Educational Policy Institute

Much Ado About a Very Small Idea

Straight Talk on Income-Contingent Loans

Alex Usher

January 2005

Canadian Higher Education Report Series

The Educational Policy Institute

The Educational Policy Institute, Inc. (EPI) is a non-profit, non-partisan, and non-governmental organization dedicated to policy-based research on educational opportunity for all students. With offices in Washington, DC, and Toronto, ON, EPI is a collective association of researchers and policy analysts from around the world dedicated to the mission of enhancing our knowledge of critical barriers facing students and families throughout the educational pipeline. In addition, EPI has developed extensive partnerships and collaborative arrangements with other leading research and educational organizations, further supporting our mission and ability to conduct policy-relevant research for practical use.

The mission of EPI is to expand educational opportunity for low-income and other historically-underrepresented students through high-level research and analysis. By providing educational leaders and policymakers with the information required to make prudent programmatic and policy decisions, we believe that the doors of opportunity can be further opened for all students, resulting in an increase in the number of students prepared for, enrolled in, and completing postsecondary education.

For more information about the Educational Policy Institute, please visit our website at**:** **www.educationalpolicy.org** or contact us at:

Educational Policy Institute, Inc.
Washington Office
25 Ludwell Lane
Stafford, VA 22554
(877) e-POLICY
email: **info@educationalpolicy.org**

Educational Policy Institute, (Canadian Office)
77 Bloor Street West, Suite 1701
Toronto, ON M5S 1M2
(416) 848-0215
email: **info@educationalpolicy.org**

About the Author

Alex Usher is the Vice-President of the Educational Policy Institute. Prior to joining the Institute, he was the Director of Research and Program Development for the Canada Millennium Scholarship Foundation, where he was in charge of Canada's largest-ever research project on access to post-secondary education. He is a native of Winnipeg, Manitoba, and graduate of McGill University. *(ausher@educationalpolicy.org)*

Citation:

Usher, A. (2005). *Much Ado About a Very Small Idea: Straight Talk About Income-Contingent Loans.* Toronto, ON: Educational Policy Institute.

---

www.educationalpolicy.org

Table of Contents

Much Ado About A Very Small Idea: Straight Talk on Income-Contingent Loans

Alex Usher

Introduction

For the first time in the better part of a decade, the idea of making student loans "Income-Contingent" (often referred to as "ICR", which stands for Income-Contingent Repayment) is making a re-appearance on the Canadian policy scene. The Government of Quebec has said that it wants to introduce some form of income-contingency into its loan system and it is widely rumoured that Bob Rae will recommend an income-contingent student loan scheme for Ontario when his much-anticipated report on postsecondary education is released in February 2005. If the Government of Ontario accepts this recommendation, it will have nation-wide consequences: Ontario represents over 50% of the Canada Student Loans Program (CSLP) portfolio and Ottawa cannot afford to get too far out of lock-step with Ontario on this matter. As such, the potential exists for a full-blown, national debate on the merits of this loan repayment system over the course of the next twelve months.

For those who have long favoured ICRs, this debate will be an opportunity to dust off their ideas and suggest why ICRs will increase access to post-secondary education. For those who oppose these policies, it will be an opportunity to rally the faithful and denounce those wishing to cripple access to education through the introduction of ICRs. A debate long on rhetoric and passion and short on analysis can be expected.

This paper will demonstrate that most of the passion around ICRs – both for and against – is fundamentally misguided. Both camps argue their cases based on program features that are either not intrinsic to an ICR program or which could easily be present in *any* type of loan repayment system. While a properly designed ICR program has the potential to make loan repayment easier for the minority of students that have repayment problems, there is no reason to believe that ICR of any type would have an effect on access to post-secondary education one way or another.

The paper will begin by briefly examining what is meant by the term "Income-Contingent Loan" and examine the features of nine different programs internationally that have income-contingent features and categorize them according to their program features. It will then look at some of the policy choices associated with "hard" ICR programs that can make ICRs either very attractive or very un-

attractive. The following two sections will critically assess the common arguments made both for and against ICRs, and the final section will discuss the merits of introducing greater income-contingency in Canada.

What are Income-Contingent Loans?

First, what constitutes an "income-contingent" loan? This question is by no means as straightforward as it may seem; even within the literature on income-contingency there is no commonly accepted definition of what makes a loan income-contingent. At its simplest level, obviously, income-contingency means that the amount of a loan that one repays is related to one's income. However, there are several methods by which income and repayments can be linked to one another and it is here that the concept begins to lack definition.

Due to this lack of clarity, debates about income-contingent loans often appear to be conducted between two camps talking past each other, the protagonists talking about two different programs entirely. The reason for the confusion is that ICRs are not monolithic and can take many forms. ICR is simply a general concept which can be expressed in many ways. When proponents and opponents talk about the wonders and evils (respectively) of ICR, they usually have very different models of ICR in mind and are making very different assumptions about the policy contexts in which ICRs will be introduced.

