

Joint Oireachtas Committee on Education and Skills

Submission on the Fiscal Implications of Income Contingent Loans by Dr. Aedín Doris (Maynooth University) and Dr. Darragh Flannery (University of Limerick), May 2, 2017

Introduction

We have been asked to appear before the Committee to discuss the advantages of an income-contingent student loan system compared to other forms of higher education funding. The particular context for this hearing is the recent dissemination of a research paper by Charles Larkin and Shaen Corbet (2017) questioning the viability of income-contingent loans in the Irish context from a public finance viewpoint. The Committee has previously heard deliberations regarding the importance of the various parameters involved in the design of an income-contingent loan (ICL) system. Because of the context for this hearing, the focus here will be on how the variation in these parameters impacts on the public finances and how ICLs compare to other forms of funding.

We first provide an overview of the rationale for income-contingent student loans in the Irish context. We then respond to the paper by Larkin and Corbet (2017). Finally, we present some public debt and deficit analysis of a variety of funding options to provide some evidence on this issue.¹

Higher Education Funding Context

Both the current level of HE funding and the current mix of state support and upfront student fees are widely accepted to be unsustainable. The need for further investment, competition with other areas of public spending and concerns about accessibility and affordability has turned the main focus of this debate towards alternative funding systems.

As you are aware, the report of the Expert Group on Future Funding for Higher Education (the Cassells Report) outlined three possible options, namely a full state model of funding (Option 1), increased state funding with a continuation of up-front student fees (Option 2) and increased state funding combined with an ICL system (Option 3). Although a fully taxpayer-funded system may seem attractive because it provides access to education at no up-front cost to the student, it is ultimately the most regressive option as it entails a transfer of resources from those who have not benefitted from a higher education – the lower paid – to those who have – the better paid. Moreover, this option would entail a continued heavy reliance on tax revenue for any future investment in the sector. In addition, it would entail the highest cost to the exchequer of all of the options considered.

The second option, combining state support with up-front fees, may alleviate some of the public cost in the short and long-term but raises concerns about affordability and accessibility due to the up-front nature of the costs. The purpose of an ICL system is to remove such concerns while also sharing the burden of financing higher education in an efficient and equitable manner. ICL repayments, which are

¹ In preparing this submission, we have benefitted from extensive discussions with experts reporting the ICL experiences in other countries, including Bruce Chapman, Lorraine Dearden and Nick Barr.

automatically deducted from the graduate's pay cheque on the basis of their monthly earnings, are low or zero for low earners and increase as earnings increase, so they are designed to be affordable. Income-contingent debt is, therefore, unlike other forms of debt.

It is important to note that all three options outlined in the Cassells Report involve an increased public cost. This is inevitable, given the recommendation in the Report that HE funding be substantially increased. However, it is also salient that Options 1 and 2 are estimated in the Report to incur a higher direct cost to the state by 2030 relative to the specific ICL proposal outlined in the report. This is not surprising, since all graduates contribute to the cost of their education under Option 3, but not under the other two options.

A note of concern that is specific to the introduction of an ICL system in Ireland relates to the public costs in the initial stage of implementation. These arise because revenue will be lost due to existing up-front fees being removed, while the revenue generated from graduate repayments will take time to flow. The exact design of any ICL system can have a significant impact on the scale of these costs; we will illustrate this point with some examples in the final section of this submission.

Response to Larkin and Corbet (2017)

Larkin and Corbet purport to analyse ICLs as they would apply in the Irish case, and claim to show that an ICL could not work in Ireland due to the high probability of default. There are serious shortcomings in the methodology used in their modelling of ICLs, many of which are too technical to detail here. One problem can be readily explained, however: in the international literature on ICLs, it is recognised that the default rate is the result of how graduate earnings evolve over time and how repayments are calculated in each particular ICL scheme. Rather than calculating the level of default that would prevail in Ireland, Larkin and Corbet assume that a high level of default would apply and on that basis dismiss all ICLs, ignoring the fact that the default rate of any ICL scheme is a function of its parameters.

A fundamental problem with Larkin and Corbet's work is that they model the costs of an ICL but do not model the costs of the alternatives. Moreover, they appear to confuse issues of financing with issues of cost. For example, they propose an 'education levy' on earned income (of 5% for most workers) that could fund an increase in expenditure resulting from the implementation of Option 1. Apart from the fact that they ignore the significant negative effects on efficiency of such a substantial increase in income taxation, and the fact that such an increase is unlikely to be politically feasible, it should be noted that an increase in tax revenue could also be used to fund any outlays associated with ICLs, or indeed any other method of increasing HE funding.

Finally, it should be stressed that the conclusions of Larkin and Corbet are not substantiated by their analysis. Their particularly eye-catching conclusion that that an Irish student loan company would create an "Anglo in slow motion" simply cannot be supported.

Despite its shortcomings, Larkin and Corbet's paper has served to focus the debate on the costs to the exchequer of ICLs. It is obvious that if an increase in HE funding is funded by means of an ICL, there will be an initial period where loans issued will not be matched by repayments. The Cassells Review addresses the point about the initial deficit, concluding (p. 84) that there would be a build-up of debt of over €10bn in the first 20 years of an ICL scheme. This number is based on very detailed graduate age-earnings profiles and non-repayment rates that are estimated from data rather than assumed.

Although the figure of €10bn may seem very high, it is worth noting that it would be spread over a long time period. Moreover, it is important to note that it arises because the ICL would be associated with a substantial increase in HE funding, not because of the nature of an ICL scheme; an equivalent increase in HE funding raised through general taxation would be even more costly, a point we return to in our analysis below.

