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## Learning to Live With Loans? Policy Transfer and the Funding of Higher Education

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## 1. Introduction

Over the last twenty years of the twentieth century there was a remarkable increase in participation in higher education (HE) in a number of OECD and non-OECD countries (for details see OECD 1998 and Greenaway and Haynes 2000). In the case of the former, this was partly demand driven, with key factors being increased female participation and increasing private rates of return to a first degree. In some countries, it was also supply driven, with policy initiatives to increase the number of universities and increase publicly funded places to support development of the 'knowledge based economy'. 'New growth theory' points to human capital formation as a key driver of economic growth and in industrialised economies higher education appears to be especially important. Therefore, getting the policy environment right offers the potential for relatively high pay-offs, (see Temple 2000).

One of the key debates triggered by increased participation was how to pay for it. The debate on funding HE has been particularly lively in countries such as Australia, New Zealand and the United Kingdom since, historically, university education was publicly provided in the sense that tuition was free at the point of consumption. Whilst it was possible to sustain such a system in an environment of relatively low participation, it could not support mass higher education without a very serious diminution in quality. That triggered two questions: should the beneficiaries of HE make a larger contribution to the costs of provision and, if the answer to this question is 'yes', how and when should they make that contribution? The conclusion that has been reached in the countries we are interested in is that beneficiaries should indeed make a larger contribution but that, rather than making this up-front, they should do so on a deferred basis, after they have graduated and when their income has reached a certain level. In other words, repayment should be via income contingent loans (ICLs).

Not all countries have adopted ICLs simultaneously and the process whereby their use has proliferated, following their initial introduction in Australia in 1989<sup>1</sup>, is the subject of this paper. What we are interested in is whether learning has taken place, with adoption occurring in one country as a consequence of successful implementation in another: in other words, we are interested in whether this might be a case of international policy transfer.

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<sup>1</sup> In the 1980s the Swedish student loans system allowed borrowers to defer repayments when incomes were low, which is a very simple form of an ICL. The Australian scheme was the first universal application of an ICL using the tax system as the collection agency (Chapman, 1997).

The remainder of the paper is organised as follows: In section 2, we set out an analytical framework which distinguishes policy transfer from policy co-ordination since the two are sometimes confused. Section 3 considers the conceptual basis of ICLs for higher education, and section 4 examines the emergence and non-emergence of this form of financing. Section 5 discusses the transfer process and section 7 concludes.

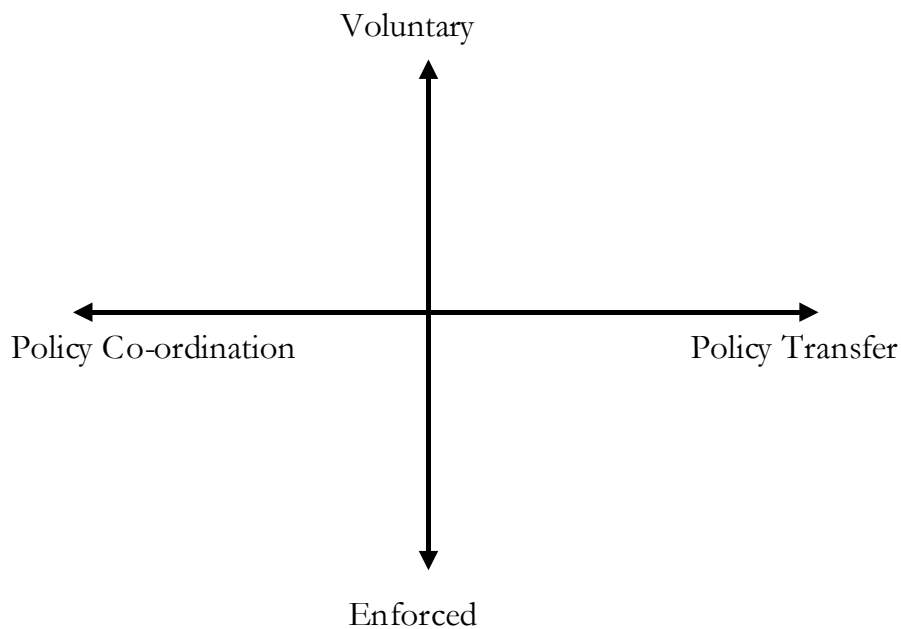
## **2. Globalisation, Policy Co-ordination and Policy Transfer**

We begin by clarifying some basic concepts and start with globalisation since that process has been associated with the transfer process. Globalisation we define as the internationalisation of economic activity, driven by increased armslength trade, increased cross-border investment and increased migration. It is well known that globalisation increases interdependence between economies. With increased openness, shocks that originate in one economy are more likely to impact on another. This is also true of policy innovation: in a closed economy there is no scope for policy induced spillovers, in an open economy there is, and the more open the economies concerned, the greater the potential. Thus, with increasing openness comes pressures for *policy co-ordination* to minimize the spillovers that might be associated with individual governments acting independently, for example with regard to exchange rate policy; or outright policy competition, for instance in trade policy. And, of course, increased openness offers increased opportunities for learning from policy experience elsewhere.

