

Submission to the Financial Sector Enquiry
Privately Financed Income Contingent Loans (ICL) for Individual Workers

Summary

Mirroring the diversity of its resource base and population centres, and its geographical vastness, Australia has a dispersed yet inter-related network of labour markets. External shocks, and their associated real exchange rate movements, create significant and well-known challenges for policymakers in a small open economy. No less significant, however, are the potential difficulties for individual workers and their families who, faced with scarce employment opportunities, must relocate.

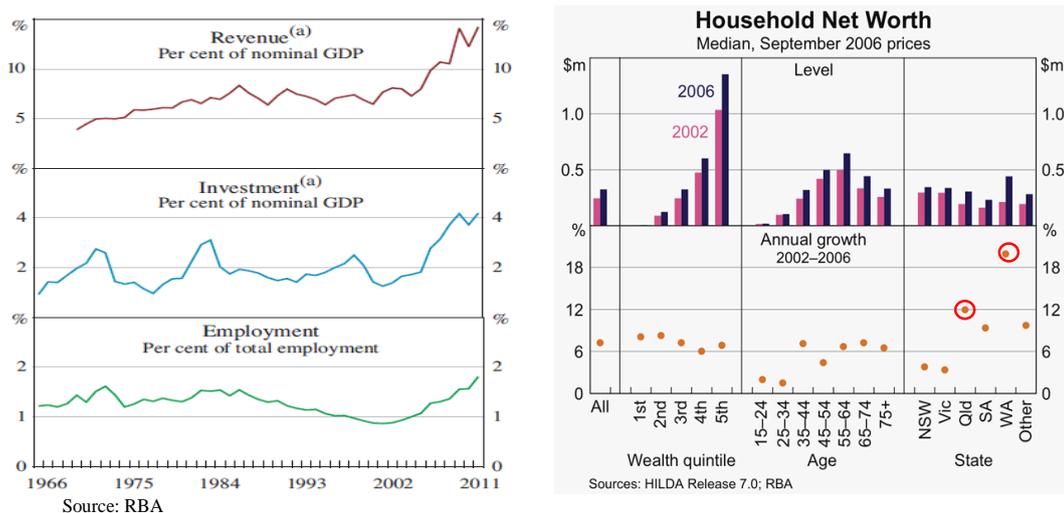
This submission proposes income contingent loans (ICL) for retraining and relocation expenses partially insured by the Federal Government and collected via the income tax system. We propose the loans be provided by private financial institutions, using their likely comparative advantage in selecting and screening borrowers. The market failure addressed is the familiar problem motivating all government intervention in post-compulsory schooling education investments, the unwillingness of banks to lend in the presence of risk and the absence of collateral.¹

Motivation

Australia is a Mobile Country

An ongoing example of the realignment of labour in response to an external shock is the resources boom. A decade of strong mining revenue growth had drawn in both capital and labour into Mining (left panel), disproportionately located in the ‘mining states’ of Queensland and Western Australia. Household wealth in mining states grew rapidly, reflecting higher returns to both factors (right panel).

Figure 1: The Resources Boom



¹ For a full explanation of this issue, see Chapman (2006).

With mining investment now waning, capital and labour drawn by in the resources boom are increasingly facing poorer prospects.

Why income contingent loans?

In general, for training and retraining purposes it is not possible to borrow against future income (assured or probable) within the institutional framework of the current financial system, and one possible solution to this problem is the use of income contingent loans.

ICL, collected through the income tax system, began as a policy innovation to facilitate the reintroduction of university tuition fees in Australia in 1989. Once the system appeared to be administratively feasible, and politically acceptable, the Australian template encouraged the governments of other countries to adopt similar approaches. It would be fair to suggest that there has been a quiet revolution internationally in the way that student loans have been designed, and recent events in countries such as the US imply strongly that the trend towards ICL is continuing.

While the original motivation for contingent approaches to higher education financing was documented over 50 years ago by Milton Freidman, some of the more sophisticated aspects of ICL have been understood properly only over recent decades. These include the fact that ICL essentially offer insurance to borrowers against both consumption hardship and default, advantages which are unavailable through the use of traditional mortgage-type systems of student loans.

In a forthcoming book Chapman, Higgins and Stiglitz, (2014) report the proceedings of a high-level International Association workshop, held in Bangkok in April 2103, on the theory, policy and prospects for the use of ICL in a disparate range of potential economic and social policy reforms. A strong advocate of the potential for the use of ICL, Joseph Stiglitz, writes:

“ICL represents an efficient (low transactions cost) way of implementing equity contracts for human capital. While it seems natural to link ICL with investments that increase the value of human capital—most notably education—there is no necessary reason to limit it to such investments.”
Stiglitz (forthcoming 2014)

His analysis also highlights the issue of ‘transactional efficiencies’ and makes a strong case that governments are particularly well-placed to be engaged in financial intervention in many areas of economic behaviour because the use of the internal revenue service as a loan collection agency is an extremely efficient, as well as equitable, way to collect debt.