It is also important to note that Appendix 3 of Cassells includes a discussion, provided by the Department of Finance (see footnote 56), of whether such costs are feasible within the constraints of the Fiscal Treaty and concludes that they are.

However, neither the discussion in the Cassells Report nor that in Larkin and Corbet provide a full analysis of the fiscal implications over time of alternative ways of funding an increase in higher education funding. We have therefore undertaken to provide such an analysis in what follows.

An Analysis of the Fiscal Implications of Alternative HE Funding Proposals

In this analysis, we assume that policy makers wish to increase the income (from core funding) of HEIs by €2000 per student. There are many alternative ways of achieving this, and three options were given in the Cassells Report:

Option 1: Removing the €3000 fees that are currently paid by about 50% of students, and making a payment of €5000 per student from central government funding.

Option 2: Retaining the €3000 fees that are currently paid by about 50% of students, with the increase of €2000 for all students coming from central government funding.

Option 3: Increasing fees from €3000 to €5000, applying fees to all students and making an ICL facility available.²

As well as the basic ICL described in the Cassells Report, we also show results for two alternative ICLs that are designed to have a lower impact on public debt:

Option 4: Incentivizing students (or their families) to pay up-front by giving a 10% discount on fees, resulting in an assumed 10% of students not availing of the ICL.

Option 5: As well as allowing for up-front payment as above, fees are increased gradually over the early years of the ICL scheme. So in the first two years, fees remain at €3000, but are payable by all students rather than the current 50% and are covered by an ICL; in the following years, fees increase by €500 every two years until they reach €5000 after eight years.

To think about the costs of each of these options, it is important to specify what alternative they are being compared to. Here, each option is compared to the alternative of maintaining the current level and system of HEI funding, i.e. leaving fees at the current level of €3000 per student (increased annually at the rate of inflation), with 50% of those fees payable by government because the students

² Option 3 reflects the 'basic' ICL described in the Cassells Report. This is based on an earnings threshold of €26000, with repayments starting at 2% of total income once the threshold is reached, increasing by 1% for every additional €5000 earnings, up to 8% of total income for earnings over €56000. The subsidy rate estimated in Chapman and Doris (2016) for this ICL was 26%.

qualify for grants. Using this comparison allows us to take into account that, because of demographic pressures, the cost of HE funding is set to increase in the coming years even if funding is left as it is. The analysis therefore isolates the effect of increasing funding per student by different methods.

The graphs in the Appendix to this submission show the effects of the above five alternatives on the annual budget deficit and on accumulated public debt.^{3 4} It is clear from the graphs that all three ICLs have an advantage over the other options in terms of their effect on the annual budget deficit. It is also clear that all ICLs have a substantial advantage over Option 1 in terms of their effect on public debt, and also over Option 2 in the long-run. In the near term, the effect on public debt of Option 2 is lower than for the ICL given by Option 3. However, the calculations for Options 4 and 5 show clearly that it is possible to design ICLs that will have a lower effect on public debt than Option 2, even in the immediate aftermath of their introduction.

It is important to emphasize that an increase in HEI funding by €2000 per student will be costly, no matter how it is done. However, if done through an ICL, the costs to the taxpayer are substantially lower, with the burden being shared with those that benefit financially from higher education. Moreover, an ICL is more equitable – the subsidization of higher education by those who have never benefitted from such an education is reduced and education is free at the point of access for all students.

In the countries that have adopted an ICL to date, their situations at the point of adoption were different to that which pertains in Ireland. In all cases, they were moving from a situation where no students paid fees to one where deferred fees were payable; therefore, no revenue stream was being eliminated. Moreover, they were not motivated by needing to increase HEI funding per student dramatically. While concern around the public costs of ICL schemes in other countries has been voiced, these concerns largely stem from issues such as graduate emigration, the interest rate attached to the loans and supply side reforms; these are issues that can be mitigated when designing an ICL to begin with.

There is nothing about an ICL system that is inherently costly in terms of government finances; in fact, because students repay most of their debt, costs are lower under an ICL system than under systems based entirely on taxpayer funding. The costs incurred if an ICL is introduced in Ireland will not be costs of the ICL system itself, but the costs of moving to a system where no fees are payable up front (for equity reasons) and where funding needs to be increased dramatically (for quality reasons).

³ Both graphs take into account future student numbers as predicted up to 2029 by the Department of Education and extrapolated beyond that date. All values are expressed in 2017 prices and discounted back to 2017 values using a discount rate of 2%.

⁴ National income accounting standards determine how ICLs are treated in calculating the budget deficit and the national debt. The budget deficit is the gap between government revenue and expenditure in a given year. Because the loans issued under an ICL are assets, they are not counted as expenditure and repayments are not counted as revenue. However, to the extent that a subsidy is anticipated when the loans are issued, this is counted as expenditure at the time of issue. ICL loans have a bigger effect on public debt, however. In each year, the government borrowing undertaken to fund student loans adds to the public debt, and any graduate repayments received offset this.

Conclusion

A careful analysis of the fiscal implications of ICLs shows that they are entirely feasible in Ireland. The design of any ICL scheme should be carefully considered, as the choice of the parameters of the scheme will determine the extent of the subsidy required. An ICL scheme can be designed so as to minimize the immediate costs of the introduction of the scheme, and this should also be a consideration of the design of any ICL.

Our conclusion is that an ICL would allow a substantial increase in HE funding without reducing access and at a lower cost to the exchequer compared to other alternatives. The resulting savings can then be used to improve funding for earlier education, from pre-school through to secondary school, which is where the main barriers to participation in higher education lie.

Appendix