To fix some basic ideas, Figure 1 which is taken from Duncan and Greenaway (2003) provides a simple organising framework. In the figure policy co-ordination is mapped in the north-east and south-east quadrants, depending upon whether it is voluntary or enforced. Table 1 gives examples of each in different policy domains. Policy co-ordination is generally a device for avoiding spillovers from policy competition. The latter can take place with regard to both border and non-border measures and any co-ordination introduced to deal with it can be voluntary or enforced. Tariff wars are a classic example of policy competition in the trade domain and the GATT's principle of non-discrimination combined with tariff binding, the (rules based) device used to co-ordinate policy and minimize negative spillovers. The mechanisms are voluntary in the sense that Members opt in but there are punishment mechanisms to deal with defection: including withdrawal of privileges and sanctioned retaliation.

Macroeconomic policy is another area where the literature on policy competition and policy co-ordination is well developed. G7/G8 attempts to manage exchange rate fluctuations are an obvious case in point. More generally, fixed exchange rate regimes can be thought of as a device for exchange rate co-ordination. In the case of the Eurozone in Western Europe, this has been taken one step further: a single currency imposes a single co-ordinated monetary policy. Clearly however, if national policy makers respond to asymmetric shocks via active fiscal policy, this has the potential to undermine a common monetary policy. Hence the 'Growth and Stability Pact' to ensure fiscal co-ordination. Moreover, in the case of the latter, compliance is enforced by stringent financial penalties (see Gros and Thygesen 1998 for details).

*Figure 1 Policy Co-ordination and Policy Transfer*



As noted earlier, the globalisation process has increased the visibility of non-border measures and brought pressures for greater co-ordination across a whole raft of policy domains. For the first time, the GATT sponsored Uruguay Round of multilateral trade negotiations brought many non-border issues into the multilateral domain: regulatory arrangements in services provision; protection of intellectual property; trade related investment measures. These issues comprise part of the core for the so-called 'built-in agenda' which is being carried forward in

the Doha Round of trade negotiations. But that Round (which is now underway) is also likely to push discussions and attempts at co-ordination into completely new domains, including competition policy, welfare and labour market policies, and environmental issues. It may even impact on higher education by bringing aspects of service provision such as market access under the General Agreement on Trade in Services. Insofar as it does, it is likely to be rules-based and enforced.

*Table 1. Examples of Policy Co-ordination and Policy Transfer.*

	<b>POLICY CO-ORDINATION</b>	
	<b>Voluntary</b>	<b>Enforced</b>
<b>Trade Policy</b>	Most Favoured Nation	Tariff Binding
<b>Macroeconomic Policy</b>	Exchange Rate Management	EU Growth and Stability Pact
<b>Industrial Policy</b>		US Special 301 Provisions
<b>Environmental Policy</b>	Kyoto Protocol	
	<b>POLICY TRANSFER</b>	
	<b>Voluntary</b>	<b>Enforced</b>
<b>Trade Policy</b>	Unilateral Liberalisation	SAL Liberalisation
<b>Macroeconomic Policy</b>	Central Bank Independence	Single Currency
<b>Industrial Policy</b>	Privatisation	SAL Privatisation
<b>Welfare Policy</b>	Tax Credits	

In contrast to policy co-ordination, policy transfer which is mapped in the north-west and south-west quadrants of Figure 1 as defined by Dolowitz and Marsh (2000) is a process where "..... *knowledge about policies' administrative arrangements and ideas in one political setting is used in the development of policies' administrative arrangements, institutions and ideas in another setting.*" There are two important characteristics of policy transfer that should be noted.

First, it is predicated on the belief that policy intervention of the type envisaged will be welfare enhancing in a new institutional context; second, it is evidence based. This is a quite different perspective to the public choice view of policy

formulation and implementation which views a given set of policies as the outcome of a process of interaction between competing interest groups. In contrast, policy transfer is a process whereby governments adopt what they see as best practice, or better practice, by reference to experience with those policies elsewhere. With increased globalisation we seem to be seeing more examples of international policy transfer, which is hardly surprising since, with increased openness, governments (or to be more accurate their advisers) have access to a wider information set and evidence on what appears to work or not work, elsewhere in the global economy.