Chapman, Higgins and Stiglitz (forthcoming, 2014) is the outcome of a history of research and policy analysis in the area, and can be traced to a series of papers from the late 1990s involving ICL applications in areas as diverse as for the financing of: tertiary education income support; drought relief; community investments into social and community projects; the payment of low level criminal fines; legal aid expansion; the purchase of energy efficient devices, and extensions of paid parental leave.

A critical insight into the potential of ICL to be applied to a host of other social and economic reforms is that the instrument fits comfortably into the intellectual and policy space of government as a manager of risk. Thus while some of the research applications of ICL well beyond student loans are apparently novel and arguably unprecedented, they are not a long way from some increasingly commonplace perceptions of the role of the public sector in many other areas.²

It is clear that the disparate areas of potential financing ICL are very diverse, but there are some striking similarities in terms of their conceptual and potential policy basis, including:

- (i) *They are all associated with a recognised area of either market or government failure;*
- (ii) *They all involve the use of the income tax system, often in different ways, to collect debt, a point which can be traced in general to the transactional efficiencies associated with the use of the government's income tax monopoly powers;*
- (iii) *Given that repayments of debt in all these areas are based on capacity to pay they have the two insurance advantages of consumption smoothing and default protection;*
- (iv) *There is a significant potential for improvements being made in the areas of both efficiency and equity given well-designed ICL interventions; and*
- (v) *Very importantly, in all policy areas there is the possibility of both adverse selection and moral hazard to undermine the value of the ICL intervention. Indeed, much of the modelling energy associated with the analyses has been related to design issues of ICL motivated by the need to minimise revenue loss from non-collection which can be traced to adverse selection and moral hazard.*

This last point is the key policy issue, since the effective design of ICL instruments depends critically on design features that deal with both moral hazard and adverse selection. In an ICL context the moral hazard relates to the behavioral consequences of having the repayment of obligations depend on work (or business) effort and choices. Adverse selection concerns the real possibility that if the take-up of an ICL is voluntary (for example, as it would be with respect to paid parental leave) then it is clear that those most interested in the scheme would be those with the poorest prospects of repayment.

In what follows we give one such proposal as an example of what could be accomplished, though we acknowledge that many policy choices stand between design and implementation. The main benefit of the example is to show how the involvement of the financial sector could be welfare enhancing. We believe that the concept is arguably of interest to the Financial Sector Inquiry and provide more details in what follows to encourage further thought and debate with respect to such a possible reform.

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² For many of these applications and/or summaries, see Chapman (2006), *Australian Journal of labour Economics* (September 2009), and Chapman, Higgins and Stiglitz (forthcoming, 2014)

An Illustrative Proposal

In this proposal workers in a particular area or industry deemed eligible by the Commonwealth for an ICL would be allowed to enter a competitive financial market where intermediaries offered different packages, much as they do in the current market for loans. Contracts would be for workers with prospects for employment, but no definite job on offer. These workers might need a period of retraining, with significant related costs.

The advantage of involving private financial institutions is that they might offer more effective screening than central government screening. This point is explained comprehensively in Chapman and Simes (2006) in which the case is made for a government/private partnership for the financing of social and community investment projects. The scheme would reduce, but not eliminate, business risk, and would thus encourage greater private sector involvement in the financing of retraining than would otherwise be the case. The Chapman and Simes example suggests that, if designed well, such an arrangement could be revenue neutral.

Apart from more effective screening, another advantage of the use of private markets for these loans is that, unlike the funding of higher education where very few students can provide collateral, some of the potential ICL recipients will have collateral to post, and the menu of contracts available should be more nuanced, to reflect this.

The loans would be for worker education expenses, technological purchases relevant to the workplace and removalist fees. Importantly, though, the biggest need for those in retraining is for income support, up to a reasonable cap. There is a case for including education expenses for some family members who wish to retrain, since these people often bear significant external costs of a move.

The collection of the loan repayment will occur through the tax system, in the event that the worker, or any family member in receipt of assistance, goes above a HECS-style income threshold. Until such a threshold is reached, the debt grows at the interest rate determined in the market for these contracts and, as in HECS, the loan is never repaid if the worker fails to exceed the threshold. It is useful to note that analysis by Chapman, Higgins and Taylor (2009) illustrates that it is feasible and inexpensive for the government to collect debts for retraining purposes which take the form of income support for mature aged workers.

