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Equity Financing for Human Capital

by Miguel Palacios

Funding higher education remains one of the greatest public-policy challenges throughout the world. On one hand, everyone acknowledges the importance of education; on the other hand, the intangible nature of education makes it difficult to finance through traditional market mechanisms such as loans. One solution to the funding crisis is to create opportunities for private equity investments in higher education through the use of a "human capital contract," a financial instrument by which, in exchange for financial support, a student agrees to pay a percentage of his or her income for a specified period of time. Like a venture capitalist who acquires a share in a company's profits by financing its development, an investor in a human capital contract temporarily acquires a share in an individual's income.

Milton Friedman introduced the idea of such a financing scheme in 1945. He reasoned that loans are not suitable for risky investments, such as education, because interest rates must be prohibitively high to offset the risk involved. Private financing of education would be feasible, Friedman argued, if investors could participate in a student's financial success in the same way that they participate in a company's financial success by acquiring an equity stake in it.

Friedman's idea led eventually to the development of income-contingent loans such as those offered by Yale University in the 1970s and, since 1989, by the Australian government's Higher Education Contribution Scheme. Such loans have indeed been used successfully in some parts of the world, but they do not solve the problem of attracting private capital and thus do not represent a long-term funding solution. Somewhere along the way, the idea of equity financing—the central part of Friedman's argument—was lost.

In light of advances in financial markets, such as the rise of investment funds and the introduction of asset securitization, equity financing for education is now a realistic alternative. These advances create the possibility of pooling risk in ways that Friedman and others did not foresee. And modern technology lowers the costs of managing funds that invest in students.

In addition to attracting private capital, human capital contracts would generate information on the expected earnings derived from different universities and fields of study, creating pressure for universities to price their programs in proportion to their graduates' earnings. Human capital contracts also give rise to another innovation: the creation of options based on the value of those contracts; that is, options that have human capital as their underlying asset. Such "human capital options" could be designed to create hedges against variations in earnings.

Equity financing for human capital faces some hurdles. First are ethical concerns: Is a human capital contract just another name for indentured servitude? No. If investors cannot influence a student's decisions, human capital contracts are no more oppressive than taxes. Second are legal issues, such as ensuring that investors can enforce the contract and that they receive the same protection they do when they provide money for student loans. In developing countries, the biggest concern for investors is accurately determining an individual's income.

Resolving these issues will help clear the way for a private-market solution to a public-policy problem. The consequences of increasing the amount of private capital devoted to higher education will be enormous for students in all countries but particularly for those in developing countries, whose economic growth depends on an educated citizenry.

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