Note that we are essentially operating with a sub-set of the policy learning mechanisms defined by Morrissey and Nelson (2001), who discuss *learning by doing*, *learning from others* and *hierarchical learning*. The first refers to a process whereby experimentation takes place, strictly without reference to experience elsewhere. We only discuss this possibility in passing. The second is informed by what works and does not work elsewhere. In our taxonomy we refer to this as *voluntary policy transfer*. Morrissey and Nelson's third concept refers to a process whereby some third party, such as a multilateral lending agency, decides on what works and does not work and takes responsibility for persuading individual governments to change policies. This can be a form of social learning, which is obviously what Morrissey and Nelson have in mind. When it is genuine social learning we would include it as voluntary policy transfer. Often however multilateral agencies act as enforcers rather than persuaders, in which case it is clearly enforced policy transfer.

To fix ideas again, it is helpful to take some specific examples from a range of policy domains. In trade policy for instance, unilateral liberalisation is a good example of policy transfer that can be voluntary. Krueger (1997) argues that most of the trade liberalisations that occurred in developing countries in the 1980s and 1990s were voluntary and evidence based, in the sense that developing countries that had pursued import substitution policies introduced policies like trade liberalisation to make them more outward oriented, as a result of having observed the success of countries that had developed with outward orientation. Arguably, however, many of these liberalisations were actually enforced policy transfer. In other words, they would not have occurred had the multilateral lending agencies in general and the World Bank in particular not imposed liberalisation as a condition of a given lending programme, having themselves become persuaded that outward oriented policies are the right ones to follow. No doubt this was still

seen as evidence based but it can more accurately be thought of as enforced rather than voluntary, (see Greenaway 1993 and 1998).

In the domain of macroeconomic policy, the increasing trend to central bank independence can also be seen as another good example of policy transfer. An accumulation of evidence that linked the degree of central bank independence to an economy's (mean and variance) inflation performance was instrumental in the move to give independence among others to the Bank of England and European Central Bank, (Artis, Mizen and Kontolemis 1998). In the field of industrial policy, deconfinement of the public sector - or privatisation - is another good example and again there are cases of both voluntary and enforced. With regard to the former, the influence of British experience on other programmes in continental Europe is a case in point; with regard to the latter, World Bank conditioned programmes are a good example. Another recent episode in the field of industrial policy is the auction of broadband spectrums. Here British experience which resulted in yielding revenue of £22 billion rather than the expected £2 billion was followed adapted in auction design elsewhere, (see Binmore and Klemperer 2002).

In summary, we view policy co-ordination as a mechanism for minimising potentially negative spillovers from policy competition. In contrast, policy transfer is a process of adopting or adapting policies from elsewhere that are deemed to be more efficacious than current practice, that being judged by reference to experience with those policies elsewhere. We now turn to evaluate the spread of ICLs against that background.

### **3 The Conceptual Basis of ICLs for Higher Education Financing**

#### ***Should There be a Charge for Higher Education?***

Many, although increasingly fewer, countries do not levy tuition charges for higher education. However, one role for government is to help ensure the production of optimal quantities of goods and services and in some circumstances this requires public subsidies equal to the marginal value of the externalities associated with an activity, with contributions from students to cover net marginal benefits. Having no charge suggests an implicit judgement that societal benefits are at least equal to the size of the subsidy and, implicitly, that graduates receive no direct benefits. While there is little agreement on the size of externalities, the

process delivers important private benefits to graduates across the OECD, as Table 2 shows.

**Table 2**

**Private Internal Rates of Return to Tertiary Education in the OECD (1990s)**

	<b>Men</b>	<b>Women</b>
<b>Australia</b>	13.1	12.6
<b>Canada</b>	8.7	9.9
<b>Denmark</b>	11.5	11.1
<b>France</b>	14.3	15.4
<b>Germany</b>	9.1	8.4
<b>Italy</b>	6.5	8.4
<b>Japan</b>	7.9	7.2
<b>Netherlands</b>	12.1	12.5
<b>Sweden</b>	11.4	10.8
<b>United Kingdom</b>	18.5	16.1
<b>United States</b>	14.9	14.7
<b>Unweighted Average</b>	11.6	11.6

*Sources: Blondal, Field and Giroard (2002) and Chapman and Ryan (2003).*

Apart from the promotion of efficiency in the allocation of resources, the essential argument for charging students for higher education is that of equity. That is, not only is it the case the graduates receive high returns on average to investment in university there is also no doubt that university students are more likely to come from more privileged backgrounds. These two points, taken together, mean that a no charge system is unquestionably regressive (see Chapman 1997, Greenaway and Haynes 2000, Blondal Field and Giroard 2002).

***How Should a Charge be paid?***

If a charge is warranted, the next issue concerns how it should be paid. One possibility would be to for the government to offer subsidies to universities to cover the assumed value of externalities but beyond that allow institutions to charge fees, with there being no other financing assistance provided. Such an arrangement would unambiguously be poor policy.



