



Innovating Out of Student Debt

A “College Finance Innovation Fund” could accelerate ideas to lower debt and make schools more accountable for their graduates’ success

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INTRODUCTION

For many students, the burden of student debt lingers years after leaving college, dragging down their finances and household security. New federal data find that, 12 years after enrollment, students with debt still owed, on average, two-thirds of what they had borrowed – and as many as 27 percent had defaulted.¹

Colleges, however, face no equivalent long-term financial stake in their students' education: their obligations are done once the tuition is paid and the last exam is graded. Except perhaps for the pressure to put on a good show for *U.S. News & World Report's* college rankings, schools have little incentive to ensure their students can land good jobs with decent pay – let alone graduate. Students bear the full risk of their investment and cope with the fallout if things don't pan out as planned.

This lopsided burden of risk is one reason a dramatic expansion in financial aid – i.e., “free college” – can't solve the crisis in college affordability. Schools would see no need to rein in their costs or to share the risks of investing in education with their students. In fact, the opposite. If the government is willing to pick up more of the tab for students, there's no reason that tab wouldn't simply grow – with potentially no reduction in student debt.

What's needed instead is to break the paradigm of how higher education is financed. That means

new mechanisms that both lower the cost of college for students and hold schools more accountable for how their graduates fare in the job market.

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Fortunately, a small but growing number of schools – aided in some instances by a burgeoning crop of social entrepreneurs – is working to achieve exactly that. Some institutions, for example, are adopting so-called “income share agreements” (ISAs), which commit students to pay a fixed percentage of their income for a certain number of years after graduation in lieu of loans. Among other benefits, proponents argue, this approach gives schools incentive to ensure students can land jobs when they graduate (and therefore have earnings to share). Other schools are exploring the idea of operating as “work colleges,” where every student is also an employee of the college, learning valuable job skills as well as earning tuition. At Paul Quinn College in Dallas, Texas, for example – a small private liberal arts school that is the newest of nine work colleges in the country – students graduate with a debt burden that’s only about a third of the national average.²

Innovative models such as these deserve encouragement, evaluation and promotion. Yet there’s no dedicated governmental funding aimed at accelerating innovation in higher education finance or supporting experiments that could make student debt obsolete. ISAs, for instance, are relatively new, and work colleges – despite a 100-year history³ – are still little known. Colleges and universities must make upfront investments to explore the feasibility

of adopting these models and to implement them, and neither approach has benefited from significant federal investment in evaluating their effectiveness, which could also increase interest and lead to improvements. And there may yet be other approaches that haven’t gotten off the ground for lack of funding for a pilot.

To remedy these deficits, Congress should create a “College Finance Innovation Fund,” modeled after the federal government’s existing Social Innovation Fund, which has seeded hundreds of innovative initiatives since its creation in 2010. The purpose of the College Finance Innovation Fund would be to kick start new ideas that upend traditional models of financing higher education and help ensure more students leave school armed with marketable skills. An added benefit would be to help reverse the growing burden on the federal government to subsidize the spiraling cost of higher education – including absorbing the expense of defaults.

This proposed Fund would provide competitive seed funding to schools, state and local governments, or private sector players seeking to develop and test innovations; support the rigorous evaluation of new models and collect data on their effectiveness; and help provide the startup funds necessary to schools that want to adopt the most promising approaches. Grantees would also be required to match their awards on at least a two-to-one basis, thereby amplifying and encouraging the emerging interest in debt alternatives among philanthropies and the private sector.

The size of the Fund could also be relatively modest – say, \$10 million a year for five years – while still sparking a desperately needed “race to the top” in reforming higher education finance.

In 2012, close to three-quarters of college students graduated with debt, and with an average burden that was 25 percent higher than in 2008.⁴ But, while soaring college costs are putting growing strain on all American families, the yoke of student debt is falling most heavily on the lowest-income students least equipped to bear this burden. The result is the exacerbation of growing class divisions in education and achievement and constriction of the mobility and dynamism we've long cherished in our economy.

