Student Loans: A Hungarian Proposal

Part 1: Design

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Contents

Executive summary

1. This paper discusses a student loan strategy proposed by the Hungarian Government. Section 1 describes the scheme. Section 2 sets out the principles of loan design, drawing on economic theory. Section 3 gives an optimistic assessment of the proposal in terms of those principles and rebuts a number of criticisms.

2. A well-designed loan scheme should have three central characteristics:

- Income-contingent repayments – i.e. repayments in the form of *x*% of a student's subsequent earnings – collected as a payroll deduction;
- A market interest rate;
- The capacity to bring in private money.

The Government strategy incorporates all three. To the best of our knowledge Hungary would be unique in achieving this.

3. *Income-contingent repayments.* The scheme proposes repayments in the form of around 6 per cent of a student's subsequent earnings, collected alongside his or her income tax payments, until the loan has been repaid. Repayments therefore track a student's earnings week by week or month by month. This approach has major advantages. It is efficient, in that it addresses the major capital market imperfection discussed in Box 2. It is fair, because people with low earnings make low repayments and people with low lifetime earnings do not repay their loan in full. This assists access; and the obvious equity advantages of the scheme increase its political appeal. The key issue is less of policy design than of implementation, discussed in a companion paper. Specifically, it is necessary to ensure that the tax authorities have the capacity to collect repayments effectively. To that extent (an additional advantage) there is synergy between organising loan repayments and strengthening the system of income tax – itself a necessary component of EU accession.

4. *Market interest rates*. It is desirable if students pay an interest rate on their loans based on the government's borrowing rate. Subsidised loan are inefficient, in that they give students an incentive to borrow as much as possible and to delay repayment as long as possible. They are expensive, crowding out other beneficial educational activities. They are also inequitable: an interest subsidy disproportionately benefits the middle class, the predominant consumers of higher education. A market interest rate, in contrast, avoids perverse distributional effects: instead of spreading interest subsidies thinly across *all* students, it charges a market interest rate and uses the resulting savings for *targeted*appeal. ThabsTJ0 -1.-6.5J-6(n)g.0002Tc5roannTJ0 -1.0885o m

Student Loans: A Hungarian Proposal

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1. The Hungarian government intends to introduce a system of student loans as part of a wider reform of higher education. This paper

Income-contingent loans minimise deterrents to access since the individual is automatically protected if he/she has a low income. In sharp contrast, mortgage-type loans, which have a fixed repayment period, bear no relation to the individual's income.

Because repayments are exactly related to a person's income, it is possible to have a low starting point for repayments, thus strengthening the flow of repayments, with major fiscal advantages.

(2) *The maximum loan* will be HUF 21,000/month for state-financed students and somewhat higher for self-financed students, both figures to be indexed to the rate of inflation.

(3) *Phasing*. The system will be introduced for first year students thus automatically phasing in the system. First-year students will have access to the existing grant and also to the loan.

(4) *Real interest rate*. The loan will have a market interest rate based on three elements: (a) the one-year government bond rate, (b) a risk premium to cover non-repayments and (c) administrative costs. This real interest rate is considerably lower than students would pay for a commercial loan. Nevertheless, it creates a genuine incentive to repay. In contrast, a general interest subsidy is expensive, distortionary and inequitable, since it subsidises all students including those from well-off backgrounds.

(5) *Targeted assistance*. The system would include a targeted interest subsidy where a person's income is temporarily low; and it would write off the debt of someone who dies young or who retires with outstanding debt. The costs of those targeted subsidies and write-offs will be built into the interest rate. Separately, the scheme could accommodate options for active family policy, for example more advantageous repayment arrangements for large families, financed from general taxation.

(6) *Sharing risk*. The cost of non-repayment built into the interest rate means that risk is shared among the cohort of students. In the proposed system (income contingency, collection through the tax authorities) the risk premium is considerably lower than with mortgage-type loans.

(7) *The role of the income tax authorities*. Collection should be organised through the income tax system. The tax authorities are uniquely placed for this task. (a) They can exploit large administrative economies of scale. (b) Only the tax authorities can can cost-effectively collect repayments on the basis of a person's *current* income (an essential

element of income contingency). (c) They

2 Designing student loans: lessons from economic theory

5. This section discusses in turn the objectives of higher education policy, why loans are necessary at all, and design issues. For fuller discussion of the underlying economic theory, see Barr (1998, Ch. 13).