The critical point concerning higher education financing relates to a major borrowing problem, referred to as “capital market failure”. This relates to the fact that some prospective students without the resources to pay up-front fees would need to approach a bank for a loan. However, banks will be reluctant to loan to students because of problems associated with default. The major problem, recognised by Friedman (1955), Arrow (1992) and others, is that an education loan is risky for a bank since, in the event of default - and unlike a housing loan - the bank has no collateral to sell. Without assistance, banks will tend not be interested in the underwriting of human capital investments.

Capital market failure means that prospective students without sufficient financial resources to cover up-front fees will not be able to enrol. There will be three important effects: a loss of talent, and thus a cost to the whole society; a loss of opportunity to individuals; and a cementing of the nexus between family background and a person’s lifetime income - such a system is not characterised by equality of educational opportunity.

A possible solution to the capital market problem is used in many countries, such as Canada and the US, and involves government-assisted bank loans to students with low family incomes. The most important forms of public sector support are paying interest on the debt while students are enrolled, and the guarantee of repayment of the debt to the bank in the event of default. While this seems to address the capital market failure, several important problems remain.

First, because of the expense to taxpayers, students’ access to loans is limited and usually means-tested on the basis of family income. This then presumes equal access of individuals to family resources. However, those in charge of the distribution of household finances to household members may not have the prospective student’s view of the value of education. This implies that some not qualifying for bank loan assistance will not be able to pay fees. If so, outcomes will not be optimal.

The second problem is default. For the government this is costly since bank-financed student loans default rates are very high<sup>2</sup>. And, if there is a guarantee that defaults will be paid for by the government, banks will put little effort into debt recovery. It follows that default can be very expensive for taxpayers.

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<sup>2</sup> Harrison (1995) notes that in US Propriety Colleges the default rate is as high as 50 per cent. The average default rate for student loans is around 15-30 per cent (Wran Committee Report, 1988).

Students also face an important default issue. This is that some may be reluctant to borrow for fear of not meeting future repayment obligations, with concomitant damage to a person's credit reputation (and thus access to future borrowing, for example, for a house). A consequence is that some eligible prospective students will not be prepared to take bank loans<sup>3</sup>. This problem can be traced, in part, to the fact that bank loan repayments are insensitive to the borrower's financial circumstances and are thus associated with default risk for students. Work by Dynarski (1994) reveals that this type of default problem is associated with exclusion of the disadvantaged, since it is members of this group that are more likely to default. In other words, the provision of bank loans does not solve the capital market failure.

A final approach to student financing involves income contingent loans, such as those introduced in Australia in 1989 and New Zealand in 1991. An ICL involves students contracting to repay debt depending on their future incomes. The attraction of income contingent schemes is that they can be designed to avoid the problems associated with alternative financing policies outlined above.

First, there is no concern with intra-family sharing so long as the scheme is universal. That is, no students would be denied access through the imposition of means-testing arrangements that could exclude some whose parents or partners are unwilling to help.

Second, given an efficient collection mechanism, there is no default issue for the government if, for example, the tax system is used to collect the debt, since it is extremely difficult for the vast majority of graduates to avoid repayment<sup>4 5</sup>. There is a trivial "default" issue in that some students will not pay back in full, but this is because income contingent systems are designed to excuse some former student's payments because their lifetime incomes are too low.

Third, and most importantly, because repayments depend on incomes, there should be no student default concerns related to an inability to pay. That is, once an individual's income circumstances determine repayment – so long as the repayment parameters are sufficiently generous – it is almost impossible for a former student to default because of a lack of financial resources. This has the

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<sup>3</sup> For analysis of this issue see Chapman (1997).

<sup>4</sup> At least for Australia, this is essential because the Australian Taxation Office is the only institution with reasonably good information on a former student's income.

<sup>5</sup> An additional concern relates to former students emigrating. A solution to this loss of revenue is offered in Barr (2001).

critical advantage of removing the borrower's risk from the transaction, which is of considerable importance given the high levels of uncertainty associated with private investments in higher education.

#### **4 The Emergence and Non-Emergence of ICLs in Higher Education**

##### ***The Political Economy for Contemporary Higher Education Financing Reform in OECD Countries***

Since 1989 there have been four applications of ICLs in OECD countries: Australia, New Zealand, South Africa and the UK. These countries had an important common characteristic underlying their changed financing policy approach. This was that they instituted higher education charges on students in place of arrangements in which higher education had previously been free at the point of consumption for participants.

Two major justifications were used for the introduction of student charges. One is that higher education was in need of expansion in an environment in which governments were not prepared to finance this growth without contributions from beneficiaries. This is explicit in statements made in Australia<sup>6</sup>, New Zealand<sup>7</sup> and the UK<sup>8</sup>, and is implied for South Africa in Ishengoma (2002) and Jackson (2002). Two, it was considered that a higher education system financed entirely from the public purse can be seen to be a regressive use of taxpayers' resources. Both rationales for ICLs are consistent with the basis of the conceptual discussion offered in Section 3.

The experiences of the four countries are now explored.