Lower-income students are not only more likely to borrow for school but to borrow more than their wealthier counterparts.⁵ They are also far more likely to carry their debts long after leaving school and to default.⁶ Worse, many of these students likely do not even have a degree to show for their efforts or their indebtedness. One long-term study by the National Center for Education Statistics, which followed a large group of 10th-graders beginning in 2002, found that just 14 percent of students in the bottom income quartile had earned a bachelor's degree eight years after high school, compared to 60 percent of students in the top 25 percent.⁷

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While a four-year degree isn't the only path to middle-class security,⁸ college should not be out of reach to all but an elite few. Nor should a student's aspirations for college be tainted by the specter of years, if not decades, of financial insecurity. Investing in innovation could reverse these unsustainable trends and create a system of higher education finance that is both affordable and delivers better results.

The Plan:

- Establish a five-year, \$50 million College Finance Innovation Fund to encourage the development of alternatives to student debt.
- Use Fund proceeds to provide seed capital for exploring and testing new ideas; to collect data and to conduct evaluations; and to defray implementation costs for schools adopting the most promising approaches.

TWO INNOVATIONS THAT COULD HELP MAKE STUDENT DEBT OBSOLETE

Among the promising ideas a College Finance Innovation Fund could help support and promote are income share agreements (ISAs) and "work colleges." Though very different in their approach, both models are laudable for two reasons: (1) they offer innovative alternatives to taking on traditional student debt and (2) they require colleges to take a far greater stake in their graduates' ability to find jobs and economic success.

Income Share Agreements

At Indiana's Purdue University, nearly 500 students have now signed contracts promising to pay a fixed percentage of their income after graduation for a set number of years, in exchange for up-front aid with their tuition.⁹ So far, the university's "Back a Boiler" program, financed largely from its endowment, has awarded \$5.9 million to students in ISA funds.¹⁰

The terms of these awards vary by major, reflecting in part the expected "market value" of a graduate's degree. According to the school's ISA calculator, a computer science major graduating in 2020, for example, could expect an income share commitment of 7.31% over 88 months, based on an expected starting salary of \$68,000 and an ISA award of \$26,000.¹¹ An

English major, on the other hand, might see an income share commitment of 7.45% over 116 months, based on expected starting pay of \$30,000 and an ISA award of \$20,000.

Though the purpose of the ISAs is for students to pay back the funds they've been awarded – and many will pay back more than they got – there is no “principal” or “interest” per se. This means no fixed dollar commitment to haunt graduates long after leaving school. Moreover, says Purdue, its typical ISA should cost less than a traditional loan, assuming a student earns the salary anticipated for his or her field.

Champions of ISAs argue this approach offers students three major advantages over traditional loans. First, students get protection from income volatility. While traditional loans demand fixed monthly payments regardless of a student's financial circumstances, the amount of an ISA payment varies with a student's earnings, thereby providing flexibility if a graduate hits a rough patch. At Purdue, for example, students earning less than \$20,000 pay nothing for as long as their income falls below that level, and the university cannot collect more than 2.5 times what it originally awarded.¹² Moreover, students who do not graduate also owe nothing.

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Second, some students might be more likely to get financial aid. Because ISAs are determined on the basis of *future* income, a student's credit

history and family finances don't affect her eligibility for aid, as it could for traditional private loans and federal PLUS loans.¹³ Advocates say this is one way ISAs could help expand college access for lower-income students.¹⁴

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Most significantly, ISAs demand that colleges take an interest in their students' post-graduate success, which means students no longer bear the entirety of the risk of their investment. Because ISA commitments don't kick in unless and until a student has a job, colleges need to get their graduates employed if they want to recoup their investments. For this reason, social entrepreneurs investing in ISAs argue these instruments are the tip of the spear in prompting broader higher education reform. Among these advocates is Tonio DeSorrento, the CEO of technology company Vemo Education, which helps schools design and administer ISAs. As DeSorrento told *The Atlantic*, “College isn't just about getting jobs, but for many people, at least some of the value is the job, so linking some of what's paid to colleges to employment outcomes can help colleges better serve students.”¹⁵

While the ISA model isn't perfect – its focus on post-graduate earnings potentially distorts students' choices away from both liberal arts and public service fields, such as social work – it could still appeal to many students and deserves wider availability.

ESTABLISHING A MARKET FOR ISAS

As interest in ISAs grows, an important step in legitimizing this model is to create a fair and transparent marketplace for students and ISA providers. Setting reasonable regulations around income share agreements would also help develop a robust market for this product and ensure “bad actors” don’t cripple the market for ISAs before it takes root.