2.1 Objectives

6. In the Hungarian context, the following are major objectives.

7. *Improved access*, for both efficiency reasons (Hungary cannot afford to waste talent) and equity reasons. There is much confused thinking about equity B particularly in the higher education context B

against loans; more plausibly, they are an argument against excessively large loans. For these reasons, the introduction of loans can be argued to be a progressive move, putting into place now a system of (possibly small) loans, which will mature and grow, and contribute to private funding in the future.

2.3 How should student loan repayments be organised?

18. It is useful to distinguish three ways of organising loans:

Mortgage-type loans have repayments organised like a mortgage or bank overdraft. Thus the student faces repayments of (say) $100 per month for (say) 5 years. Repayments and the duration of the loan are predetermined; the endogenous variable is the fraction of the student=s income absorbed by loan repayments.

Income-contingent loans have repayments calculated as (say) 5 per cent of the student=s subsequent earnings until such time as she has repaid the loan. Thus the fraction of the student=s income absorbed by repayments is predetermined; the endogenous variable is the length of time it takes the student to repay. It is desirable if repayments are collected by the tax or social security authorities.

A graduate tax is similar to an income-contingent loan in that repayments are (say) 5 per cent of the student=s subsequent earnings, but fundamentally different in that repayment continues for life (or till retirement). Unlike the previous two cases, therefore, repayments do not cease when the student has fully repaid the loan.

19. The rest of this section argues that a well-designed loan system has three characteristics.

Provided that they can be implemented effectively, loans should have income-contingent repayments collected as a payroll deduction, i.e. alongside income tax or social security contributions.

Loans should attract a market or near-market interest rate.

The loan scheme should have the capacity to bring in private money.

The first of these topics occupies the rest of section 2.3. The latter two are taken up in section 2.4.

2.3.1 MORTGAGE LOANS

20. The major advantages of mortgage loans are:

The cost of the loan is transparent to the student
Mortgage repayments do not depend on a good tax collection mechanism.
Mortgage repayments might discourage work effort less than income-contingent loans.

21. Mortgage-type repayments, however, face significant problems.

They put access at risk, particularly for disadvantaged groups. This point is explained in the discussion of income-contingent loans in section 2.3.2.

They do not solve the need for sophisticated administration. The following discussion amplifies this point.

22. *Mortgage repayments require a fairly sophisticated collection mechanism.* Mortgage repayments are not collected by the tax authorities, but they still have to be collected by someone. Banks have expertise in collecting repayments for loans which are (a) short term and (b) secured on some tangible asset. On (a), however, there are good reasons for wanting student loans to have a fairly long duration: it is efficient if the duration of a loan bears a rational relationship to the lifetime of the asset being financed by the loans B hence we have 3-year car loans but 25-year home loans; in addition, a longer repayment period makes possible smaller repayments and/or larger loans. Turning to (b), there is no security for borrowing to finance human capital. For both reasons, collection by banks is likely to be administratively demanding and hence to require some sort of government guarantee. However:

23.

The classification problem. A second problem with government guarantees is the classification problem (Box 1). If government guarantees are too generous, there is no genuine risk-transfer and, under international statistical guidelines, the resulting loans, *in their entirety*, count as public spending.

24. *A public collection agency?* One way to get round these problems is to abandon the idea of private collection of loan repayments and instead to have a public collection mechanism. To be effective, however, any such agency will need investigative and enforcement powers which match those of the tax authorities. A further prerequisite is a legal structure capable of enforcing compliance, a prof we -.0040 0u1r4ahegaa0TD.109 .6oclhl[(p)33 Tc.1

Box 1: The expenditure classification problem

Guidelines on national income accounting include detailed discussion of the dividing line between public and private spending. To simplify a complex issue, three factors are relevant when deciding whether a loan scheme is public or private:

Who designs the scheme, e.g. who decides on interest rates or whether a particular student is eligible?
Who bears the risk of default?
Where does the money come from?

If a student takes out a conventional loan from a bank, it is the bank=s scheme, e.g. the bank can decide what interest rate to charge and whether or not it wishes to lend to the student; the bank bears the risk that he/she will fail to repay; and the money he/she borrows comes from the bank. Clearly this is a private scheme.

In contrast, if the government designs a loan scheme, decrees that all students are eligible (even those with a criminal conviction for fraud), bears the risk of default itself, and provides the money the students borrow, the scheme is public.

