

ISSUE BRIEF

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Income Share Agreements Have the Potential to Revolutionize College Financing

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In 1955, economist Milton Friedman wrote his famous essay, “The Role of Government in Education.” This foundational essay offered great insights into the proper function of America’s education system. Among them, Friedman’s suggestion that college students could finance their education with the help of lenders who bear the up-front cost of a student’s tuition. These lenders would then be repaid by taking a percentage of the student’s future earnings. Friedman suggests that both lenders and students could benefit from this arrangement:

In this way, a lender would get back more than his initial investment from relatively successful individuals, which would compensate for the failure to recoup his original investment from the unsuccessful.¹

Friedman states that there are no direct legal barriers to the creation of such contracts, but that the “presumably high cost of administering them” might discourage lenders from participating. Today, there are still no legal barriers to the creation of what have become known as income share agreements (ISAs). While the idea has existed since at least the 1950s, schools are only now beginning to truly experiment with the concept.

Today, students and taxpayers are increasingly frustrated with the current state of higher education financing. Americans are \$1.5 trillion in debt from student loans, and taxpayers are on the hook for students who do not earn sufficient wages to pay back their loans, as well as for students who benefit from government loan forgiveness policies. Meanwhile, universities continue to receive federal student aid, even if many of their students are not earning sufficient wages to pay off their loans.

When structured well to be financially solvent and beneficial to both parties, income share agreements offer an innovative way to provide access to education at no up-front cost to students—and without undue government intervention and taxpayer burden.

Income Share Agreements in Practice

Yale University experimented with an ISA option from 1971 to 1978. Through Yale’s Tuition Postponement plan, students were able to borrow funds from the school; however, these funds only barely covered the increases in tuition that Yale introduced at the same time. The program was set up so that students were a part of a cohort, and payments went into a pool to pay off the entire cohort’s debt. Students were required to repay 0.4 percent of their earnings per every \$1,000 borrowed no matter what income bracket they entered after college.²

Ultimately, Yale’s cohort-based ISA program was considered a failure. High earners were required to keep paying off their cohort’s debt for 35 years, or until the entire balance of the cohort’s principal and interest was paid off. Low earners and students who exited the workforce were able to receive subsidiza-

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tion from their high-earning classmates. In response to dissatisfaction from alumni who were paying into this program for decades after graduation, far surpassing their original loan, Yale discontinued collection of payments from participants in 2001.³

However, private companies have developed a more efficient way to structure ISAs. For example, Lumni, founded in 2002, became a pioneer in such agreements. Lumni currently operates in the United States, Mexico, Colombia, Peru, and Chile. Students who do not have the funds to finance their college education can enter into a contract with the company. Lumni manages a fund created by private investors and pays a school for a student's education in exchange for a certain fixed percentage of the student's wages for 10 years after graduation. Co-founder Miguel Palacios has argued that "human capital contracts are a superior way of funding higher education because they reduce risk for students, improve information and decision making regarding the value of education, and increase competition in the higher education market."⁴

The Purdue Model

Purdue University is leading the way on reviving ISAs. Instituted by Mitch Daniels, who became president of Purdue in 2013, the "Back a Boiler" program allows participating students to enter into a unique agreement with the school. Purdue covers the cost of the student's education up front. In return, the student agrees to pay back a portion of his future earnings.

This requires Purdue to be extraordinarily transparent about a student's expected salary after graduation. Purdue's website explains,

For example, you're a rising senior Economics major with an ISA of \$10,000. Based on your

anticipated salary in that field upon graduation, you pay 8% of your \$47,000 salary for 100 months. At the end of the contract, you would have paid back \$15,673 and fulfilled the terms of your ISA.⁵

Colleges very rarely publish their median starting salaries on their websites. In order to offer this agreement, Purdue administrators had to do the math and provide transparent information to students. This agreement requires that Purdue has confidence in the product it is offering. This kind of transparency and quality assurance is severely lacking in today's higher education system.

What Congress Can Do

There is nothing preventing more schools from offering students a new way to finance their college education. However, federal lending programs guarantee a virtually blank check to colleges as long as they are accredited. This open-ended access to federal subsidies discourages colleges from changing their funding stream in search of options that do not expose American taxpayers. In order to encourage free-market options to flourish and provide better options for students, policymakers must significantly reduce student aid expenditures in Title IV of the Higher Education Act.

Additionally, Representative Luke Messer (R-IN) has introduced the Investing in Student Achievement (ISA) Act of 2017 to create a streamlined legal process for private entities to form partnerships with schools. Since ISAs have never been widely practiced, the ISA Act creates policies outlining how such agreements are to be interpreted by the IRS. Specifically, "ISA funders would only owe taxes on earnings from ISAs in excess of the amount they originally funded. Students would not owe taxes on the amount of funding they receive initially through an ISA."⁶

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1. Milton Friedman, "The Role of Government in Education," 1955.
 2. William M. Bulkeley, "Some Yale Alumni Find That They Owe Their Alma Mater a Real Debt," *The Wall Street Journal*, February 23, 1999, <https://www.wsj.com/articles/SB919722795412915000> (accessed October 15, 2018).
 3. Bret Ladine, "'70s Debt Program Finally Ending," *Yale Daily News*, March 27, 2001, <https://yaledailynews.com/blog/2001/03/27/70s-debt-program-finally-ending/> (accessed October 15, 2018).
 4. Diane M. Ring and Shu-Yi Oei, "Human Equity? Regulating the New Income Share Agreements," *Vanderbilt Law Review*, Vol. 68, No. 3 (2015), p. 694, <https://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1992&context=lsfp> (accessed October 15, 2018).
 5. Purdue Research Foundation, "Back A Boiler™ Program Overview," <https://www.purdue.edu/backaboiler/overview/index.html> (accessed October 15, 2018).
 6. Preston Cooper, "A New Way to Pay for College Gets a Boost in Congress," *Forbes*, July 6, 2017, <https://www.forbes.com/sites/prestoncooper/2017/07/06/a-new-way-to-pay-for-college-gets-a-boost-in-congress/#7dd1dafc203b> (accessed October 15, 2018).
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The ISA Act is a good first step toward paving the way for innovative higher education payment options. However, while the federal student loan program continues to offer subsidized loans to students with virtually no requirements, market-based programs will have trouble competing.

Private Financing Is the Way Forward

Despite Milton Friedman’s insightful suggestion in the 1950s to invest privately in human capital, modern-day income share agreements are scarce. However, growing frustration with college quality and mounting student loan debt has catalyzed a conversation among many Americans who are looking for colleges and universities to put some “skin in the game.” With reduced federal subsidies for higher education and forward-thinking schools willing to participate, privately funded ISAs may be the future of college financing.

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