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I Z A
World of Labor
Evidence-based policy making

Income contingent loans in higher education financing

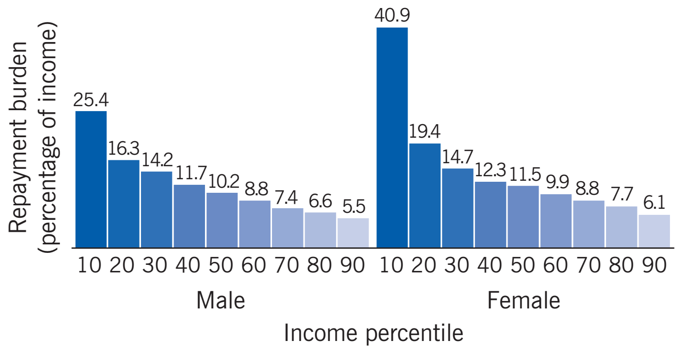
Internationally, there has been a student financing revolution towards income contingent loans

Keywords: income contingent loans, government-guaranteed bank loans, consumption smoothing, default insurance, repayment burdens

ELEVATOR PITCH

Around nine countries currently use a national income contingent loan (ICL) scheme for higher education tuition using the income tax system. Increased international interest in ICL validates an examination of its costs and benefits relative to the traditional financing system, government-guaranteed bank loans (GGBLs). Bank-type loans exhibit poor economic characteristics: namely, repayment hardships for the disadvantaged, and default. This damages credit reputations and can be associated with high taxpayer subsidies. ICLs avoid these problems, but effective collection of debt requires a sophisticated mechanism.

US repayment burdens for college graduates at the age of 25 by income percentile



Source: [1].

KEY FINDINGS

Pros

- ICLs deliver consumption smoothing by reducing the burden on disposable income from student debt, particularly for those at the lower end of the earnings spectrum.
- By coupling loan repayment amounts to a debtor's actual income, ICLs provide insurance against default.
- ICL debt can be efficiently collected if functional tax and personal identification systems are in place.
- GGBLs provide debt default insurance for lenders but not borrowers.

Cons

- GGBLs can lead to credit reputation loss for the borrower due to default.
- Systems based on GGBLs create inequality in educational access due to an increased 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 GGBLs. ICLs provide insurance to borrowers against both future loan repayment hardships and default. In contradistinction, GGBLs 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 payment administration in place. This, in combination with the additional borrowers' insurance benefits, strongly suggests that ICL policies are preferable to the standard GGBL model.

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