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An Economic Perspective of Income Share Agreements

Income Share Agreements (ISAs) have received attention as an alternative to student loans for financing higher education expenses. Purdue University's "Back a Boiler" program has perhaps received the most attention recently, although the University of Utah and a number of smaller schools—Colorado Mountain College, Messiah College, and Clarkson University—as well as several independent private companies offer such programs.

This In Focus provides an overview of ISAs along with a comparison to student loans. Because no federal ISA program currently exists and the majority of student loan debt is associated with the federal student loan program, the overview and comparison primarily focuses on private ISAs and federal student loans but generalizes some parts of the discussion to highlight particular features of each financing approach. To conclude, potential policy issues and questions Congress may consider are presented.

Overview of ISAs

An ISA is a contract between a student and an investor in which the student receives college funding in exchange for pledging a fraction of the student's future income to the investor for a specified period of time. As an example, a student may receive \$20,000 for college in exchange for repaying 5% of the student's income for 10 years upon graduation. Under these terms, the student could end up paying more or less than the student received depending on his or her future earnings. If the student were to earn \$50,000 each year for the next 10 years, the student would repay a total of \$25,000. Alternatively, if the student were to earn \$35,000 per year after graduating, the student would repay a total of \$17,500. In either case, the student's repayment burden is proportional to his or her income.

From an economic perspective, ISAs are an equity-like source of financing because students are effectively "selling" a claim to their future earnings in exchange for funding. The comparison that is occasionally made is that of a company selling stock to finance business investment. Equity can be well-suited to finance risky ventures such as startups or higher education because no collateral is required, repayment is dependent on the outcome of the investment, and the equity investors bear the majority of the downside risk for the right to share in a potentially significant return. College can be considered a risky endeavor even though the *average* return to graduating is high because for any *individual* student there is the potential of not completing school, earning a lower-than-expected income, or being unemployed at some point.

Whether ISAs are perceived by students as an attractive source of financing depends on the uncertainty they face about their future income. For those who face a great deal

of uncertainty, ISAs provide protection against the risk of a low-paying job and unemployment since the amount a student repays depends on the income they earn and not on the amount of initial funding they received. In contrast, conventional debt financing generally requires full repayment with interest regardless of income, which places a borrower at risk of becoming overly debt-burdened if their income is too low. Income contingent loans, which are discussed below, address this feature of conventional debt.

Alternatively, students who are confident about their future prospects may determine that repaying a fraction of their income is too costly of a commitment. In this case, student loans may be a more attractive option because the amount the student would have to repay is limited to what they borrowed plus interest and fees. The student would be, however, at risk of becoming overly debt-burdened should their income be lower than they expected.

The ISA model relies on risk-based underwriting to set specific terms for each student or type of student. This means that students who are perceived to be lower risk and have higher earning potential are offered more favorable terms. Investors may consider a range of student characteristics during the underwriting process, such as a student's major, degree track, year in school, academic record, and alternative sources of financing, among others. Investors may also consider the quality and type of school the student plans to attend—for example, traditional four-year college, two-year technical college, or online college.

The individualized financing terms may influence students' educational and career decisions. For example, a student with a passion for art history may decide the financing terms are better if she minors in the subject and majors in engineering, which has higher income prospects on average. As another example, the financing terms may sway a student to pursue a two-year technical degree over a traditional four-year degree given their desired career path.

This feature of ISAs is popular among its advocates, because in their view students are being provided transparent market signals about the cost and return to students' education and career decisions. On the other hand, it can be argued that such signals could reduce the number of students who may enter careers that generate social benefits beyond the private returns, or that some students may not be granted financing to pursue a particular college path.

Comparison to Student Loans

Student loans are debt, while ISAs are a form of equity financing; the distinction can be critical. The structure of a typical loan limits a lender's return to the loan amount and

interest. However, there is a chance that the lender will not recoup its initial investment since some borrowers will default. As a result, private student loan lenders would generally demand a high interest rate to compensate for the risk of not being fully repaid, and this rate would likely be such that some students no longer find it financially beneficial to attend college. This failure of private credit markets to fund investments in college with an otherwise positive return is one of the principal rationales for government intervention; by bearing some of the risk, the federal government can offer loans with below-market interest rates, albeit at a cost, and fund educational investment with a net positive social return.