The problem arises where a scheme meets some of the criteria to be classified as private, but

more difficult B for precisely the reasons that implementing an effective income tax is difficult B stretched administrative capacity and a large grey economy. An income test, in short, will be administratively demanding and costly. With a mortgage scheme, these costs will be *in addition* to those of the tax system.

26. In conclusion, mortgage-type schemes do not get round the need for effective administration.

2.3.2 THE PRINCIPLE OF INCOME-CONTINGENT LOANS

27. There are two strategic sets of arguments for income-contingent loans: they address important capital market imperfections; and they have philosophical advantages.

Addressing capital market imperfections

28. Conventional (i.e. mortgage-type) loans, when used as an instrument to finance investment in human capital, face the capital market imperfections described in Box 2. As a result of those problems, risk for both borrower and lender is inefficiently high and, in consequence, borrowing and lending for human capital formation inefficiently low.

29. Income-contingent loans directly address these capital market imperfections.

Box 2: Capital market imperfections for student loans

for buying a house. For house purchase, the following is generally true:

(a) A person who buys a house knows what he is buying, having lived in a house all his life.
(b) The house is unlikely to fall down.
(c) The house will generally appreciate in value.
(d) If his income falls, making repayments burdensome, he has the option to sell the house
(e) Because the house acts as security for the loan, he can get a loan on good terms.

Contrast the case of lending to buy a degree:

(a) Applicants to university may not know the benefits of getting a degree. This potential problem is particularly relevant for students from poor backgrounds B the very people for whom access is the most fragile, and the very people whose participation the Hungarian government wants actively to foster.

(b) A degree can >fall down=, in the sense that there is a high risk (or at least a perceived high risk) of failing exams.

(c) Though the *average* private return to a degree is positive (UK National Committee of Inquiry into Higher Education, 1997*b*), there is considerable variance around it. Thus there is uncertainty to the individual student about the benefits of a degree.

(d) If a student who has borrowed to pay for a degree subsequently has low earnings and high loan repayments, he or she does not have the option to sell the degree (because slavery is illegal).

(e) Because of (d), there is no security for the loan. Thus mortgage-type loans for human capital formation, as well as being risky for the student are also risky for the lender. As a result, loans will have a substantial risk premium, further discouraging student borrowing.

For all five reasons, borrowing to finance human capital is more risky than borrowing to buy a house. Conventional loans therefore lead to an inefficiently low level of borrowing. Separately, the risks are likely to be greater for people from poorer backgrounds and for women. Thus conventional loans are inefficient because they waste talent and inequitable because they bear most heavily on the least well-off.

Philosophical arguments

30.

31. *The benefit principle*. In his classic book, *Capitalism and Freedom* (1962), Milton Friedman considered the government=s role in postcompulsory education and training. He

loans are *precisely* the same thing B a device for redistributing from one=s middle years to one=s early years. In addition, as discussed in section 3.1 (point 10), it is possible to design loans so that repayments continue for an extra year or two after the loan has been repaid; thus higher-earning graduates repay somewhat more than they have borrowed, making good any shortfall from lower-earning graduates. Thus the cohort as whole insures itself – a pure social insurance arrangement.

35. A final point in thinking about repayment models is to note that conventional loans (on which mortgage-type student loans are modelled) and student loans are intended to operate in very different circumstances. Loans for house purchase are normally made to people *after* they know their income and assets. Student loans, in contrast, are given *before* people know their income and assets; indeed, it is one of their central purposes to increase borrowers' income and assets. Of necessity the latter situation is much more uncertain than the former, hence the usefulness income-contingent arrangements.

2.3.3 DESIGN ASPECTS OF INCOME-CONTINGENT LOANS

36. The previous paragraphs discussed the *why* of income-contingent loans. This section briefly discusses some issues of *how*.

37. *The starting threshold*. At what level of income should a student start to make repayments? The case for a relatively high threshold (e.g. average earnings) is mainly political; people think that such a system is fairer. That argument, though widely believed, is false. Income-contingency is *automatically* fair. If the repayment rate is 5 per cent of earnings and the starting threshold is low, then repayments will be low. If a beginner kindergarten teacher earns 30,000 Ft. per month, her monthly repayment would be 1500 Ft. The case for a low threshold is that it makes for a much stronger repayment flow, i.e. it makes the loan scheme more effective. A key issue for policy makers is to assess the balance between these economic and political advantages which pull in different directions.