The "classic" ICR program – that is, the one that is best known internationally – is the Australian Higher Education Contribution System (HECS). Prior to the introduction of HECS in 1989, Australian students paid no tuition fees, a policy which then-Labour Minister of Education, John Dawkins believed constituted an unfair subsidy to the rich by the poor. Rather than simply introducing tuition fees, Australia turned instead to a system of "deferred contributions". In theory, each student was charged an "obligation" of $1,800 Australian dollars per year of study. Students were not required to pay this sum immediately; instead, they could repay the sum over time after the end of their period of studies, with no real interest. Furthermore, students were not required to repay any of this contribution if their income was below that of the average industrial wage (at the time, about $30,000 annually). To the extent that their income exceeded this amount, a percentage of their income would be collected through the income tax system as a deferred "contribution" to the higher education system. This repayment would continue until the contribution was paid in full or 25 years had passed (in which case the outstanding contribution would be forgiven). Students could receive a discount if they paid the tuition up-front, but for the most part students chose to use the deferred payment system.[1]

[1] For a good background discussion on the creation of HECS, see Chapman, B. (1997) "Conceptual Issues and the Australian Experience with Income-Contingent Charges for Higher Education" *The Economic Journal*. Vol. 107 (442): 738-751.

The benefits and drawbacks of such a system largely depend on one's vantage point. Clearly, this type of loan repayment system is superior to the one students have in Canada; most importantly, no real interest is charged on the loan in repayment, which saves students considerable sums of money over the long term. However, students often see the whole system as a negative because students are worse off with HECS than they were prior to its introduction when no fees existed. The counter-argument is, effectively, that it could have been a lot worse – *given* that tuition fees were going to be imposed, HECS made the burden of fees much easier to bear through a combination of subsidies (i.e. no real interest on the loans, easy repayment terms). We will return to the complex intertwining of the issue of tuition fees and ICRs later in this paper; for now, suffice to say that, in part because of the Australian example, the two issues are identical in the minds of some. For most commentators, the key features of the HECS system are the following:

- universal coverage (anyone can benefit)
- no real interest on the loans[2]
- a lengthy (25 years or more) repayment period
- an income threshold below which no payments are required
- a fixed rate of repayment of marginal income above the threshold
- loan collection through the income tax system

While these six key program features are the core of HECS, most of HECS' imitators altered one or more features when they implemented ICR in their own countries. Sweden (whose system actually pre-dates Australia's) does not use the tax system for collection. New Zealand and the United States charged real interest on their loans (although New Zealand subsequently made exceptions for those students whose earnings were below the repayment threshold). South Africa means-tests its student loans, meaning they are not universally available. Both the United States and South Africa chose not to use the tax system to collect their income-contingent loans.[3] In fact, only the United Kingdom has fully adopted all six of these central features of the HECS system.

Adding to the confusion is that many loan programs which are not generally considered to be ICR also contain some of these HECS features. German BAföG loans are not usually considered to be an ICR program and yet they carry no interest and there is a threshold level of income beneath which no repayment is required. Dutch and Canadian loans also have threshold income levels below which no repayment is required, as do non-ICR loans in the United States. Norwegian loans are not ICR but all students may borrow without a means test – this

[2] Real interest refers to interest net of inflation. The HECS system links the value of the outstanding contribution to the consumer price index but does not charge additional interest on top of this.

[3] For an excellent summary of the features and histories of various ICR systems, see Chapman (2005), "Income Related Student Loans: Concepts, International Reforms and Administrative Challenges" in *Cost-Sharing and Accessibility with Respect to Higher Education in Mature Economies*. Dordrecht" Kluwer Academic

was also true of UK loans prior to the introduction of ICR there and continues to be true of US "Stafford Unsubsidized" loans.

Finally, it should be noted that only two of these features – the threshold for non-payment and the fixed rate of repayment above it - actually have anything to do with income and repayment. The rest are ancillary features that could be attached to any loan: home mortgages in Canada, for instance, are usually 25 years, but that does not make them income-contingent. Universal coverage is a feature of eligibility, not repayment. The tax system is a means of collection, but could equally be used to collect any other kind of debt as well (indeed, the Government of Canada has been garnishing the tax refunds of defaulted student loan borrowers for almost a decade now).

Even this very brief policy tour shows is that ICR is not monolithic and that the boundary between "ICR" and "non-ICR" programs is blurry as well. Therefore, generalizations about "ICR" or its alleged opposite of "mortgage-style" loans should be treated with great caution. However, beneath this policy cacophony there are in fact two distinct melodies in the world of student loan repayment, which are explored below.

"Hard" and "soft" varieties of ICR

Broadly speaking, there are two "streams" of ICR which for the sake of convenience we will call "hard" and "soft". Hard ICR programs include Australia, New Zealand, South Africa, the "income-contingent" loan stream in the United States[4] and the new system of loan repayment in the UK. Soft ICR programs include the balance of the US student loan system, Canada, the Netherlands and Germany.

