The New York Times

Let Your Rich Uncle Pay for College

By: Nancy Folbre, an economics professor at the University of Massachusetts, Amherst.

July 15, 2013

If you borrow money to go to college, you should be able to pay it back from your higher post-graduation income. Rather than a loan, you could offer an equity investment — a share of your future earnings.

Most education in modern economies is financed either through debt or equity. The big issue is who's making the investment and on what terms.

The Oregon state legislature dramatized this issue with its decision to develop a pilot program to eliminate tuition and fees for students in the state university system who agree to pay about 3 percent of their income for the next 20 years to help finance the education of future students.

The "pay it forward" scheme, proposed by students at Portland State University and building on a model developed by the Economic Opportunity Institute, has re-energized debate over ways of alleviating the burden of student debt. As it happens, the Oregon legislature voted to pursue it on the same day that federal student loan interest rates doubled to 6.8 percent from 3.4 percent.

Would you be better off paying 3 percent of your income for 20 years, or 6.8 percent on a specific loan amount? The answer depends both on your projected income and the amount you need to borrow. In general, students from low- and middle-income families would fare better than students from rich families under the Oregon plan, because they are more dependent on loans to pay for college.

The Oregon plan would improve educational opportunity and reduce income inequality, raising more payback money from high earners than low earners. Yet it is less egalitarian than the largely free public university system that once existed in the United States and currently survives in countries including Denmark, Sweden and Norway.

Subsidized public higher education is also based on a "pay it forward" principle. College graduates are expected to earn more and, as a result, pay more in income and other taxes over their lifetime. The reciprocity is just less direct. Instead of helping pay only for future college students, graduates help reimburse all past taxpayers — including the older generation — for the taxes they invested in previous years.

At the other end of the spectrum, "human-capital contracts" can be fully privatized, with students offering investors a share of their prospective earnings in return for an upfront investment. This model, originally suggested by Milton Friedman, developed in some detail by Miguel Palacios of the Cato Institute and advocated by Luigi Zingales in a commentary in The New York Times, was put into practice by a student-loan company called My Rich Uncle about 10 years ago.

Both socialized and individualized human-capital contracts help solve an important problem, increasing productive investments and contributing to economic growth. Yet neither type of contract is foolproof.

Critics of public investment in higher education often contend that it is inefficient, because it subsidizes students who goof off along with those who indulge in the development of skills with little market payoff — such as theater arts. Public subsidies can also have the effect of reducing pressure on providers of higher education to cut costs or to encourage students to develop job-specific skills.

Advocates of public investment in higher education assert that there are compensating benefits. They often couch their arguments in terms of political rights to educational access and enhanced equality of opportunity. These political rights have economic consequences. Students develop general skills in college that don't necessarily pay off in higher wages but may nonetheless generate tangible benefits for themselves and others. College graduates may become better informed citizens, more successful parents and more creative members of society.

Some students who may not seem like a good bet either for private investors or public taxpayers at age 18 can be transformed by their college experience.

It's pretty hard to assign a specific value to their human capital, however you define it.
The lifetime payoff to a college degree depends on many factors other than individual effort or choice of major, including global supply and demand for educated workers, and a business cycle that economists don't fully understand.

On the Marginal Revolution Web site, Tyler Cowen registers his skepticism with the Oregon model, suggesting it would suffer from adverse selection: "At the margin I would expect this to attract people who don't have a vivid image of the distant future."

But if everyone's vision of the distant future is blurred, public investment in human capital becomes especially important. The large number of students taking part in the payback scheme pools risk and provides more effective insurance against unanticipated declines in earnings. This insurance helps encourage human capital investment. As the Economic Opportunity Institute report points out, "pay it forward" systems in Australia and Britain have contributed to increased college enrollments there.

Do you doubt the significance of risks to private investments in human capital? Consider that the lending enterprise known as My Rich Uncle declared bankruptcy in 2009, exercising a legal privilege of getting out from under its obligations that most student debtors are denied. Students who don't have a family member or other angel investor willing to finance their college education might consider moving to Oregon. Or, they could start organizing to win more generous support from their Uncle Sam.