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Evidence-based policy making

Income-contingent loans in higher education financing

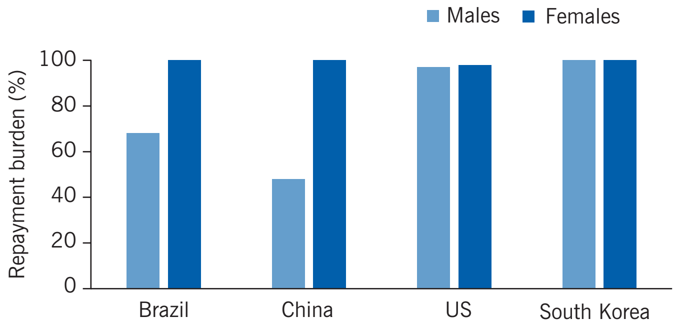
Internationally, there has been a student financing revolution toward income-contingent loans

Keywords: income-contingent loans, time-based repayment loans, consumption smoothing, default insurance, repayment burdens

ELEVATOR PITCH

Around ten countries currently use a variant of a national income-contingent loans (ICL) scheme for higher education tuition. Increased international interest in ICL validates an examination of its costs and benefits relative to the traditional financing system, time-based repayment loans (TBRLs). TBRLs exhibit poor economic characteristics for borrowers: namely high repayment burdens (loan repayments as a proportion of income) for the disadvantaged and default. The latter both damages credit reputations and can be associated with high taxpayer subsidies through continuing unpaid debts. ICLs avoid these problems as repayment burdens are capped by design, eliminating default.

Repayment burdens of time-based repayment loans for poorest 20% of graduates



Note: Burdens in excess of 100% are shown to be capped at that level.
Source: Based on Figure 1.

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KEY FINDINGS

Pros

- ICLs deliver consumption smoothing by reducing or eliminating student loan repayment burdens on disposable income when debtors' future incomes are low.
- By coupling loan repayment amounts to a debtor's actual income, ICLs provide insurance against default.
- ICL debt can be collected efficiently if functional tax and personal identification systems are in place.

Cons

- TBRLs have the strong potential to create major repayment difficulties for borrowers.
- TBRLs do not provide debt default insurance for borrowers.
- TBRLs can lead to credit reputation loss for the borrower due to default.
- Systems based on TBRLs create inequality in educational access due to a high fear of future debt default by low-income prospective students.
- ICLs have sophisticated administration requirements that may be unachievable for some countries.

AUTHOR'S MAIN MESSAGE

ICLs possess considerable benefits (when compared to TBRLs), providing insurance to borrowers against both future loan repayment hardships and default. In contradistinction, TBRLs can be very costly to some borrowers who experience periods of low future income. In general, the public sector administration costs of an ICL scheme are very small for countries that have a comprehensive income tax or social security payment administration in place. This, in combination with the additional borrowers' insurance benefits, suggests strongly that ICL policies are preferable to the standard TBRL model. This appears to be particularly true in weak graduate labor markets, such as those experienced during the economic stagnation associated with Covid-19.

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