38. *Implementation*. To have their desired effect, it is important that loan repayments track a person=s earnings on a *current* basis, i.e. week by week or month by month, rather than being assessed retrospectively on the basis of income in a previous year. The only cost-effective method of implementing repayments on a current basis is as a payroll deduction alongside income tax or social security contributions.

39. Earlier discussion of mortgage-type loans stressed the practical problems of collecting repayments. Analogous problems arise with income-contingent loans, whose effectiveness is

heavily dependent on the effectiveness of the tax system. This raises problems in countries where income tax collection is leaky and where a large fraction of the population is outside the formal income tax net. A central issue for Hungarian policy makers is the need to ensure that income tax collection is sufficiently robust to support a student loan system if this line of policy development is to be pursued. Note that an effective tax system is a significant component of EU accession.

40. To sum up, the major advantages of income-contingent loans are:

They address important capital market imperfections;
They assist access;
They have philosophical advantages, being compatible with the benefit principle, the ability-to-pay principle *and* the social insurance principle;
They offer synergy with strengthening the tax system.

41. The disadvantages of income-contingent loans are:

They require robust tax collection;
They may be perceived as a tax, with potential disincentive effects.

2.4 Other design features of student loans

2.4.1 MARKET INTEREST RATES

42. This section sketches out briefly why it is desirable if students pay an interest rate on their loans broadly equal to the government's borrowing rate. Market B or near-market B interest rates have efficiency advantages. The interest rate is a price which, like other prices, gives signals which induce people to act efficiently. In this case, the signals concern the efficient allocation of income over a person=s lifetime. That efficiency function depends on a number of conditions, well-informed consumer

44. Market or near-market interest rates also have equity advantages. An interest subsidy is untargeted. It benefits most those who borrow most. Since it is the middle-class who disproportionately go to university, the interest subsidy benefits the middle-class most. Instead of spreading interest subsidies thinly across *all* students, a more equitable approach is to charge a market or near-market interest rate and to use the savings for *some* students, specifically those for whom access is most fragile, and those whose subsequent earnings are low. In short, market interest rates make it possible to replace an untargeted subsidy by a targeted one.

2.4.2 PRIVATE MONEY

45. As argued earlier, the logic of expansion of higher education makes it inevitable that public funding will need to be supplemented on a significant scale by private funding, an imperative which is all the more acute if higher education is to maintain its quality.

46. As also argued earlier, the only large-scale and equitable source of private funds is through student loans. However, if students borrow from the taxpayer, there is a net saving in public spending only when the loan scheme is mature, i.e. only when the flow of repayments from former graduates exceeds this year=s disbursement to current students *and* has done so for enough years for the loan scheme to be in steady state. Since one of the key objectives of a well-designed loan scheme is to allow the student to spread repayment of borrowing for a long-lived asset over an extended period, it follows that the loan scheme, even if well-designed, will not reach maturity for at least 20 years.

47. If a way can be found to allow students to borrow from private sources, the upfront costs of the loan scheme no longer fall on the public budget. This may not be a major advantage in a country like New Zealand (where students borrow taxpayer money) but is an issue of obvious and acute relevance to Hungary.

48. At this stage, however, the classification problem, discussed in Box 1, comes into play. If students borrow from banks, but the banks receive what, in practice, is a complete guarantee from government (so that there is little or no risk-transfer), the scheme will be classed under IMF rules as being publicly funded. Careful design is necessary to avoid the problem.

2.5 Loan schemes in practice

49. An earlier paper (Barr, 1999) discussed student loans in the USA, the UK, the Netherlands, Sweden, Australia and New Zealand (see also Woodhall 1990 for discussion of loans throughout the OECD).

50. Table 1 summarises institutions in terms of 5 core design features:

(a) Tuition fees: are there fees; and if so, are they set by government or by universities?
(b) Grants: do students receive a tax-funded grant towards their living expenses?
(c) Are loans intended to cover tuition fees, living costs or both?
(d) Do loans have mortgage or income-contingent repayments?
(e) Is the interest rate on student loans subsidised?

The following discussion focusses on (d) and (e).

50. *The USA*. There is a wide array of different loan schemes, which typically have mortgage repayments and an interest subsidy. These arrangements can be strongly criticised.

Complexity. There is no real *system*, but lots of disparate bits, making it difficult for students to understand what is on offer (to study the complexity close up, see http://www.finaid.org).

