

# **Bruce Chapman (ed.), *Government Managing Risk: Income Contingent Loans for Social and Economic Progress***

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Motivated by a desire to increase the participation rates in higher education of individuals from disadvantaged backgrounds, the Whitlam Government significantly increased subsidies to education. But the ensuing burdens this placed on the government budget led to supply restrictions that limited growth in student numbers without significant changes in the socio-economic composition. As these subsidies are largely regressive in nature, with most of the benefits flowing to recipients by way of higher future earnings, the Higher Education Contribution Scheme (HECS) was introduced in Australia in 1989. This was not only a politically clever way of increasing the small upfront fees that had been reintroduced in 1983 as the Higher Education Administration Charge (HEAC), but also salved the concern that higher fees would create problems for potential students from low-income groups who could not borrow against their human capital. The HECS gives students access to 'income-contingent loans' — ICLs — that are repaid only when their taxable income rises above a threshold reflecting average income.

*Government Managing Risk: Income Contingent Loans for Social and Economic Progress* examines the costs and benefits ICLs made by the public sector. It looks at ways of using them to collect revenue from beneficiaries of government spending, and to manage risk. Most of the chapters are written by Bruce Chapman, who advised the Wran Committee that recommended HECS in 1988.

Part I looks at using ICLs in higher education and provides a summary of the HECS in Australia. After a brief overview in Chapter 1, efficiency and equity concerns are examined in Chapter 2 as a basis for considering higher education funding. In particular, the case is put for charging fees. There is a detailed summary of the arguments for and against ICLs in Chapter 3, where income and consumption profiles for students with HECS debts are compared under (government-guaranteed) bank loans and ICLs. It is argued that ICLs generate

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insurance and consumption smoothing benefits not provided by bank loans. In particular, people who default on repaying their debt are not forced into bankruptcy under ICLs. Two types of ICLs are considered: those with 'risk pooling' (where the default risk is spread across other borrowers under the scheme), and those with 'risk sharing' (where the default risk is transferred to taxpayers), as well as graduate taxes and human-capital contracts as other ways to fund education spending.

In my view, the main advantage of HECS, which uses risk-spreading ICLs, is that it corrects the regressive redistribution from subsidies to higher education. By doing so, it generates revenue that can be used to expand the supply of higher education places. It is unfortunate that under the current arrangements students have limited ability to affect the nature of the service provided to them by public universities, but that is not really the fault of the HECS. Instead, it is more to do with the way governments in Australia attempt to create pseudo-markets where outcomes meet social and political objectives which would not be realised by private-market outcomes (even with partial subsidies). In this regard, there are circumstances where some of the externalities, which are used to justify government intervention in the first place, may be negative. Poor incentives under public provision can lead to bad education outcomes which are difficult for individuals to avoid.

Other policy applications for ICLs are examined in Part II. There is examined a proposal to collect drought-relief payments (Chapter 7) and criminal reparations (Chapters 8 and 9), the provision of finance to economically disadvantaged regions (Chapter 10) and loans to low-income households (Chapter 11). In most of these applications, borrowers have some form of collateral, which is not true for loans made for higher education fees, and that significantly weakens the case for governments using ICLs. It would be better not to make expenditures which are going to be collected from agents who can access finance in private markets. Thus, any social benefits from using ICLs in these circumstances must come from their ability to provide risk benefits that cannot be obtained from trading in private markets.

It is argued throughout the book that there are two critical advantages of risk-sharing ICLs — consumption smoothing and protection against default. By allowing individuals to repay loans when their incomes rise above a prescribed threshold they can smooth consumption over their lifecycle. And as noted above, those without high-enough taxable incomes to repay their loans are not forced into bankruptcy which adversely affects their credit rating and capacity to borrow in the future. But in my view, this aspect of risk-sharing ICLs is their greatest weakness. Chapter 4 cites Quiggin (2003), who argues that there are welfare gains from income-contingent repayment schemes relative to the alternative of upfront fees (yielding the same revenue in present-value terms)