##### **Case Studies**

***Australia:*** In 1989 Australia instituted the world's first broadly based income contingent charging system for higher education, known as the Higher Education Contribution Scheme. When HECS was introduced higher education was essentially free of charge, and this had been the case since 1973<sup>9</sup>. HECS seeks to

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<sup>6</sup> See Wran Committee Report (1988).

<sup>7</sup> See New Zealand (1988).

<sup>8</sup> See the Dearing Committee Report (1997).

<sup>9</sup> For a brief history of Australian higher education financing, see the Wran Committee Report (1988).

recover a part of tuition costs, and is not concerned with student income support<sup>10</sup>. In 1989 HECS was characterised by the following:

- a charge of \$A1800 (in 1989 terms) pro-rated by course load, but with no variation by discipline;
- on enrolment students could choose to incur the debt, to be repaid through the tax system depending on personal income, or;
- students could avoid the debt by paying up-front, which was associated with a discount of 15 percent (later increased to 25 percent);
- those students choosing to pay later faced no repayment obligation unless their personal taxable income exceeded the average income of Australians working for pay (about \$A30,000 per annum, in 1989 terms);
- at the first income threshold of repayment a former student's obligation was 2 percent of income, with repayments increasing in percentage terms above the threshold; and
- HECS could be paid up-front with a discount, but there was no additional interest rate, although the debt and the repayment thresholds were (and remain) indexed to the CPI.

While its essence remains, the HECS arrangements changed significantly in 1997, in three respects: all the charges increased significantly, by about 40 percent on average; differential charges were introduced according to course, with the new charges essentially reflecting cost differences; the income thresholds for repayment were reduced significantly<sup>11</sup>.

While many other countries introduced ICLs after the beginning of the 1990s, the Australian system remains the most studied. Several broad conclusions can be drawn from research completed thus far. First, HECS has turned out to be very inexpensive in administrative terms (Chapman and Ryan, 2002). That is, while around \$A800 million (at current prices) is currently collected per annum, it costs less than three percent of this to administer the program. This low cost is traceable

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<sup>10</sup> In the main income support takes the form of means-tested grants.

<sup>11</sup> Chapman and Salvage (1998) argue that the last of these changes was the most likely policy variation to affect access.

to the fact that students' debts, and their collection, were fairly straightforward given the mechanisms of the Australian Taxation Office – a point emphasised in ensuing discussion of other countries' administrative arrangements.

Second, HECS has delivered considerable revenue, of the order of \$A6 billion in current dollars over the 13 years since its introduction. It is projected that the system will provide around \$A1.2 billion per year in current dollars by 2005, which will be about 20 percent or more of annual recurrent costs.

A third factor is that it appears there have apparently been no consequences for the accessibility to higher education for students from relatively disadvantaged backgrounds. Broadly speaking, the socioeconomic make-up of the higher education student body was about the same in the late 1990s as it was before HECS was introduced<sup>12</sup>. Finally, higher education enrolments in Australia have increased considerably, by around 50 percent, since the introduction of HECS. This has happened for two reasons: there were no obvious overall deterrent effects from the new system; and in response to the expectation of high future revenue, governments substantially increased higher education expenditure, particularly in the early periods after the institution of HECS.

Overall, HECS is seen to have been a successful policy innovation, as reflected in policy and public debate. Even so, Barr (2001) offers some criticisms, but nevertheless supports the arrangements generally. He suggests that the weaknesses are the absence of real interest rate on the debt and that the centralised nature of funding limits the prospects for HECS having any implications for allocative efficiency. Overall, however, in collection terms, the scheme has served as a template for several other countries with respect to the adoption of ICLs.

***New Zealand:*** The second country to adopt a broadly based ICL was New Zealand in 1991. The New Zealand system shares several features of HECS. Specifically:

- loan repayments depend on an individual's income, and are collected through a tax system which made this simple in operational terms; and
- a first income threshold of repayment, after which there is a progressive percentage rate of collection.

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<sup>12</sup> See Chapman and Ryan (2002).

However, the New Zealand arrangements differed importantly to those introduced in Australia. In particular:

- the loans are designed to cover both university fees and some living expenses, although there is also a system of means-tested grants for students from poor backgrounds;
- initially the loans carried a market rate of interest; and
- universities are free to set their own fees (although it is notable that the resulting charge regimes did not differ much between institutions).

In other words, the New Zealand system was designed to be more consistent with free market principles. For example, there is a potential for resource allocation efficiencies through the freedom of institutions to choose fee levels. Further, having a market rate of interest on the debt arguably reflects the true opportunity cost of loans (Barr, 2001). However, in response to public disquiet over the interest rate regime, the government changed the scheme significantly in early 2000. The changes introduced a zero nominal interest rate for the period a student was enrolled, and variations to the real rate of interest depending on graduates' employment circumstances. These complications have apparently added to the administration costs of the scheme, with some commentators estimating that it now costs three times as much to run the New Zealand system compared to HECS<sup>13</sup>.