All these systems should be considered as formally income-contingent because all of them have some income threshold below which no repayment is required, hence making repayment of a loan to some degree contingent upon income. What distinguishes hard ICR programs from soft ones is the existence of fixed rate of repayment once the threshold is exceeded: "hard" ICR systems have it while "soft" ones don't (above the threshold, repayments revert to a mortgage-style repayment system). The main features of the various programs are summarized in Table 1.

[4] Under the US Direct lending program, borrowers in repayment may choose one of four repayment options: "standard", which is a traditional 10-year loan; "extended", which is the same but which can last from 12-30 years; "graduated", in which monthly payments start low and then rise every two years over a period of 12-30 years, and finally "income-contingent", described above. Borrowers choose one stream at the time they consolidate their loans but are free to switch back and forth between repayment programs at any time. In the three non-ICR streams, students with subsidized loans (i,e, equivalent to Canada Student Loans) who experience difficulties in repayment may request a "deferment" in payments, during which time no payments need be made and the Government pays the interest in the loan. Students with unsubsidized loans can receive "forbearance", which means they do not have to pay anything on the loan, but interest accrues on the loan during the forbearance period.

Table 1 – Features of Different Income-Contingent Loan Programs

	Type of ICR	Threshold for Repayment	Fixed Repay-ment Rates	Extended repayment period	Universal Coverage	Use of Income Tax System	Interest Subsidy in Repay-ment	Possibility of Negative Amor-tization?
Australia	Hard	Yes	Yes	Yes	Yes	Yes	Yes	No
New Zealand	Hard	Yes	Yes	Yes	Yes	Yes	Partial	No
UK	Hard	Yes	Yes	Yes	Yes	Yes	Yes	No
South Africa	Hard	Yes	Yes	Yes	No	No	Yes	No
US ICR	Hard	Yes	Yes	Yes	Yes	No	No	Yes
US non-ICR	Soft	Yes	No	See footnote 4	Yes	No	No	See footnote 4
Netherlands	Soft	Yes	No	No	Yes	No	No	No
Germany	Soft	Yes	No	No	No	No	Yes	No
Canada	Soft	Yes	No	No	No	No	No	No

Table 1 clarifies certain aspects of ICRs in international context. In order to be considered an ICR program, a program needs to have a threshold below which no repayment is required, making loan payments at least minimally dependent on income. Fixed repayment rates – that is, rules stating that a students must pay a certain percentage of income in loan repayment – is *not* a condition of ICR, though possession of one is the defining characteristic of a hard ICR. Use of the income tax system in repayment is not an essential conditions of an ICR, though it certainly reduces administration costs in loan collection. Universal coverage (i.e. anyone may borrow, regardless of income or need) is used in several ICR systems, but as noted above it is not an integral aspect of an ICR system.

Hard ICRs, Interest Subsidies and Extended Repayment

Hard ICR programs (nearly) all have two policy correlates which, though essentially income-contingent have major effects on the costs of the program to governments and students. The first is the existence in nearly all cases of a real interest subsidy and the second is the extended period – usually 25 years – over which a loan or deferred contribution is repaid.

The reason for the interest subsidy should be self-evident. The whole point of an ICR program is to protect a borrower from default in situations where his or her income may not cover the monthly amortization costs of the loan. Yet simply because the borrower is excused from paying the full amount of interest and principal on a monthly basis does not mean that the time-value of money changes,

and someone must pay the interest cost of the loan during this period of repayment deferral.

If it is the student who is asked to pay this interest cost, then there exists the possibility of "negative amortization" – that is, the size of the outstanding loan can grow to be larger than the original principal. For instance, imagine a loan program which had a threshold repayment level of $10,000 and an 8 percent rate of repayment on all income above this level. Now imagine a recent graduate making $20,000 per year carrying a $20,000 loan that carried a five percent rate of real interest. Just to cover the real interest in the loan, the student would have to make $1,000 in repayments, yet the formula only requires the borrower to make $800 ([$20,000 - $10,000] x .08). At the end of the year, the graduate ends up with a remaining balance of $20,200, or $200 more than at the start of the year. In theory, graduates with persistently low income could see their outstanding loan balances increase consistently each year, thus burdening them with ever-larger amounts of debt.

For the most part, negative amortization does *not* occur in hard ICR systems because there is no real rate of interest. New Zealand initially did have a problem with negative amortization, but changed its rules so as to suspend charges of real interest if a student's income fell below the repayment threshold. Neither – interestingly enough – does negative amortization occur in soft ICR systems, all of which have some variation of the Canada Student Loans Program's Interest Relief program. These programs suspend repayments of both interest and principal for individuals undergoing a period of low income and, where interest is not already subsidized, pays the interest on the student's behalf during the period of repayment suspension. In fact, the only place where negative amortization does occur is in the American ICR system, which happens to be the only hard ICR system which does not subsidize interest.