Two bipartisan proposals – the Investing in Student Success Act of 2017 (S.268) and the ISA Act of 2017 (H.R.3145) – establish a promising regulatory framework toward that end. Both bills establish standardized terms for ISAs, including the percentage of income and duration of payment required of the graduate, terms for potential prepayment, and an explicit definition of income, which can help ensure the creation of a uniform financial product with legal certainty for both students and institutions.

Both bills also establish some protections for graduates regarding their ISA payments. For instance, the bills establish a “maximum commitment factor” of 2.25, which is calculated by multiplying the percentage

of income required in the ISA contract by the number of years left in the agreement. This prohibits ISA providers from requiring both a very high percentage of income and long duration of payments from graduates. The bills also dictate that graduates will not be required to make any payments during periods of time when their incomes fall below a certain level (\$15,000 adjusted for inflation annually in the Senate bill; 150 percent of the poverty line for a single person in the House bill). The bills also establish an overall maximum commitment level for students who might have multiple ISAs (e.g. for undergrad and graduate school) and include explicit protections to guard against discrimination in the administration of ISAs.

For students eager for alternatives to traditional student loans, ISAs offer one way to help many young people supplement or replace their existing funding for school. Smart regulation can help ensure ISAs live up to their potential.

By Olivia Blom

Work Colleges

A second promising model is the federal “work college” program, which was authorized by Congress in 1992¹⁶ but still has a relatively tiny footprint and budget (about \$8.4 million in fiscal 2017¹⁷). As of 2018, there were nine federally recognized work colleges in the United States – the most famous of which might be Berea College in Kentucky, founded in 1855 as the first interracial college in the South.¹⁸

While related to the federal work-study program, the federal work-college program puts the concept of work-study on steroids. To qualify for federal funds, institutions must provide a “comprehensive work-learning-service” program¹⁹ in which students must work at least five hours a week (or at least 80 hours per term) and every student must participate. Unlike colleges that offer regular work-study

gigs for students who need tuition help, work colleges make work and service integral to their curriculum.

At Berea College, for example, where more than 70 percent of the student body hails from surrounding Appalachia and 96 percent of students are eligible for Pell grants,²⁰ students work 10-15 hours a week at one of more than 100 on-campus and off-campus job opportunities. Under Berea's "Labor Program," students literally help run the school, working in everything from food service to grounds keeping, and are reviewed on their performance just like in post-graduation real life.²¹ In exchange, and with help from the college's endowment, students attend tuition-free.

Unlike colleges that offer regular work-study gigs for students who need tuition help, work colleges make work and service integral to their curriculum.

At Paul Quinn College, the nation's first urban work college, students have the option to apply for paid internships at Dallas-area employers in addition to jobs on campus. All students must work between 300 and 400 hours per year but also earn \$5,000 in tuition assistance, plus a cash stipend of between \$1,000 and \$1,500.²² The purpose of the program, says the school's website, is "to provide students with meaningful work opportunities that allow them to better serve the Paul Quinn community while also developing the necessary skills, habits, and experiences to be competitive in the 21st-century job market."²³ All students are guaranteed a job, which means they leave school with work experience already on their resumes.

"Work gives students self-worth," said Robin Taffler, Executive Director of the Work College Consortium. "It becomes a critical part of their education and gives them opportunities they wouldn't have had before. Students learn how to show up. They learn how to work in teams, be responsible and take charge."

The result, said Taffler, is that students leave school with both the academic and "soft" skills they need to succeed in the job market. According to one 2014 study by the National Bureau of Economic Research, students with relatively low SAT scores who participated in the work-study program were about 6.8 percentage points more likely to earn a degree than other low-SAT students and 4.3 percentage points more likely to be employed six years after leaving school.²⁴

WHAT A COLLEGE FINANCE INNOVATION FUND COULD DO

Income share agreements and the work college model are both intriguing alternatives to traditional higher education finance. Yet few students have access to these mechanisms. Research on their large-scale viability is also non-existent, and financial barriers stymie schools from adopting or experimenting with these or other ideas.

More colleges are starting to offer ISAs – for example, New York State's Clarkson University and Lackawanna College in Scranton, Pennsylvania – yet they are still far from mainstream. While tech company Vemo reported that it helped arrange about \$23 million in ISAs in 2017,²⁵ that figure is dwarfed by the roughly \$106.5 billion in loans taken out by students and their parents during the 2016-2017 school year.²⁶ Likewise, the combined enrollment of the nation's work colleges is about 5,000

per year²⁷ – a minuscule fraction of the nearly 21 million students enrolled in post-secondary institutions in the fall of 2017.²⁸

While it's possible that alternatives to traditional financing could develop and spread organically, the student debt crisis is accelerating at a pace much faster than that of innovation.

