See also my longer paper: A Fairness and Incentives Analysis of H.R.1330

U.S. House Representative Karen Bass recently introduced H.R. 1330, the “Student Loan Fairness Act,” as an “equitable system” to “alleviate the financial burden of student loan debt on college graduates and support them as they begin their careers and lives.” Students would pay 10% of their income toward their loan for 10 years, after which the loan balance would be forgiven. Though unstated how, per Rep. Bass’s web site the bill “promotes financial responsibility in higher education and incentivizes students to be mindful of educational costs and for colleges and universities to control tuition increases” (emphasis original;) I assume this to mean that the maximum loan amount forgiven is $45,520.

In this regard I find insightful Vernon Smith’s structural analysis of student loans. In “Asymmetric Information and Equilibrium without Process” (*Rationality in Economics*,) he addressed the “problem of excess consumption of services, induced by third party payment systems” (96.) That is, educational institution A defines what student B should buy from A, and third party C pays for it with subsidized tuition and/or low interest loans.

Smith’s conclusion is stark: with A harboring “an inherent conflict of interest,” it is an “incentive nightmare … There is no equilibrium in this A-B-C statement of the problem” (97.) The lack of equilibrium is important in that B has little or no incentive not to take the loans. In Smith’s terms, “incentive compatibility problems that fail to align prices with individual costs and benefits” is evidence of a market failure (97.) Consequently, while well-meaning, and in opposition to its stated goals, by capping student loan repayments H.R. 1330 only incentivizes consumption, which will drive up tuition and increase both the amount students must pay and federal debt spending.

One might object that federal subsidization is required to keep higher education affordable for the poor. While I am sympathetic to the dilemmas U.S. students face, and the poor in particular, ultimately it is only by managing costs that education can be made consistently affordable for all people. If my analysis is correct in the light of Smith’s analysis, managing costs requires not massive federal cash infusions that only further distort the education market, but by rethinking the incentives, institutions, and finance of higher education.

Rep. Bass’s page: http://bass.house.gov/bill/student-loan-fairness-act
Bill text: http://beta.congress.gov/bill/113th-congress/house-bill/1330/text

* *This is adapted from a series of one page papers I wrote for an independent study in micro- and macroeconomics; the material included the excellent text* The Economic Way of Thinking *by Heyne, Boettke, and Prychitko, as well as several texts I brought in from communitarian, market anarchy, and experimental economic perspectives.*

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