Mortgage-type repayments. Loans have mortgage-type repayments, notwithstanding that the US has ample capacity to administer an income-contingent system effectively.

Subsidised interest rates. Loans attract an interest subsidy. This tends to benefit the better off, and is also inefficient.

The default rate is uncomfortably high, particularly for students at vocational institutions. This >leakiness= has two causes: a high default rate, and the fact that students borrow at subsidised interest rates. As a joint result, a significant fraction of lending to students is not repaid, the shortfall being a cost to the taxpayer. This outcome is predictable, and offers an important lesson in policy design. Students till recently got their money from banks; and banks were supposed to collect repayments. However, the loan was guaranteed by the federal government, and banks therefore had little incentive to enforce repayment. Thus loans in the US bring in much less private money than is at first sight apparent B a problem in which the USA is far from unique.

Technical violation of IMF rules. The classification problem was discussed in Box 1. Under IMF guidelines, if students borrow from banks, but banks receive a generous guarantee from government, loans count as *public* spending, since the public sector bears the risk of default. The US system of government guarantees to private lenders may or may not violate these rules.

51. There are a number of reasons why mortgage-type loans are likely to have less of a disincentive effect in the USA than elsewhere.

Income is different, the US being a rich country.

History is different, the US having no tradition of free higher education.

Attitudes are different: people in the USA are less risk-averse and hence less debt-averse

cohorts of former students exceeds outgoings on loans for new students. That, however, will take at least 20 years.

Inequity. The arrangements put access at risk and are also unfair in other ways (see Barr and Crawford 1997).

55. *The Netherlands*. Student loans pay a near-market interest rate. On the face of it, the system has mortgage-style repayments but, if students provide evidence of low earnings, they

Administration. The >cacophony of complaints ... related to the alleged administrative burden ... in retrospect ... were seriously exaggerated= (*ibid*. p. 746). In the mid-1990s the Australian Tax Office estimated that collection costs were 1 per cent of HECS revenues.

Access. Here Chapman is unequivocal. >[T]he introduction of HECS does not seem to have had any discernible effects on the socio-economic composition of the student body= so that >there is no evidence of HECS diminish

3 The proposal in detail

60. Section 3.1 explains and comments on the Hungarian Government's proposal. Section 3.2 offers an enthusiastic overall assessment and rebuts a number of criticisms.

3.1 The proposal

1 INCOME CONTINGENT LOAN REPAYMENTS. LOAN REPAYMENTS TAKE THE FORM OF A SMALL PERCENTAGE (AROUND 6 PER CENT) OF A STUDENT'S INCOME AFTER GRADUATION, WITH AN OPTION FOR VOLUNTARY EARLY REPAYMENTS.

61. Why have a student loan scheme at all? The topic was discussed in section 2.2. Officials are clear that they consider the primary objective of the loan scheme is to release resources for higher education institutions in order to improve quality and access. Given this objective, the Minister stressed the importance of analysing the budgetary implications of the proposed scheme, and emphasised the need to ensure that the cost to the Education Ministry's recurrent budget is kept to a minimum. This implies that the scheme must be efficient (points 7 and 8 below), largely free of subsidy (points 4 and 6) and largely privately financed (points 9 and 10). The scheme is also equitable (points 1 and 5).

62. Why income-contingent repayments? This part of the strategy is based on the arguments in section 2, namely that income-contingent repayments are more efficient, more equitable and, in the Hungarian context, more politically sustainable than mortgage-type loans.

> Income-contingent loans minimise deterrents to access since the individual is automatically protected if he/she has a low income. In sharp contrast, mortgage-type loans, which have a fixed repayment period, bear no relation to the individual's income.
>
> Because repayments are exactly related to a person's income, it is possible to have a low starting point for repayments, thus strengthening the flow of repayments, with major fiscal advantages.

63. Why a flat-rate of around 6%? In Australia, the student loan repayment rate rises with income, i.e. borrowers with higher earnings make higher percentage repayments. Such an arrangement might be worth considering at some future time. In the short run, however, the imperative for administrative simplicity points strongly towards a single repayment rate for all borrowers.

students rather than to first-year students, though at a cost of bringing one year closer the starting date for the collection of repayments.