Unlike HECS, the New Zealand system seems to be fairly controversial. It is currently under further review and additional changes are likely to be made in the next short period. Much of this controversy is apparently about the interest rate regimes chosen on the debt<sup>14</sup>. Even so, in administrative terms the New Zealand ICL has apparently worked well. The use of the tax system as the collection agency has proved to be a capable mechanism, as is clearly the case with respect to HECS.

***South Africa:*** The South African Government introduced an ICL in 1991, and is known as the National Student Financial Aid Scheme. NSFAS was motivated

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<sup>13</sup> Private conversation with Australian tax authorities who have explored the comparative costs of the two policies.

<sup>14</sup> See Warner (1999).

essentially by a concern that without assistance the marked racial skewing of the higher education system away from non-white students would remain (Jackson, 2002). While bursaries could have been used instead of ICL, it was considered that the costs involved "...would not be financially sustainable." (Jackson (2002), page 83). The scheme initially provided resources to about 7,500 students, but by 2002 this number had risen to over 100,000, or more than 20 per cent of South Africa's higher education students.

Resources are distributed via the universities, with preference going to prospective students who are both poor and academically able. Collection takes the form of former students repaying directly to NSFAS when their income reaches R26,000 per annum, at a rate of 3 per cent of income, and this proportion rises to reach a maximum of 8 per cent of income per year when income exceeds R59,000. In this sense the collection parameters are similar to HECS in that they are progressive, but there are two major differences between the South African approach and those used in both Australia and New Zealand.

The first difference concerns the first rate of repayment, which at about \$A5,000 is very much lower than the thresholds used in other countries' ICLs.

Second, in the first instance the student repays directly to the lending institution. That is, the taxation system is not the first port of call, but is instead a last resort. Employers are required to be involved only when a student is apparently not maintaining expected debt repayments. It is unclear how much this adds to administrative costs, but it would seem to be the case that collection would cost more with such an approach.

***United Kingdom:*** Higher education financing policy over the last 15 years or so in the UK has been characterised by considerable instability. Until very recently there were no tuition charges: such charges have now been introduced with the adoption of (a highly modified) version of HECS. As well, there have been notable changes over time in the value and institutional nature of student income support. In the 1980s grants covering living costs were offered on the basis of parental income, but the real value of this support eroded significantly and Barr argues that "by the late 1980s [it] was no longer adequate fully to support a student's living costs"<sup>15</sup>.

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<sup>15</sup> Barr (2001), page 202.

In 1990 a student loan scheme was introduced but collection was not based on a former student's income. In fact, they resembled a mortgage repayment scheme. The loans were designed to replace half of the maintenance support previously covered by the grant but in effect their impact was likely to be smaller than this given that they attracted a zero rate of interest. Barr (2001, p.202) notes critically that "It would have been cheaper to give the money away".

In 1995 the then Conservative Government set up a wide-ranging review of higher education funding, due to report after the election of 1997. Chaired by Sir Ron Dearing, its Report<sup>16</sup> recommended strongly the adoption of a scheme based on HECS. It had the following features:

- a uniform charge of about 25 percent of average course costs;
- the charge to take the form of a debt, with loan recovery to be contingent on income and collected through the tax system;
- the debt to be adjusted over time, but by less than the market rate of interest; and
- revenue from the scheme to flow to the Internal Revenue.

The Labour Government, elected in 1997, adopted a heavily modified version of the Dearing Committee's recommendation. A modest contribution to tuition of £1,000 per annum (indexed to the rate of inflation) was introduced, but liability for this was means tested<sup>17</sup>. One very important change that was introduced but not widely noted, however, was the switch in the maintenance loan from a mortgage repayment scheme to one in which repayments depend on future income; this is then the UK's first experience with an ICL.

The Dearing recommendations were seen as not going far enough by many and, following several years of debate and a number of Reports and enquiries, a further Review of Higher Education was published in January 2003. The major changes proposed in this Review are:

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<sup>16</sup> See Dolton, Greenaway and Vignoles (1997) for a summary of the economic issues and Dearing (1997) for the full Report.

<sup>17</sup> This decision would seem to reflect a concern by the government that relatively disadvantaged students would be more likely than others to find a loan a deterrent to higher education participation, a view at variance with the evidence from the Australian experience.



- the introduction of some price discretion for universities but with a cap of £3,000 per full-time student year; and
- the introduction of tuition fees for all students but with the poorest being provided with subsidies.

The critical point for our purposes is that these higher loans will continue to be repayable on an income contingent basis and the collection mechanism, through the tax system and depending on a student's future income, remains unchanged. As with the Australian and New Zealand schemes, the UK ICL policy is likely to be relatively inexpensive to administer, which is directly traceable to the fact that income tax arrangements in these countries facilitate the operation of ICL.