Since the repayments are collected via the income tax system, there would obviously need to be a financial agreement between the Commonwealth and the relevant institutions in which the loan is repaid at a set rate over time by the government. There is already a precedent for this type of arrangement: in 1994 the government instituted the Special Supplement Loan Program designed to increase financial resources going to Austudy recipients with the initial outlays provided to students coming from the Commonwealth bank (see Chapman, 1993).³

³ The scheme was discontinued in 2004..

Whatever the details, the Commonwealth would insure the institutions (perhaps not fully) against non-payment. Schemes such as this need to take into account the twin problems of adverse selection and moral hazard, to which we now turn.

Adverse Selection and Moral Hazard

ICLs exhibit the classic challenges of hidden action. Adverse selection (pre-contractual opportunism) occurs when pool of applicants is overrepresented by those who do not intend to work in the future, or to anyway not earn enough to reach any income threshold necessary for repayment. Moral hazard (post-contractual opportunism) occurs when the behaviour of the loan recipients changes in such a way as to thwart repayment.

One key risk factor is that, unlike the recipients of higher education funding, the ICL recipients may be mid- or late-career workers with a relatively short working life left. The relative attraction of the scheme for those wishing to retire at the earliest date possible (adverse selection) and the change in behaviour of those who, having taken out a loan, then decide on an earlier-than-planned retirement (moral hazard) will increase the exposure of the insurer, that is, the Commonwealth, to losses.

There are three ways in which the proposed scheme could redress moral hazard and adverse selection.

First, the use of private financial intermediaries taps into their skills for screening loan applicants, as we have already noted. Some of the applicants may have credit scores, or other indicators which will help the intermediary craft an appropriate contract.

Second, the insurer (the Commonwealth) will have the power to determine eligibility at a global level – for example offering entry into the ICL market to all workers in a major company that shuts down. They will not be generally available, so the total number of ICL market entry offers can depend upon the fiscal position of the Commonwealth at any point in time.⁴ The government can thereby manage its risk in much the same way as it now takes account of its higher education exposure when determining the number of university places on offer.

Third, and related to the last point, the Commonwealth can choose to offer ICL market entry to workers whose labour market position is clearly the result of an exogenous development, rather than a hard-to-unravel combination of choice and external circumstances. One of the difficulties in offering assistance to agents responsible for the fortunes of an enterprise, such as managers, is that the pool of applicants will be over-represented by those whose position is influenced by their own mistakes (adverse selection). On the other hand, offering ICL market entry to *the workers* in an enterprise adversely affected by poor management should replicate a more-or-less random sample of the population.

⁴ It is a matter of accounting how important this consideration would be. If the expected repayments appear as an asset, the effects will be attenuated. The exposure to default, though, is real enough, regardless of the accounting.

Of course, the Commonwealth may make the judgement that in a particular instance the management was not significantly at fault, being, for example, victims of a high exchange rate. It may even make the judgement that it wishes to accept a degree of adverse selection in the applicant pool because it wants to help people even if they are at fault to some degree. The only point being made here is that the power of the insurer to choose the pool of applicants provides a lever to choose the extent of adverse selection and moral hazard.

It may be possible, as a result of detailed design, to provide additional funding for ICLs by requiring successful applicants to forgo other welfare payments for a period of time (for example, eschewing unemployment benefits for a number of months). On equity grounds, this could be argued for on the basis that since ICLs are voluntary no one is being denied unemployment benefits. There are problems with time consistency, however, because someone who mishandles their ICL money, or is otherwise unlucky, may still find themselves in need above and beyond their culpability. It seems to be unreasonable, under these circumstances, to decline other payments. We flag this limitation to other payments as a possibility to be explored, but it is not central to the idea.

How would the proposed scheme compare with HECS?

It seems natural compare our proposal to the initial national ICL Australian Higher Education Contributions Scheme (HECS).

Table 1: Proposed ICL vs HECS

HECS	Proposed ICL	Comment
Target of spending (higher education) separately regulated for quality	Targets of spending regulated (training) and unregulated (income support, removalists)	Proposed ICL represent greater risk of spending on low quality items
Repayments collected via tax system	Repayments collected via tax system	
Missing market for future income	Missing market for future income	
Single contract, relatively homogenous loan recipients	Multiple contracts, heterogeneous recipients	financial sector is better placed to deliver proposed ICL
Government bears all risk	Government shares risk with financial intermediaries	ICL are a public-private partnership

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