4 REAL INTEREST RATE. THE LOAN WILL HAVE A MARKET INTEREST RATE BASED ON THREE ELEMENTS: (a) THE ONE-YEAR GOVERNMENT BOND RATE, (b) A RISK PREMIUM TO COVER NON-REPAYMENTS AND (c) ADMINISTRATIVE COSTS. THIS REAL INTEREST RATE IS CONSIDERABLY LOWER THAN STUDENTS WOULD PAY FOR A COMMERCIAL LOAN. NEVERTHELESS, IT CREATES A GENUINE INCENTIVE TO REPAY. IN CONTRAST, A GENERAL INTEREST SUBSIDY IS EXPENSIVE, DISTORTIONARY AND INEQUITABLE, SINCE IT SUBSIDISES ALL STUDENTS INCLUDING THOSE FROM WELL-OFF BACKGROUNDS.

70. Interest subsidies, as discussed in section 2.4, have major flaws.

A central objective of the loan scheme is to release resources to improve quality and access. This this objective is compromised – potentially fatally – if the cost of interest subsidies falls on the higher education budget.

The cost of an interest subsidy would make it difficult to expand the system in future, for example to postgraduate and part-time students or for vocational training.

A general interest subsidy is not only costly but also regressive, since it disproportionately benefits middle-class students.

71. For these reasons, the Government has rightly rejected the idea of a *general* interest subsidy. However, there is a strong case for *targeted* interest subsidies.

5 TARGETED ASSISTANCE. THE SYSTEM WOULD INCLUDE A TARGETED INTEREST SUBSIDY WHERE A PERSON'S INCOME IS TEMPORARILY LOW; AND IT WOULD WRITE OFF THE DEBT OF SOMEONE WHO DIES YOUNG OR WHO RETIRES WITH OUTSTANDING DEBT. THE COSTS OF THOSE TARGETED SUBSIDIES AND WRITE-OFFS WILL BE BUILT INTO THE INTEREST RATE. SEPARATELY, THE SCHEME COULD ACCOMMODATE OPTIONS FOR ACTIVE FAMILY POLICY, FOR EXAMPLE MORE ADVANTAGEOUS REPAYMENT ARRANGEMENTS FOR LARGE FAMILIES, FINANCED FROM GENERAL TAXATION.

72. Income contingency ensures that repayment is linked to ability to pay. High earners will make larger monthly repayments than low earners; and those with little or no income will not pay at all as long as they remain in that position. Thus there is no case for a general interest subsidy.

to use the same parameters as the income tax system, for example the same definition of income.

80. *Only the tax authorities can can cost-effectively collect repayments on the basis of a person's **current** income.* The efficiency and equity gains of income-contingency depend on repayments tracking a borrower's *current* income on a weekly/monthly basis. Given (a) large numbers and (b) a standardised task, there are clear administrative economies of scale if one entity administers student loans. Given (c), the imperative for repayments to track earnings week by week – precisely the task which the tax authorities already carry out – there are overwhelming advantages in terms both of cost and of minimising the drain on scarce administrative resources if loan repayments are piggy-backed onto an existing administrative operation. Since the income-tax authorities by definition are collecting income-contingent tax payments, it is only a marginal additional task to collect income-contingent loan repayments.

81. *The tax authorities have enforcement powers which would be unconstitutional for a private collection agency.* As a result:

82. *Collection via the tax authorities is cheaper and has a stronger repayment flow than any private collection mechanism* and, for those reasons, opens up opportunities for private finance on the most advantageous terms, with benefits both for students and the taxpayer.

83. For precisely these reasons, the use of a state collection mechanism minimises default, giving confidence to the financial institutions which, it is intended, should provide the loan capital (see point 9, below).

84. For precisely these reasons, commercial banks in the UK refused to organise the collection of student loan repayments; commercial banks in Hungary are likely to take a similar view. Banks cannot, in general, collect repayments as cost-effectively as the tax authorities. In addition, as discussed in Box 2, there are major imperfections in the market for student loans, the most important from the banks' perspective being the lack of any security. And, as discussed in Box 1 and the surrounding text, any attempt to give private lenders a government guarantee rapidly runs into the expenditure classification problem. Finally, and specific to Hungary, the banking sector is not without problems at the moment (see the paragraph in Appendix 1 from *Magyar Hirlap*, reported by Reuters, on losses in the financial sector).

The proposal in detail

Agency. This would improve the political acceptability of loans in comparison with a situation where repayments are seen as part of the tax-gathering exercise.