### **Common Factors in OECD Adoption of ICLs**

There are several factors shared by these four countries which might help in an understanding of their adoption of ICL schemes within a similar time frame. Two critical aspects of this relate to shared institutional background.

The first is that Australia, South Africa, New Zealand and the UK all have in place taxation systems that could be used to collect efficiently student charges on the basis of future incomes. The data noted above with respect to administration costs of ICLs in Australia and New Zealand illustrate how cost-effective such approaches can be. This is a critical administrative issue, and is fundamental to the prospects of the adoption of ICLs in other countries. It is interesting that in the South African case authorities chose to use the tax system as a back-up rather than the port of first call for loan collection, but it still remains the case that the tax system is available for collection.

Second, in all four countries there is a similar higher education system, essentially inherited from the UK. An important characteristic is that the vast majority of universities are public sector institutions. This has meant that the recovery of a loan designed to pay a charge is uncomplicated if the collection authority is also part of the public sector, that is the internal revenue service or equivalent. Indeed in the Australian and UK cases the revenue from ICLs were centralised and accrued to the Treasury without reference to, and with no implications for, the direct financing of universities. This has meant that the more complicated

problems associated with delivery of a direct revenue base to specific universities have been avoided<sup>18</sup>.

It is also worth stressing that in all of these countries there was a clear recognition that the time for “free” higher education was over. The expansion of the number of university places, or improvements in the quality of the service, were seen to be desirable, and none of the governments was prepared to finance the required outlays from additional taxation or reduced public services elsewhere. This can be traceable to a world wide move towards more parsimonious government and, perhaps more importantly, to the recognition that university education financed without direct contributions from the private beneficiaries is in essence regressive and inequitable.

It is possible that the apparent successful implementation of the Australian ICL helped motivate administrative change in these directions in some of the other countries. New Zealand policy advisers were aware of developments in Australia, and there is little doubt that direct contact between analysts from Australia and the UK influenced the nature and form of debate in the latter country. Perhaps the policy point is, as Samuel Boulding once observed: “If it exists, then it is possible”.

### **The Non-Emergence of ICLs Outside the OECD**

While there have been significant reforms in the direction of the adoption of ICLs in the above countries, this has not so far been a shared experience in developing countries. This is the case even though there has been a significant amount of attention with respect to ICL reforms from the World Bank, the UK Department of International Development and other international aid agencies.

There have been many missions to developing countries exploring higher education financing reform, with a particular focus on the possibility of introducing ICLs. Specifically, these have been to: Indonesia (1995 and 1998); Papua New Guinea (1996); Namibia (1996); Malaysia (1999); Ethiopia (2000); Rwanda (2001); and the Philippines (2002 and 2003)<sup>19</sup>. The major problem seems to be that of implementation and administration.

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<sup>18</sup> As Chapman (1997), Barr (2001) and others note, this characteristic of ICLs has the important cost of not delivering any resource allocation benefits from price competition.

<sup>19</sup> For description and analyses of these experiences, see Chapman and Nicholls (2003).

Chapman and Nicholls (2003) argue that the essential point is that developing countries, with some notable exceptions, typically do not enjoy the soundly based, efficient and comprehensive income tax arrangements that characterise the four countries examined earlier. Most often, alternative parallel systems of collection - such as universal social security systems - are also not to be found. These countries are often beset by problems of corruption in public administration, and their informal economies are comparatively large. There is intense competition between various priorities for public finance and, due in part to weaknesses in the taxation system, there is little revenue for propitious public administration.

Where government-subsidised student loan schemes, of any description, exist or have been tried, failures and extremely high default rates have induced scepticism about the potential for success of any future programs in this area. The legislative frameworks surrounding the financial sector are often weak, archaic and/or undeveloped, with the practical effect that there is little legal recourse where borrowers default on loans of any kind. Furthermore, in some countries a culture has developed among students and former students that relates specifically to student loans: namely, an atmosphere of disregard for the integrity of student loans as legitimate policies.

Chapman and Nicholls argue that the minimum conditions to implement a successful system are:

- . a reliable, preferably universal, system of unique identifiers;
- . an efficient way of determining with accuracy, over time, the actual incomes of former students;
- . accurate record-keeping of the accruing liabilities of students (while studying); and
- . a collection mechanism with a sound, and if possible, a computerised record-keeping system.

In the absence of the above, it is difficult to see how an effective ICL can be made operational. While the case for financing reforms in these countries seems as strong as it was in Australia, New Zealand, South Africa and the UK, at least at the moment progress seems stalled in a way that can be traced to institutional barriers.