One could argue that there is nothing wrong with negative amortization – that although the nominal principal may grow, the net present value of the debt never does. Moreover, it could easily be argued that there are some benefits to negative amortization; after all, the alternative to negative amortization in an interest bearing loan is default and bankruptcy. And while many students might face negative amortization in a single year, the vast majority could be expected to break the negative amortization cycle quickly and repay their loans with little or no distress. Yet there will always be a few students for whom this will not be the case and who will face a spiral of increasing debt – and for these students, an ICR that permits negative amortization is a bad policy.

At a larger level, however, the fundamental argument against negative amortization is that it is political suicide. Very few voters perceive as fair a regime where student debt – which after all is incurred by people with very little financial sophistication and a low or unsteady income in the immediate post-graduation period – continues to grow after graduation. This is true also of students; in the US direct lending program, where students are given a choice of which of four re-

payment streams they wish to enter, only 7 percent choose the ICR option, the lowest of any of the four streams.

The importance of the relationship between hard ICRs and interest subsidies is underlined by the other common feature of hard ICRs: that is, the extended repayment period. In a normal loan, a longer amortization period inevitably means more interest will be charged. For example, a $20,000 loan with 6 percent interest paid over 10 years will have monthly payments of $222/month and incur $6,645 in interest charges on top of the principal. A similar loan paid over 25 years will require monthly payments of just $129 per month but incur $18,658 in interest on top of the principal. Generally speaking then, if one is concerned about paying too much interest, one should repay a loan in the shortest period of time possible.

In most hard ICR programs, though, this problem does not arise. With the government paying the interest, borrowers have no incentive to repay early and no penalty for repaying at their leisure – a long repayment period is an unmitigated boon to the borrower. Indeed, those who remain poorest the longest actually receive the largest subsidy. In the US system, on the other hand, the incentives run the other way. If one actually takes 25 years to repay an ICR loan in the US then not only does one face the possibility of negative amortization, but also the prospect of much higher interest payments as well. Moreover, the highest interest charges would fall on those borrowers who had low income for the longest period of time.

Proponents might point out that no one would force people to extend the repayment over 25 years and that early repayments could be made, thus eliminating the problem for those borrowers who could afford it. While technically correct, it is unlikely that such a system could be easily administered through the tax system, which is one of the alleged primary benefits of income-contingent loans. The lesson for ICR proponents, in short, is this: successful hard ICR programs have real interest subsidies, because interest subsidies are the simplest way to make two politically unattractive side-effects of hard ICRs - negative amortization and excessive interest charges – disappear.

Common Claims Made in Support of ICR

Primarily, ICR is supposed to have two positive outcomes: first, that it is more efficient and is therefore less costly to run than other loan schemes and second, by acting as a type of insurance scheme, that it will improve access to post-secondary education. These two central claims will now be examined.

Are Income-contingent Programs Cheaper to Run Than Other Types of Programs?

Inherently, income-contingent systems should be *more* expensive to run rather than less expensive. Under a mortgage-style system of loan repayments, income need not be taken into account at all. A repayment schedule is drawn up once, at the start of repayments, and is adhered to for the balance of the repayment period. Income-contingent loans, on the other hand, require constant re-evaluations of repayment amounts. In fact, when the Governments of Ontario and Canada discussed implementing an ICR program with the major chartered banks in 1997, the banks turned the Governments down flat because it was too complicated to run.

The only way that income-contingent loans become cheaper than regular loans is if loan collection is handled through the tax system, as is done in Australia, New Zealand and the UK. In this case, there are definite savings to be had: administrative costs in HECS are about 4 per cent of annual receipts or $12 million per annum[5]; in contrast, the Government of Canada's planned spending on loan collection costs for 2005-6 is just over $123 million.[6] Even allowing for the fact that the Canada Student Loans Program has more borrowers owing more money than Australia's HECS, Australians' use of the income-tax system appears to be a more cost-effective collection mechanism.

From a financial point of view, collecting student loans through the income-tax system should be uncontroversial. That is not, however, the way some tax officials see it. A major source of resistance to income-contingent loans in both Canada and the U.S. has in fact been the two countries' respective tax-collectors. They believe that ICR opens the door to using the tax system to collecting all sorts of debts and this, they fear, might put in jeopardy citizens' willingness to truthfully self-report their income. Since this is the foundation on which the efficient administration of tax collection is based, tax officials' reluctance to go down this road is perhaps understandable. But while this is an important countervail-

[5] See Chapman, B., Freiberg, A., Quiggin, J. and Tait, D. *Rejuvenating Financial Penalties: Using the Tax System to Collect Fines*. Canberra: Australian National University Discussion Papers. Available at: http://econrsss.anu.edu.au/pdf/DP461.pdf

[6] Figure is taken from Annex 12 of the 2004-5 Human Resources Development Canada Report on Plans and Priorities and includes costs for "collection costs" (i.e. collection agencies), "service bureau" (i.e. Edulinx) and "risk premiums" (still being paid on loans taken out prior to 2000 but only now going into repayment).

ing consideration, it does not alter the basic calculus – using the tax system to collect student loans has the potential to be efficient and cost-effective.

