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Popping the Tuition Bubble

By Kevin Carey and Frederick M. Hess

What if, instead of borrowing, students could arrange for investors to pay their college bills in exchange for a fixed percentage of their future income? In this article, Kevin Carey and AEI's Frederick M. Hess answer this provocative question. The time has come, they say, to think more creatively about financing college, especially because Congress seems more inclined to pour more money into loans and grants.

In August 2006, an incoming freshman at California State University, Fullerton, had a bright idea about paying for higher education. Instead of doing what more and more students are doing these days—borrowing—he decided to go on eBay and auction off a share of the most valuable thing he owned: his future. "Hi there," he wrote. "My name is Ron Steen. I am selling 2% of my future earnings for a chance to go to college."

A few months later, U.S. congressional leaders hammered out the 2007 budget. Like Steen, they were concerned about skyrocketing tuition: between 1989 and 2005, college costs had increased at double the rate of inflation. Their solution was to pour more money into grants and loans while hoping that colleges would keep tuition growth under control. Later in 2007, President George W. Bush signed legislation providing an additional $1 billion for Pell Grants and slashing student loan interest rates by up to 50 percent.

While the policymakers congratulated themselves on their generosity, eBay was pulling down Steen's offer before the auction could begin. But in the long run, Steen's strategy may turn out to be the wiser course. With steadily increasing prices and a bevy of financial scandals, the higher education market bears more than a passing resemblance to the respective markets that preceded the dot-com crash of 2001 and the subprime mortgage meltdown of 2007. Except that this time, the problem is too little market speculation, as opposed to too much.

Because most student loans are guaranteed by the federal government, there is little risk involved for colleges or lenders. But for students who borrow too much, drop out before graduation, or earn less than they anticipated, the result can be financial hardship, ruined credit, and default. Today, one in ten student borrowers default on their loans within a decade of leaving school.

What if, instead of borrowing, students could arrange for investors to pay their college bills in exchange for a fixed percentage of their future income, as Steen suggested two years ago? Students would shift the financial risk to lenders who could pool that risk and then package their students' bonds into bundled securities that could be sold on the open market. Regulators and investors would set bond parameters—the period of repayment and percentage of earnings—based on certain key criteria. For example: a student with a 2300 SAT score, straight As, and an aptitude for computer programming could expect favorable terms, just as he or she would be more likely to receive a scholarship or merit aid today.

Of course, lenders would also be interested in which particular college the student attends.

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Almost immediately, investors seeking to maximize their return would uncouple the college component from the student portion, separating the value added by a given institution from the attributes of its entering students.

In gauging college value, graduation rates would be a critical variable because the job market does not pay much to dropouts. Unfortunately, many colleges have terrible graduation outcomes, particularly for disadvantaged students. Investors would also be interested in long-term results: what are postgraduation job placement rates, in what fields, and at what salaries?

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At first, investors might be tempted to price bonds based on measures like the annual *U.S. News & World Report* rankings, sticking with "blue chip" universities such as Harvard, Stanford, and Duke. But it is probable that these brand-name institutions are already "fully priced," given that their reputations draw on factors such as historical legacies and famed research labs—things that have a modest impact on how likely their already accomplished students are to graduate and succeed professionally.

Instead, the smart money would go hunting for bigger returns at less expensive colleges that add great value. After all, other things equal, an investor fares much better by lending a student $48,000 over four years and collecting 4 percent of his or her future earnings than by lending that student $180,000 and collecting the same 4 percent.

Investors who found the hidden gems early would be rewarded, creating incentives for private firms to seek out those institutions and alerting potential students to their value. As money sought out students at Great Value University, costs to new students would decline (since investors would ask for a smaller percentage of future earnings), effectively lowering prices. Meanwhile, investors would steer away from overvalued institutions, making them more expensive, raising red flags, prompting hard questions from investors, and lending real urgency to institutional efforts to cut costs and boost student success.

Some might look to the current woes of the real estate market and worry about the perils of speculation. But there are crucial differences. Though thoughtless or greedy investors would get hurt by a student bond bubble, graduates would be unharmed because—unlike in the housing market—they would already have fully consumed their education. Meanwhile, prospective students who saw college A becoming more expensive could opt for college B. As for enrolled students, they could be insulated through various hold-harmless mechanisms (such as locking in repayment rates for six years when they first enroll). Finally, watching funds for potential students dry up might be exactly the dose of tough medicine that underperforming colleges need, as it would force them to confront soaring prices and dismal educational outcomes.

"Decoupling" would present a terrific opportunity for Washington and the states to ensure that the tens of billions they spend on grants and loans are targeted to those students who truly need it, while ensuring that these dollars flow through a marketplace characterized by real incentives to control costs and deliver results. Public dollars could target those students unable to find investors, and the government could subsidize funding for those graduates who went on to work in low-paid, socially valuable professions like teaching. And when problems arose or foolish decisions were made, the risks of higher education would be shouldered predominantly by colleges and investors, rather than by students and taxpayers.

Poor Ron Steen. His crazy idea may not have been so crazy after all.