## 5. Factors Influencing Policy Transfer

It is clear from the foregoing that in the financing of higher education policy transfer has taken place of the ‘learning from others’ variety. It has been a voluntary process and it has been evidence based in that Governments have learned lessons about implementation from experience elsewhere. It seems equally clear that this is a case where enforced policy transfer, or even hierarchical social learning has not taken place. Although multilateral aid agencies and in particular the World Bank have attempted to persuade many developing countries to move in this direction, as yet no major policy innovations have been implemented. In this Section we discuss the factors which might help explain fairly rapid adoption in a number of OECD countries and non-adoption in developing countries.

When one looks back at the experience of Australia, New Zealand, the United Kingdom and South Africa several features stand out. First, *similar pre-conditions* held prior to reform. In all cases there was a felt need for an increase in HE participation ratios, but given constraints on public funding an unwillingness and/or inability to finance this through higher taxes. Second, *similar core objectives* lay behind deciding upon undertaking reform. Obviously these include securing stable and predictable non-public sources of finance. They also include not only increasing but widening participation. Given the under-representation of entrants from low income families it was seen as imperative that access was not damaged by any new arrangements.

The combination of similar preconditions and similar core objectives means that a third factor in place was *similar anti-reform lobbies* were in place, using similar arguments to oppose change. These were essentially middle income groups defending their subsidies and low income groups concerned about access. The ingenious feature of ICLs is that they shift responsibility for finance towards the beneficiaries of HE, thereby generating a stable and substantial income stream, but do so in a way which makes it a future rather than current liability. HE can therefore remain free at the point of consumption and access is not damaged, unless of course the poor are more debt averse than the better off. (Admittedly access is not automatically improved either, but that is a separate issue.) These are powerful arguments. But that does not mean that they were readily adopted in any of the countries discussed above. In the first mover, Australia, the introduction of HECS was highly controversial. Their subsequent evolution has

been informed by experience or learning by doing, as indeed has proliferation elsewhere.

The introduction of ICLs in the New Zealand, South Africa and the UK was most certainly influenced by experience in Australia, which brings us to a fourth factor ***similar institutions***. All four countries are former members of the British Empire (and current members of the Commonwealth). Not only do they share a common language, but not surprisingly have similar institutional arrangements in higher education. After all, the bedrock for each was introduced by the then colonial power and influenced strongly by arrangements back in the UK. So for example in the heated debate which has raged in the UK over the last few years, evidence from implementation of ICLs in Australia and New Zealand was taken much more seriously than comparisons with arrangements in the US or continental Europe. Both of these were seen as very different to the UK; Australia and New Zealand were not. Thus, ‘if it could work there, it could work here’ was ultimately an important comfort to policy makers.

As we have stressed earlier, the institutional environment and cultural empathy were not the only features of the infrastructure that were important. So too was a ***secure and low cost collection mechanism***. In all cases being able to route repayment through the income tax collection arrangements minimised the potential for default and minimised collection costs.

Turning to non OECD countries, there is an interesting contrast between the success of the multilateral lending agencies in initiating or enforcing reforms in trade policy, industrial policy and so on and their failure to make progress with ICLs. This is partly due to the ***diversity in initial conditions*** and ***diversity in core objectives*** of reform. The range of countries discussed in Section 4 speaks for itself. There are therefore not the same benchmarks as existed for New Zealand, South Africa and the UK. More importantly however ***institutional arrangements differ*** quite radically, not only in terms of the kinds of University systems in place but perhaps more crucially in the ***lack of availability of reliable collection systems*** which minimizes leakage and minimizes administrative costs.

The other important point to make is that World Bank and IMF success is initiating reform in many countries in many areas has resulted from applying conditionality to loan finance. As yet, HE finance has not figured in the negotiations over adjustment lending, one assumes because it is seen as a low priority relative to other policy domains. And it is presumably seen as a low

priority because success would be much harder to monitor and indeed deliver than in the case of (say) trade policy reforms.

## **6. Conclusions**

Higher education is an important sector in most OECD economies, not only in terms of current economic output, accounting for on average about 1.5 per cent of GDP, but also in future output. It is a key sector for the formation of human capital and as such an important contributor to the growth process. In terms of financing, the US and Japan are very unusual in that more than half of HE funding comes from private sources. In all other OECD countries public funding accounts for the bulk of (and in some cases total) expenditure. This dependence on taxpayer funding has created difficulties in a number of countries which had ambitions to increase participation, but to do so without increasing public funding and without increasing the financial burden on current students. The solution to this conundrum has been the introduction of income contingent loans.

In this paper we have reviewed the introduction of ICLs in Australia, their subsequent introduction in New Zealand, South Africa and the UK and their non-introduction in a number of non-OECD countries. We have argued that the former offers a good example of voluntary policy transfer. Several countries have observed and learned from Australian experience. That learning process has been aided by similar pre-conditions, similar core objectives and above all similar institutions. In contrast, diversity of pre-conditions and institutions characterises developing countries. This, combined with the absence of conditionality to enforce policy reform explains the absence of implementation in that environment.

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