Do Income-Contingent Loans Improve Access to Education?

We have already demonstrated that Income-Contingent Loan repayment is beneficial to low-income graduates because of the protection it affords those whose incomes are temporarily low. The crucial question is: does ICR improve access to education? Despite what is sometimes claimed[7], the answer is that ICR's possible effects on access are slight at most and more likely zero. To understand why, it is important to understand the nature of the three basic types of financial barriers to post-secondary education.[8]

The first type of financial barrier is a "cost-benefit" barrier. What this means is that certain people, when examining whether or not to attend post-secondary education, decide that the combined cost of attending (i.e. the cost of tuition plus the cost of foregone income during the period of studies) will be higher than the expected return from the degree. This view may or may not be "objectively" correct; in fact, there is a good deal of evidence that incorrect information regarding the costs and benefits of education may be a significant cause of under-investment in education among low-income individuals. The point here is simply that the individual does not view the investment as a good one.

Can income-contingent loans do anything to alleviate this financial barrier? Here, the answer is "no". All that matters is tuition, length of study and the expected return on investment. Student aid – specifically, grants, which reduce the net cost of tuition - can play a role in overcoming this barrier. However, a change in the method by which loans are repaid should have no bearing whatsoever on this calculation.

The second type of barrier is a cash-constraint or "liquidity" barrier. What this means is that some individuals, having decided that the benefits of a post-secondary education outweigh the costs, find that they cannot put together sufficient funds from savings, employment income, transfers from family members and various forms of scholarship, grants and loans in order to attend. The individual wants an education, believes it to be a good investment but doesn't have the means available to attend at that point in time.

Can income-contingent loans do anything to alleviate this financial barrier? Certainly, the *amount* of available financial aid plays a role here in that the total

[7] See for example Duff and Alarie (2004), *An Income-Contingent Financing Program for Ontario*. Not all ICR proponents make this claim; in fact, one of the best known advocates of ICR, Dr. Nicholas Barr of the London School of Economics, specifically denies that any loan-repayment mechanisms would have any effect – positive or negative – on access to education.
[8] For a longer discussion on the different types of financial barriers, see Junor and Usher (2004), chapter 3.

amount of loans and grants available to an individual student will affect individuals' liquidity constraints. But there is nothing inherent in an ICR program to determine the amount of assistance available – it is after all, just an alternate means of repaying outstanding loans regardless of their size. On their own, the repayment conditions of a loan should not affect the liquidity barrier one iota.

The third type of barrier is debt aversion, which economist Richard Thaler once described as an "internalized liquidity constraint".[9] That is to say, an individual may decide that the benefits of post-secondary education outweigh the costs *and* may have access to enough funding in order to attend *but* refuses to use all the funds to which he/she has access because some of these funds are repayable and an individual does not wish to borrow.

This is the one barrier that income-contingent loans might conceivably have a role in alleviating. But whether it does or not hinges on what one believes to be the causes of debt aversion. If one believes that debt aversion is simply a form of risk-aversion, then indeed an ICR system should make a difference because it eliminates the possibility of default. However, debt aversion and risk aversion are probably not the same thing. Data from the recent Post-Secondary Education Participation Survey (PEPS) suggests that over half of the youth who indicated some form of debt aversion stated that under no circumstances would they borrow *any* amount for their education.[10] This suggests an aversion to debt itself rather than an aversion to risk. It is in any case known that much debt aversion has a cultural element – strict Muslims, for example, are unlikely to be any keener on interest-bearing income-contingent loans than they are on interest-bearing mortgage-style loans. Given that risk-aversion plays only a subsidiary role in debt-aversion, the likely effect of ICR on alleviating this type of barrier will be small as well

In sum, whatever its merits as a means of making loan repayment easier, there is no obvious reason why income-contingent loans would have any effect on access to education, either positively or negatively. Access is far more likely to be affected by tuition (cost) on the one hand, and the amount of grants and loans available on the other. Only at the most extreme margin might the manner of debt repayment have an effect on access.

---

[9] Thaler, R. (1990) "Anomalies: Savings, Fungibility and Mental Accounts" in *Journal of Economic Perspectives*, vol 4, no. 1 (Winter 1990) pp.193-205.

[10] Finnie, R and Laporte, C. (2003) *Student Loans and Access to Post-Secondary Education: Preliminary Evidence From the Post-Secondary Education and participation Survey*. Paper given at the "Pathways to Access" Conference, Ottawa, Oct.2, 2003.