ISAs and federal student loans differ in how funding amounts are determined. ISAs use risk-based underwriting to determine financing amounts, while the federal student loan program does not. Although the borrowing limits in the federal student loan program vary depending on student dependency status, and whether the student is seeking an undergraduate or graduate degree, within those categories all students are eligible to borrow the same amount. Therefore, unlike with ISAs, the loan amount a student qualifies for does not depend on the potential risk and return of each student's investment. There are at least two potential consequences of this.

First, in some cases students may be borrowing amounts that cannot be financially justified by the students' future earning potential. Second, there is no market mechanism influencing the education and career decisions of students; a student who majors in a field with low projected earnings is eligible for the same financing terms as a student who majors in a field with high projected earnings. This can lead to a misallocation of scarce resources (labor and capital) throughout the economy, currently and in the future.

Federal student loans and ISAs are also different under the routinely assigned standard repayment plan in the federal student loan program. Under the standard plan, students are required to repay their full loan amount in fixed payments with interest over 10 years, similar to a fixed-rate mortgage. Although a student borrower is never at risk of repaying more than the principal and interest that accrues, they are at risk of becoming overly debt-burdened if their income is too low. In comparison, students may repay more or less than the amount of funding they received under an ISA, but their repayment burden is always a constant percentage of their income.

The federal student loan program, however, offers several repayment plans that depend on a student's income after graduation, and that forgive the remaining unpaid loan balance after a predetermined number of payments have been made. These plans offer students protection against low income similar to ISAs. Unlike ISAs, however, income-based loan repayment plans never result in a borrower paying back more than the principal and interest. Thus, the government bears the cost when the full loan amount is not repaid under income-based repayment plans, whereas it is private investors who bear this cost with ISAs. This cost to the government may be economically justified if there are market failures in the funding of higher

education or if there are social returns beyond those realized by students who pursue certain careers.

Potential Policy Issues and Questions

Widespread use of ISAs would represent a significant change to how students finance college. The change would raise a number of policy issues and questions Congress may choose to address.

Federal Student Loan Program. ISAs and federal student loans need not be mutually exclusive financing options. What changes, if any, would there be to the federal student loan program to respond to postsecondary education financing through ISAs?

Federal ISA Program. ISAs are often heralded as a market-based solution to higher education financing. Would the federal government initiate its own ISA program? How would the government determine the financing terms of the ISAs it offers? Would federally sponsored ISAs compete with privately offered ones, or would they be geared toward serving students with limited access to the ISA market?

Regulation of ISA Industry. What aspects of the ISA industry would be regulated and by whom? What regulations would be needed to protect students from unfair ISA practices? Would regulations prohibit the use of certain student characteristics in the underwriting process? How would this affect the financing terms for participants? What limits would be placed on the securitization process, which can promote liquidity and risk sharing, but that can also reduce the incentives to scrutinize ISA applicants?

Indentured Servitude. It has been argued by some that ISAs result in indentured servitude. Others argue that as long as investors are not permitted to influence or pressure a student in any way once funds are provided, then students are free to make choices in their own interest just as with student loans. How would policymakers ensure students are free from investor influence?

Psychological Barriers. There may be psychological barriers to adoption of ISAs. Milton Friedman framed this issue as there being a potential reluctance to think of human capital investment as akin to physical capital investment. College, however, is currently primarily financed with debt, which is also a major source of financing for investment in physical capital by business and the government.

Legal Issues. What recourse would investors have to enforce ISAs? What if a student changes major or careers? How would ISAs be treated in bankruptcy proceedings? Would ISAs be subject to securities laws in the same ways that stocks, bonds, and other financial instruments are?

Tax Treatment. The income generated by an ISA would be taxable to investors. As currently written, the tax code would not provide a deduction for ISA payments similar to the interest deduction for some student loan payments. It also appears that canceled ISAs would not be taxable as is the case with some canceled student loan debt. Congress could address the tax treatment of ISAs.

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