Oregon Student Loans Proposal Will Create Adverse Selection and Moral Hazard

[Updated July 12, 2013 with comment from Megan McArdle's blog.]

The New York Times reported on a proposal making its way through the Oregon legislature. In essence, students would be allowed to attend college at a price of zero. In exchange they would promise to pay a small percentage of their income for several decades. As described near the end of the Times story, the best estimate is three percent of income for 20 years. Presumably, the student must make reasonable progress toward completing a bachelor's degree. According to the article, "The bill instructs the state's Higher Education Coordinating Commission to design a pilot program, which would then require the Legislature's approval. For now, only the broadest outlines are clear."

Economists love proposals like this because they promise a lunch that, if not free, at least has a considerably lower price. The promise is rarely realized. It's easy to predict that the Oregon student loans proposal will create adverse selection and moral hazard Permit me to digress for a few minutes on the subject of asymmetric information.

Asymmetric Information, Adverse Selection, and Moral Hazard

"*Asymmetric information* exists if one of the parties to a transaction has information relevant to the transaction that the other party does not have."[1]

The classic example, originally published by Nobel Prize winner George Akerlof,[2] is the market for "lemons." Consider Chris, who is trying to sell a car that they have owned for a few years. As the owner of the car, Chris knows quite a bit about its condition. Assume there are two types of cars in the market: cherries and lemons. Cherries are well-maintained and have few problems. Lemons are, well, the opposite. Prospective buyers do not know whether a given car is a cherry or a lemon. Akerlof shows that, under certain conditions, a market will simply cease to exist. Subsequent research has focused on ways of overcoming asymmetric information. Offering a warranty or money-back guarantee is one technique. Another is to use a service like . A third is to have an independent mechanic give the car an examination.

Asymmetric information can create "adverse selection, a situation in which asymmetric information results in high-quality goods or high-quality consumers being squeezed out

of transactions because they cannot demonstrate the quality of the products they are offering for sale.”[3] Adverse selection is common in many insurance markets, as those who buy insurance policies know much more about their behavior than the insurance companies. But even if the high-quality products are still in the market, there is another potential problem: ” Moral hazard arises when one party to a contract changes behavior in response to that contract and thus passes on the costs of that behavior change to the other party.”[4]

The best example of moral hazard that I’ve found is in the life insurance market. Most life insurance policies have a “suicide exclusion” clause. In other words, if you buy a life insurance policy, then kill yourself, the policy will not pay off. This is probably the most extreme form of adverse selection and moral hazard.

But What About Student Loans?

Following Prof. Akerlof’s lead, assume there are two types of students. One type (S) majors in art, English composition, history, and ethnic studies. The other (H) majors in mathematics, hard science, engineering, or even economics. While type S individuals may not know it, their major will, on average, result in lower lifetime income than those in group H. Type S individuals will happily accept Oregon’s offer since three percent of their income over 20 years is a good deal. Type H individuals, however, are likely to think that three percent of their income is a high price to pay. They will seek alternative methods of financing their education, paying the standard tuition and fees. (This proposal could, in fact, revive the private student loan market – but without government intervention.)

Result: Oregon will collect far less than they are predicting. The percentage of income will rise and the duration of the loan will also increase – to 25 years, then 30 years. And, just as Prof. Akerlof predicted decades ago, the scheme will eventually collapse.

Postscript: Oregon’s Proposal and the “Informal Sector”

One interesting side-effect of this proposal is the incentive to understate income. My guess is that the “income” from which the three percent is to be extracted is some variant of IRS Form 1040 income. By definition, income earned in the *informal sector* is outside the tax code. It’s easy to predict that those who opt for the three percent of 20 years’ income route will discover there are options in the informal sector that will not be exposed to the three percent rule.

Give folks an incentive and they will respond. That’s a rule even older than the laws of demand and supply.

Addendum from Comments on Megan McArdle's Blog

bronxcobra

July 9, 2013 @ 9:03 pm

Tony,

In a sense you need to think of these students being entrepreneurs. Do they want to fund their business by taking on debt, or do they want to offer an equity stake? What are the trade-offs?

Reply

Tony Lima

July 9, 2013 @ 9:23 pm Absolutely terrific analogy. That means, of course, that the state of Oregon is going into the venture capital business.

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[1] Definitions are from Karl Case, Ray Fair, and Sharon Oster, *Principles of Microeconomics* (11e). Pearson Publishing, 2013. Asymmetric information is defined on page 357.

[2] Akerlof, George A., "The Market for 'Lemons:' Quality Uncertainty and the Market Mechanism." *The Quarterly Journal of Economics*, Vol. 84, No. 3. (Aug., 1970), pp. 488-500.

[3] Case, Fair, and Oster, *op. cit.*, p. 358.

[4] *Ibid.*, p. 362