Common Claims Made in Opposition to ICR

Opponents of ICR programs make many allegations about the pernicious effects of ICRs. Two of these stand out in particular: first, that ICR systems and rises in tuition go hand-in-hand and second, that ICR programs "force" graduates into taking higher-paying jobs instead of lower-paying, more socially useful ones. We will examine both of these in turn.

ICR and Tuition Rises: Are they linked?

One of the persistent Canadian critiques against ICRs (and in this instance, critiques of ICR means critiques of "hard" ICRs) is that they are synonymous with tuition increases. The argument that is made is as follows: the flexibility of ICR systems make student debt less of a burden. As a result, students are able to take on more debt and this in turn gives governments an opportunity to raise debt levels, which they do by increasing both tuition and borrowing limits.[11] This argument is, to say the least, peculiar when it is combined with an anti-fee message. In effect, it says that making student assistance better makes tuition increases more likely; therefore, in order to keep tuition down, improvements in student assistance should be resisted. Presumably, the logical conclusion to this argument is that in order to reduce or abolish tuition, one must first reduce or abolish student assistance.

Whatever the logical flaws of this argument, history does give some succour to those who argue in favour of the existence of the tuition-ICR link. In 1945, the economist Milton Friedman wrote an article which is often cited as the start of the ICR debate.[12] Technically, Friedman's article was not about loans at all: in fact, Friedman argued that loans were unsuitable for investments in human capital and that what was needed was a system of *equity* financing, where financial instruments could be provided to students exchanging short-term cash for a long-term share of the student's increased earning potential. If this were done by governments, it would be in effect a graduate "tax"; if it were done by a commercial venture it would be an equity "instrument" (although some less flattering and not altogether fair comparisons to indentured servitude could – and have been – made to this idea). Regardless of his views on equity versus loans, however, Friedman's writings were generally interpreted as an interesting way to give students cash in the short term which could be repaid in the long term.[13]

---

[11] For an example of this argument, see the Canadian Federation of Students' Factsheet on Income-Contingent Loan Repayment Schemes, available at www.cfs-fcee.ca/html/English/campaigns

[12] Friedman, M. "The Role of Government in Education," in Robert A. Solo, ed., *Economics and the Public Interest* (New Brunswick, N J.: Rutgers University Press, 1955).

[13] Student loans for educational finance were still rare internationally at the time. Small programs were available in Colombia and Sweden at the time, but nowhere else. Canada did not start using student loans until the 1960s.

Crucial to the later development of the idea, however, is the fact that Friedman suggested this idea in the context of students paying the full cost of their education. From the start, therefore, ICR programs have been associated with higher tuition fees. Yet the two ideas are not inextricably linked in practice, as any survey of ICR countries shows.

The first country to put income-contingent loans into practice was Sweden, in 1986, which was a zero-tuition jurisdiction at the time and remains so today. Similarly, when Yale University tried to put a form of Income-Contingent loans in place for its own students in 1971, it was not done in the context of a large rise in fees, although clearly these were already fairly substantial. One student who used the Yale ICR in the early 1970s was future President Bill Clinton, who liked the experience so much that the introduction of ICRs became a plank in his 1992 election platform.[14] When ICRs were introduced in the US 1994, it was done without any changes in national tuition policy.

This is not to say that ICRs have consistently been introduced in a tuition-neutral environment. Australia's introduction of HECS and New Zealand's adoption of a similar program in 1992 are two well-known examples of ICR policies being introduced in conjunction with tuition policy changes, as do recent policy changes in the UK. In Canada, those advocating ICR - e.g. Stager (1989), West (1993), Government of Canada (1994) - have for the most part been advocated it either as a means to higher tuition or in a context where an imminent increase in tuition is taken as a given. In these contexts, the argument that ICR is linked to tuition fee increases is obviously much more plausible.

In sum, it is true that in certain countries (Canada among them), ICR has been used or advocated for use by those who also supported tuition increases. However, it is equally true that ICRs have been introduced with no changes in tuition policy and that the two ideas are not linked as a conceptual level. It is therefore a mistake to assume *a priori* that any ICR proposal will necessarily entail increases in tuition.

Do ICRs force students into higher-paying, less socially useful jobs?

This is an interesting argument if only because it stands certain ICR features on their heads. ICR is meant to be an insurance scheme, helping people during periods of low-income. Some ICR proponents have even suggested that ICR is therefore well-suited to help people who wish to pursue public-service careers.[15] Yet, opponents sometimes make the claim that ICR will do precisely the opposite and "force" students to take high-paying jobs at the expense of taking lower paid jobs that might be more interesting and/or socially beneficial. Is this true?

---

[14] Clinton, B. (2004), *My Life*. New York: Knopf p. 214-5

[15] Clinton, ibid. Brody, E (1994). "Paying Back Your Country Through Income-contingent Loans", *San Diego Law Review* vol 31: 449-518.