due to a reduction in consumption risk. But when making this claim no allowance is made for the possibility that individuals can smooth consumption over time by trading in private markets.<sup>2</sup> In effect, it is assumed (at least implicitly) that there is no opportunity for them to diversify consumption risk when they pay upfront fees. Clearly, that overstates the potential welfare gains. Firstly, is the risk diversifiable across risky activities or is it market risk which cannot be diversified and must therefore be borne by someone in the economy?<sup>3</sup> If it is diversifiable risk, why do markets not provide insurance? Are there prohibitive trading costs or moral hazard and adverse selection problems? If so, they should be included in the welfare analysis. Alternatively, if there is market risk, the ICLs transfer it to taxpayers who incur welfare losses when the HECS is not adjusted properly to provide them with compensation. These losses should be taken into account, and a proper assessment of the welfare gains needs to explicitly model the types of risk and what opportunities there are in private markets to diversify and spread them.

The present moment is, indeed, an opportune time to raise the concerns aired above. The current financial problems which are now spilling over into real economies had their origins in the home-mortgage markets where governments have provided (often implicitly through their actions) lender-of-last-resort facilities which transfer market risk to taxpayers. These problems were exacerbated in the United States by the Community Investment Act (1973) and the subsequent Acts to establish Freddie Mac and Fannie May, which encouraged significant lending to low-income groups without the capacity to repay under commercially viable terms. Many government policies have been justified by the risk benefits they provide — for example, commodity price-stabilisation schemes and macroeconomic stabilisation policies — but they frequently ignore the market risk transferred to taxpayers. When no risk premium is paid by the beneficiaries they ‘over invest’ in risky activities.

In higher education there is concern that students face uncertainty about completing their studies, the prospects of getting employment in their field of study, and the wages they can expect to receive. But why should this risk be shifted to taxpayers or, for that matter, spread to other students under risk-pooling ICLs? It is unlikely that public-sector employees have better information or face the appropriate incentives to assess this risk than do private

<sup>2</sup> Newbery and Stiglitz (1981) do the same thing when they measure the welfare effects of commodity price-stabilisation schemes. They argue private markets do not provide insurance due to moral hazard and adverse selection problems, but they do not consider whether these schemes are effective when the government also faces the same problems. Dixit (1987; 1989) shows how price stabilisation schemes are largely ineffective once moral hazard and adverse selection are included in the welfare analysis.

<sup>3</sup> Diversifiable risk can be eliminated by pooling it across agents, whereas market risk cannot be diversified in this way. When insurance trades at actuarially fair prices (in the absence of trading costs), diversifiable risk can be eliminated at no expected cost to consumers. In contrast, market risk attracts a premium to compensate those who bear it for the variance it imparts to their consumption.

lenders. A quote from Bruce Johnstone on page 23 argues that private lenders will require a creditworthy cosignatory or a credit-worthiness test of the borrower based on academic credentials or demonstrated employment prospects. They do this because they have no collateral when lending against returns to human capital. But the argument that this demands government intervention to absorb the risk does not immediately follow without considering the costs and benefits of the other options. Later in Chapter 3 consideration is given to the idea that repayments of ICLs made by private lenders could be collected by the government through the tax system. At least private lenders are likely to have better incentives and are better situated to properly assess the risk of individual students, and would be able to include the appropriate premium in their loans.

There is evidence in the book that the HECS has not much changed the socio-economic composition of the students, and that most of the additional enrolments have arisen from expansion in higher education places. Thus, it is the rationing of places at public-sector universities that is restricting the growth in borrowing and, as a consequence, the amount of risk being shifted onto taxpayers. But if risk-spreading ICLs are extended to other activities where collateral exists, and where demand and supply is less regulated, agents are encouraged to 'over-invest' in these activities with outcomes similar to those being experienced at the present time in the financial sector .

Since the main justification for using ICLs is based on risk benefits, I believe the analysis of the economic effects of the changes in risk bearing needs to be expanded considerably in the book. However, as well as providing a very useful summary of the HECS in Australia, it gives readers a great deal to think about: for example, the subtle changes in incentives under ICLs that can have unintended consequences.

## References

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