Private finance. If the Institution is separate, it could be semi-private or private, with major potential advantages in terms of of

99. Further aspects of debt sales are discussed in the companion paper.

10 WHEN THE SYSTEM IS MATURE IT WILL BE SELF-FINANCING, AND SO DOES NOT REQUIRE A 'PROGRAMMED' BUDGETARY COST INCREASE. IN CONTRAST, A MORTGAGE-TYPE LOAN SYSTEM REQUIRES SUBSTANTIAL AND CONTINUING BUDGETARY RESOURCES FOR GUARANTEES, AND OFTEN ALSO TO PAY FOR INTEREST SUBSIDIES.

100. The key point is that the design of the scheme offers not only short-run but also long-run fiscal gains.

3.2 Assessment

3.2.1 Overall assessment

101. Section 2.3 argued that a good loan scheme should have three central characteristics:

Income-contingent repayments collected as a payroll deduction (points 1 and 7);
A market interest rate (point 4);
The capacity to bring in private money (point 9).

The Government proposal incorporates all thre

109. *Giving out loans to everyone is risky* the scheme would be more secure if loans were offered selectively. Risk rating is efficient where there is only a *private* interest in a person's access to credit. It is right, for example, that banks should be free to decide to whom to make loans to buy a car or a hi fi. In this case, risk rating is beneficial. Higher education is different. It has external benefits (economic growth, national economic competitiveness) and one of its main purposes is to improve a person's chances of not being low paid. For both reasons, it is efficient to make sure that access is not diminished by lack of current income. Risk rating in this context is thus inefficient as well as inequitable.

110. *There is not much experience with income-contingent loans*. As discussed in section 2.5, the Australian scheme began in 1989. Repayment rates are good, the repayment stream is strong, administrative costs are low, and the scheme is politically acceptable (see Chapman 1997). Furthermore, annual monitoring of the effects on access (mandated by Parliament when the scheme was introduced) has identified no adverse effects. There is major controversy in Australia about higher education finance in the wake of the West Committee Report (Commonwealth of Australia, 1997, 1998); but the one thing about which there is *no* controversy is the income-contingent loan. New Zealand (a spectacularly well-run country which has dramatically modernised itself over the past 10 years) is also happy with the administrative performance of its loan scheme. Separately, mortgage loans do not always work well (the US scheme is hardly a good example).

111. *The Yale scheme was a disaster*. Yale University attempted to implement a non-state income-contingent scheme. It failed because it had a major design flaw – specifically, the rules of the scheme were changed in such a way that high-earners were allowed to opt out. Separately, it is not clear that the income-contingent mechanism is well suited to a private collection mechanism along the lines of the Yale scheme. Since the Government proposal involves a public collection mechanism, it is not clear that the Yale experience is a relevant precedent.

112. *Income-contingent loans are monolithic*. The issue is whether there should be multiple loan schemes – and in particular private schemes – to give students choice.

113. The first response is that income-contingent loans have significant choice built in; repayments automatically vary with income; and a well-designed scheme will contain provisions to allow, or actively encourage, accelerated repayment if the graduate so wishes.

114. Administrative capacity is a scarce resource, making it important that the loan scheme is administered cost-effectively. Thus it is necessary to keep the loan scheme as administratively simple as possible. Having multiple schemes is logically incompatible with worries about administrative capacity.

115. As discussed earlier, risk-rating, though useful for many types of financial instrument, is inefficient in the context of student loans.

116. Separately, there are strong equity arguments for designing loans to promote access. These equity concerns do not apply to the same extent for car loans, etc.

117. *Use of the tax system is politically dangerous.* The argument here is that the state has uncomfortably large powers over individuals. The first response is that those powers derive from the need effectively to administer a personal income tax. Since abolishing personal income tax is not on the agenda, there are strong administrative arguments for piggy-backing loan repayments onto an existing administrative mechanism. A second response is that the problem does not arise where tax systems have democratic legitimacy.

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Appendix 1: Reuters reports on the Hungarian banking sector

Magyar Nemzet, 21 October 1999

The government will issue new, digital identity cards from January that will meet Schengen agreement standards.

Magyar Hirlap, 22 October 1999

Table 1: Higher education funding in different countries

	USA	**UK (1990)**	**UK (1998+)**	**Netherlands**	**Sweden**	**Australia**	**New Zealand (1992-99)**
Fees set by Government		Zero	Flat rate[b]	Flat rate	Zero	Multiple flat rate[c]	