Leave aside for a moment the casual and highly contestable formulation that higher paying jobs are ones that provide less social benefit. Leave aside also the implicit assumption that recent graduates without loan debt are regularly turning down high-paying jobs to take lower-paying ones. There have been no empirical studies done linking the type of loan repayment with post-graduation job choice, so technically it is impossible to prove or refute this assertion definitively. But let us examine for a moment how it *might* be true by comparing the consequences of a period of low-income to borrowers in both an ICR and a non-ICR system.

A borrower with low-income in a non-ICR system faces some ugly prospects: if they cannot make their loan payments, they will face default and bankruptcy. Even though bankruptcy carries less stigma than it used to, this still has some long-term consequences in terms of higher borrowing costs in the long term.

A borrower with low-income in an ICR system, on the other hand, faces one of two different scenarios depending on how the ICR is structured. Under the Australian HECS system (and indeed all hard ICRs with a real interest subsidy), Canada's Interest Relief Program, (and all other soft ICRs), the borrower is completely protected. The student is not required to make payments during the low-income period and governments pay the interest on the loan during the suspension of payments.[16] No prospect of default or bankruptcy exists in this scenario. Under the US Income-Contingent program (a hard ICR program without an interest subsidy), the student is similarly protected from default and bankruptcy and is exempt from immediate payments. The borrower's outstanding balance will increase, however, because of the phenomenon of negative amortization described earlier. Of these two scenarios, the first is clearly preferable from the student's point of view.

Given these various scenarios, is it really tenable to suggest that ICR program are so much worse than non-ICR programs for low-income borrowers that they will be forced into higher paying jobs that they don't "really" want? If the ICR is of the Australian or Canadian variety the answer is clearly "no". These programs are far more generous to graduates with low paying jobs than non-ICR programs; in fact, these programs are arguably extremely progressive in that they provide the greatest subsidy to those who have the longest periods of low-income. If the ICR is of the American variety the answer is a little more nuanced as negative amortization is clearly a downside and it forces students into a trade-off – if the student dislikes the negative amortization more than she dislikes her less preferred high-paying job, she will take the job; if not, she will tolerate the negative amortization. The effects of ICR on job choice therefore depend vitally on program design details; the notion that ICR "must" result in restricted career choice cannot be sustained.

[16] In this respect, the Canadian system is more generous that the Australian – HECS only subsidized real interest; Canada's Interest Relief program pays nominal interest, thus reducing the student's remaining loan balance lower in real dollars.

There is of course another change in access policy that might affect student career choice: namely, fees. If fees go up, then they will affect the cost/benefit calculations of those wishing to enter a field of study will be changed (although the evidence suggests that the change in fees has to be very large indeed before any noticeable large scale behavioural changes occur). To the extent that tuition changes accompany any introduction of ICR, there may be some effect on career choices. But, again, this is an effect of tuition rather than an inherent trait of ICRs. Of themselves, the effects of ICR on career choice should either be positive or neutral

Conclusion: Does Canada Need an Income-Contingent Loan Program?

Given recent developments in Quebec and expected developments in Ontario following the publication of the Ontario Postsecondary Review, the question on the minds of many policy-makers and stakeholders is whether or not Canada should adopt an ICR system. Yet this is a profoundly misleading question: although it is not widely recognized as such, Canada already *has* an income-contingent loan system. The question is whether or not Canada wishes to adopt one or more of the features of a hard ICR system: universal coverage, fixed rates of repayment, use of the income-tax system in repayment, longer repayment periods and interest subsidies in repayment.

Unfortunately, these significant subtleties are unlikely to be captured in the coming debate. ICR opponents will argue their case against ICR on the grounds that tuition will rise and negative amortization will occur; neither of which is necessarily true, as we have seen. ICR proponents – a much less homogenous group than their opposite numbers – will cite some of the recognized benefits of the Australian HECS system, such as universal availability of loans and use of the tax system for collection, neither of which is inherently a feature of ICR.

As a result, the coming debate will be a sterile one. It is too easily forgotten that Canada already has its own system of ICR, even though it dares not call itself by that name. While it is true that certain elements of Australia's repayments system would be of help to borrowers in repayment, it is most unlikely to result in any improvement in access to post-secondary education. At most, these program features would result in marginal improvements in repayment efficiency and increased ease for borrowers to repay their loan. And yet even this is less of a boon than it seems: as it is, only about 30% of student loan borrowers currently say they experience any difficulty in loan repayment, a figure which has not changed significantly over the past decade.[17]

[17] See Junor and Usher (2004), chapter 6.

