a form of "human capital." This idea of using this concept as a private mechanism to finance higher education was articulated by such Nobel Prize-winning economists as Gary Becker, Milton Friedman, and Robert Merton as an "equity-like" financial instrument.

This idea works as follows: People who need financial assistance in order to pursue a higher education go to a capital provider (a financial institution, whether for profit or not), and request that that institution "invests" in them. Once they graduate and start working, then they make a series of periodic dividend payments back to the provider based on their earnings. Unlike a typical bank loan, these payments are variable in amount to be paid since they are proportional with the capital receiver's income after graduation. It may never total the initial investment amount made by the capital provider in the case of those who never make too much money in their careers. In other words, how much and when the payment is paid back depends upon the receiver's ability to pay.

The instrument is in the form of a contract by which an individual obtains resources to finance his or her education by committing a percentage of his or her income for a predefined period of time after graduation. Thus, the nature of the contract protects the student against periods in which earnings are small or nonexistent. It also relieves the student from high payments if his/her career path is less profitable than intended.

The students would not be the only ones benefitting from this approach. Comparisons between the price of human capital contracts and education costs would improve the efficiency of the higher education market and will serve to counter the baseless assertions that some have been making lately that a higher education is not a good investment for students and their families. At the end of the day human capital contracts will benefit students through better financing conditions.

There are other advantages for this financial system. For example, it requires minimal – if any – resources from government. Anytime that you can isolate innovative proposals like this from politics, the better the chances for its success. Yet, for them to be applicable we need human capital contracts to be recognized in every state or at the federal level, otherwise we will be at the mercy of courts where their enforceability can only be determined when one of these contracts is legally challenged. Thus, in addition to creating new mechanisms for financing higher education, we should motivate policymakers to ensure that such contracts can succeed.

Although some have criticized this proposal as a form of indenture of life-long financial obligation by an individual, it is, by far, much better that long-term, fixed interest obligations contracted with banks. After all, students are free to make their own career choices and employment decisions at all times. Further, students from lower-income households will be able to pursue a higher education. Unlike the free higher education for all proposed by some, it will distinguish between those who can afford and cannot afford a higher education, making the system much more equitable.

Among the institutions that have already tried this system is Yale University, which between 1971 and 1978 attempted to replace traditional student loans with human capital contracts under its "Tuition Postponement Option" program. Under this program, for each $1,000 borrowed from the university, students pledged 0.04 percent of their future earnings for 35 years, or until the whole class paid off its aggregate debt, whichever came first. The program was eventually abandoned when it was realized that about 20 percent of the students failed to make payments. Also, they did not anticipate that students who opted into such programs were generally those who expected to pursue low-income careers and were least likely to be able to repay their loans. Further, in order to pay less in income taxes, many graduates focused on voluntary (non-financially compensated) work or part-time jobs.

Other educational institutions, such as the University of Colorado School of Medicine and The University of California system are also currently evaluating the Human Capital Contracts system, learning from the Yale experience. Since 2013 several state legislatures have approved similar plans that could allow students to attend state colleges without paying tuition or taking out traditional loans. What is clear is that Human Capital Contracts offer a better and more evenhanded alternative to student loans. But in order to make them work their regulatory framework needs to be advanced to protect both investors and recipients in case of generalized financial crisis.

Although there are many uncertainties with this idea, it is one worthwhile to further explore as an additional alternative.

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