This is where a College Finance Innovation Fund could step in.

By dedicating a pot of federal money for exploring alternatives to student debt, many more students could gain access more quickly to new mechanisms that could make college both more affordable and more relevant to their post-employment prospects. For example, such a Fund could:

Provide seed money for feasibility studies and pilot projects – including for ideas that may fail.

By serving as a “venture fund” for bold new ideas, the Fund could help mitigate the risk for schools, state and local governments, social entrepreneurs and others who want to experiment with new approaches but lack the funding to research an idea or try a pilot. Fund monies could also help schools experiment with ISAs or the work college model in order to speed their adoption and test their effectiveness on a broader scale. Moreover, the Fund could complement other federal efforts, such as the Department of Education’s Experimental Sites Initiative, aimed at improving students’ career and academic outcomes, particularly for low-income students.²⁹

Fund data collection and evaluation of experimental approaches.

At the moment, for example, there is no centralized effort to examine the performance

of ISAs compared to traditional loans, and there have been no rigorous evaluations of the work college model. Nor is there, as of yet, a “clearinghouse” for research and academic studies exploring new models of finance. Creating a repository of this knowledge, however, could also accelerate the adoption of promising innovations while leading to important improvements and sparking new areas for research.

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Bring promising approaches to scale by providing startup funds for schools adopting the most promising approaches.

The Fund could help schools overcome financial barriers that hamper their ability to adopt new approaches. For instance, said Robin Taffler of the Work College Consortium, schools interested in becoming work colleges must make significant investments in that conversion, including retraining their staff to become supervisors of student workers and buying recordkeeping software to track students’ work hours. Grants could help defray some of these expenses, thereby encouraging more schools – especially those on tighter budgets – to consider embracing different approaches to help their students.

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HOW A COLLEGE FINANCE INNOVATION FUND COULD BE STRUCTURED

A potential College Finance Innovation Fund could be modeled after the federal government's existing Social Innovation Fund (SIF), currently administered by the Corporation for National and Community Service.³⁰ Established in 2010, the Social Innovation Fund has so far awarded \$177 million in grant funds on a competitive basis to community-based nonprofits piloting innovative models for social change. Grantees have included organizations tackling such issues as homelessness, prisoner re-entry and youth development. Programs are rigorously evaluated, and funds must be matched at least dollar-for-dollar, which has resulted in \$423 million in additional state and local and private sector funding.

Though it would be administered by the Department of Education, a College Finance Innovation Fund could borrow many of these features, including a competitive grant application process, a required two-to-one match and strict evaluation requirements. In addition, the Fund would create a clearinghouse of best practices and publicly report employment, income and other outcomes for students participating in various pilot programs.

The Fund could also operate on a smaller scale than the SIF, given that many schools will only need grants in the tens or hundreds of thousands of dollars for feasibility studies or startup costs. Funding as low as \$10 million a year for five years could be a sufficient starting point for the Fund. As far as "pay-fors," possible

sources include earmarking a portion of the endowment tax on large university endowments included in the recently passed tax bill or limiting the amount of contributions affluent families can contribute to college 529 accounts, which disproportionately benefit wealthy families. Ultimately, the growth of the Fund could potentially be supported through savings from reductions in federal student aid programs that might result from the broader take-up of new models of college financing.

A NEW RACE TO THE TOP FOR COLLEGE AFFORDABILITY

Innovations such as income share agreements and the work college model show that grants and traditional loans need not be the only ways to pay for college, and that financing higher education need not be a one-way transfer of funds from student to college with no reciprocal obligation for outcomes.

ISAs and work colleges are not necessarily silver bullets, however, for the problem of college affordability, and students deserve an array of competing choices that can maximize their success after graduation and minimize their debts. Rather than a top-down approach to the problem of debt, Congress should support the efforts of social entrepreneurs, state and local governments and forward-thinking schools to innovate and experiment. The result could be a better and cheaper way to offer "college for all" for those who aspire to it.

Research for this brief was provided by Olivia Blom.

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