It is therefore not entirely obvious what pressing problems the introduction of a hard ICR program would solve that other approaches could not achieve just as well. It may be more sensible, given the negative connotations that ICR has accumulated over the years, to abandon discussions of ICR *per se* and concentrate instead on the actual program features that appear to be of value. Universality of loan provision is something that could be achieved simply by eliminating need assessment. Better protection of low-income students could be achieved through enrichment of the existing Interest Relief program. Blanket interest subsidies could easily be introduced, as could longer repayment periods. Each of these ideas has merit and could be more profitably debated on their own merits rather than being lumped into an inevitably emotive debate about ICR.

Fundamentally, income-contingency is a reasonably good idea. Most criticisms of ICR are actually criticisms of negative amortization or tuition hikes that in some instances accompany ICR, rather than criticisms of the concept of income-contingency itself. In Canada, for instance, most critics of "ICR" would react with horror if anyone suggested cutting the very income-contingent Interest Relief program. But income-contingency, whether of the hard or soft variety, is not a silver bullet and given its inherent limitations it is hard to argue that any type of ICR is a priority, let alone an urgent one. Far more pressing is the need to provide more grants to low-income students and more loans to those for whom present levels of assistance are inadequate. The ICR debate has the potential to be a distracting sideshow from the more important tasks at hand in improving Canada's student aid system.

References

Brody, E (1994). "Paying Back Your Country Through Income-contingent Loans", *San Diego Law Review* vol 31: 449-518.

Canadian Federation of Students' Factsheet on Income-Contingent Loan Repayment Schemes, available at www.cfs-fcee.ca/html/English/campaigns

Chapman, B. (1997) "Conceptual Issues and the Australian Experience with Income-Contingent Charges for Higher Education" *The Economic Journal*. Vol. 107 (442): 738-751.

Chapman (2005), "Income Related Student Loans: Concepts, International Reforms and Administrative Challenges" in *Cost-Sharing and Accessibility with Respect to Higher Education in Mature Economies*. Kluwer

Chapman, B., Freiberg, A., Quiggin, J. and Tait, D. *Rejuvenating Financial Penalties: Using the Tax System to Collect Fines*. Canberra: Australian National University Discussion Papers. Available at: http://econrsss.anu.edu.au/pdf/DP461.pdf

Clinton, B. (2004), *My Life*. New York: Knopf

Duff, D and B. Alarie (2004). *An Income-Contingent Financing Program for Ontario*. Mimeo. Paper presented at the "Taking Pubic Universities Seriously" conference, Toronto, December 3-4 2004.

Friedman, M. (1955) "The Role of Government in Education," in Robert A. Solo, ed., *Economics and the Public Interest* (New Brunswick, N J.: Rutgers University Press.

Finnie, R and Laporte, C. (2003) *Student Loans and Access to Post-Secondary Education: Preliminary Evidence From the Post-Secondary Education and participation Survey*. Paper given at the "Pathways to Access" Conference, Ottawa, Oct.2, 2003.

Government of Canada (1994). *Improving Social Security: A Discussion Paper*. Ottawa.

Government of Canada (2004), *2004-5 Human Resources and Skills Development Canada Report on Plans and Priorities*. Ottawa

Junor and Usher (2004), *The Price of Knowledge 2004*. Montreal: Canada Millennium Scholarship Foundation

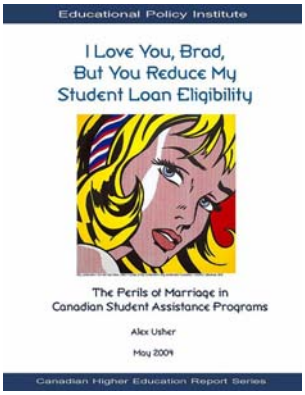
Stager (1989) *Focus on Fees*. Toronto: Council of Ontario Universities

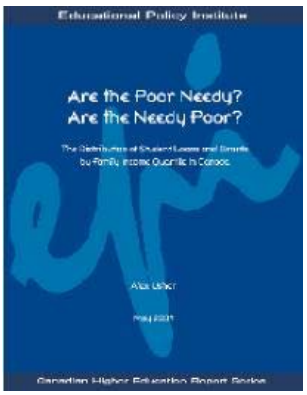
Thaler, R. (1990) "Anomalies: Savings, Fungibility and Mental Accounts" in *Journal of Economic Perspectives*, vol 4, no. 1 (Winter 1990) pp.193-205.

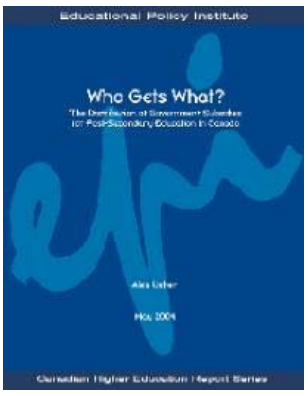
West, E. (1993) *Ending the Squeeze on Universities*. Montreal: Institute for Research on Public Policy.

The Canadian Higher Education Report Series

This publication is part of the Educational Policy Institute's Canadian Higher Education Report Series. Please visit our website (www.educationalpolicy.org) to download other reports in the series:







www.educationalpolicy.org